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Taking Advantage of the Lifetime Capital Gains Exemption for Farm Property

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With the 2015 Federal Budget effectively increasing the lifetime capital gains exemption (LCGE) for qualified farm property (QFP) to $1 million, now is a good time to revisit capital gains tax planning. (The LCGE portion of the budget was enacted on June 23, 2015.)

The additional lifetime exemption supplements the base exemption ($813,600 for 2015) and is only available to offset capital gains on qualified farm and fishing property disposed of after April 20, 2015. The LCGE for QFP will remain at $1 million until the annual indexed amount of the base LCGE exceeds $1 million. At that time, the LCGE limit – indexed to inflation – will be the same for qualified farm property, fishing property and small business corporation shares. An individual owner of QFP who exhausted their LCGE by 2014 (when the base limit was $800,000) will have an additional $200,000, which presents an opportunity for future planning.

QFP includes real property, quota, an interest in a family farm partnership and shares of a family farm corporation. Property must meet certain requirements for eligibility. The rules can be complex, so proper tax advice is important.

For property that qualifies, there are some interesting but complex opportunities for future planning.

Corporate transfers

Those who operate a farm business through a corporation but hold farm land personally may be able to transfer the land to the corporation and trigger a capital gain that can be offset by the LCGE. The corporation may provide a promissory note that can be removed tax-free. In such cases, the capital gain reported personally could trigger Alternative Minimum Tax (AMT). AMT can result when deductions (such as the LCGE) are used to offset a significant portion of a taxpayer's income. (For more on AMT, see the May 20, 2014 Farm Alert.) The reporting of the capital gain could also result in old age security (OAS) clawback for an individual who received OAS in the year. The AMT may be recovered over the next seven taxation years, but the OAS clawback is an outright cost. Those who do not control the company at the time of the land transfer can take advantage of the capital gains reserve to bring the capital gain into taxable income over a maximum of five years, which may reduce or eliminate the AMT and/or the OAS clawback.

Partnerships

Many farm operations operate as partnerships. If partners are considering incorporating a farm operation, an opportunity exists to take advantage of their LCGE when establishing the farm corporation. The traditional approach to incorporating a partnership involves transferring the farm assets to the corporation on a tax-deferred basis and filing the appropriate election forms with Canada Revenue Agency. Alternatively, however, the partners could transfer their partnership interest to the corporation and use their LCGE to offset the capital gain triggered on the transfer, taking back a promissory note from the corporation that can then be paid to the partner tax-free.

Using the LCGE to transfer a partnership interest to the corporation can be an effective way to transfer farm assets – such as inventory, *August 2015*

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quotas and equipment – at their fair market value in return for a tax-free promissory note. The sale of inventory, quotas and equipment, which normally results in taxable income (as a result of recapture of previously claimed deductions for quota and equipment) is transformed into a non-taxable capital gain by the transfer of the partnership interest to the corporation. AMT and OAS clawback considerations apply to the transfer.

The partnership must have been in existence for a minimum of two years (among other requirements) to qualify as QFP. It is not feasible to transfer farm assets to a partnership and subsequently transfer the partnership interest to a corporation in order to re-characterize taxable income into a non-taxable capital gain.

Generational transfers

LCGE planning is important for those who intend to transfer a family farm (or a portion thereof) to their children. Proper planning will ensure that parents and successors do not waste their LCGE either during their lifetime or upon death. Consider the hypothetical example of Mr. Jones, who owns a parcel of farm land with a fair value of $2,000,000 and an original cost of $500,000. Mr. Jones has his full LCGE of $1,000,000 available. The property qualifies for the farm rollover rules and is QFP for the LCGE. Mr. Jones wishes to transfer the parcel to his son and wants only $1,000,000 in consideration. Mr. Jones does not own any other farm property that qualifies as QFP. If Mr. Jones transfers the farm land for the $1,000,000 consideration, he will report a capital gain of $500,000, which will be offset by his LCGE. His son will assume the farm property with a cost base of $1,000,000. Mr. Jones will have $500,000 of his LCGE remaining, but no other assets with which to use up this balance.

But if Mr. Jones transfers the farm land to his son for $1,500,000 consideration, he will report a capital gain of $1,000,000, which will be fully offset by his LCGE, and his son will have a cost base of $1,500,000. In accordance with Mr. Jones' wishes, he will only collect $1,000,000 of consideration and will forgive the remaining $500,000 in his will. The end result is an increase of $500,000 in cost base of the land to the next generation with the additional capital gain offset by Mr. Jones' LCGE. It is important that the additional $500,000 be forgiven in the will and not during Mr. Jones' lifetime. If it is forgiven during Mr. Jones' lifetime, the cost base to the son will be reduced by the amount forgiven.

Selling to third parties

Perhaps there is no successor to the family farm and the plan is to eventually sell to a third party. With the escalating value of farm land, farm families planning to sell the family farm may look to gain access to their children's LCGE to offset the capital gains. Careful planning can help accomplish this goal, but farm owners must be willing to gift the accrued gain to their children. Such planning takes advantage of the farm rollover rules and requires transferring ownership of farm property to the children a minimum of three years prior to a subsequent sale to a third party. The children become the owners of the farm property and are entitled to the proceeds from its sale. The farm property also becomes subject to any creditor claims of the children.

These strategies for taking advantage of the LCGE can be effective, but can also be tricky. Careful planning with professional tax advice is critical. Contact your Collins Barrow advisor for assistance.

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