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Tax Planning for Farming Course
Succession Planning: Use of Trusts and Tax Issues

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Agenda

- Preliminary Matters
  - Definition of Farming
  - Farming Assets
  - Principally in a Farming Business and Actively Engaged on a Regular and Continuous Basis

- Tools in Tax Effective Succession Planning
  - Inter-Generational Rollovers
    - *Inter-Vivos* Transfer
    - At Death Transfer
  - Capital Gains Exemption
  - Spousal Trust
  - Use of a Holding Corporation/Subsection 85(1) Rollover
  - Freeze
  - Land Transfer Tax Exemption

Definition of Farming

- Question of fact
- Must have a REOP
- Section 248(1) of the Act, “farming” includes:
  - tillage of the soil;
  - livestock raising or exhibiting;
  - maintaining of horses for racing;
  - raising of poultry;
  - fur farming;
  - dairy farming;
  - fruit growing; and
  - the keeping of bees.

Definition of Farming (Cont…)

- CRA IT-322R factors:
  - the extent of activity in relation to that of businesses of a comparable nature and size in the same locality,
  - time spent on the farming operation in comparison to that spent in employment or other income-earning capacity,
  - the development of the farming operation and commitments for future expansion according to the taxpayer's available resources, and
  - qualifications of the taxpayer for some type of provincial farming assistance.

Farming Assets

- Assets that may be transferred in a succession plan:
  - land, buildings, machinery and livestock that are used chiefly in farming by the corporation;
  - shares of a family farm corporation;
  - an interest in a family farm partnership;
  - any right or license granted or issued under any Act that permits or regulates the production or sale of any commodity or thing produced, raised or grown through farming (for example, agricultural quotas or other eligible capital property); and
  - trade accounts receivable, supplies and inventory of commodities or things produced, raised or grown through farming.

Principally in a Farming Business and Actively Engaged on a Regular and Continuous Basis

- For many of the tools available to farmers, there is a requirement that:
  - The farming asset be used *principally* in a farming business by the:
    - Taxpayer;
    - taxpayer's spouse,
    - child or
    - parent; and
  - The taxpayer or taxpayer's spouse, child or parent must have been *actively engaged* on a *regular and continued basis* in the farming business

Spouse and Child

- Spouse includes a common-law spouse
- Child means:
  - natural child,
  - step child,
  - adopted child,
  - grandchild,
  - great grandchild,
  - and a person who is wholly dependent on the taxpayer for support and of whom the taxpayer has, or immediately before the person attained the age of 19 years had, in law or in fact, under their custody and control.

Principally in a Farming Business

- The use of the property as a whole is considered
- Asset must be used primarily (more than 50%) in respect of a farming business operation
- Example – transport truck

Actively Engaged

- CRA position – must be actively engaged in the management and/or day to day activities of farm
- Must contribute time, labour and attention to the farming business
- “Custom working” – may be okay
- “Sharecroppers” – may be okay
- Leasing out land – not ok

Regular and Continuous Basis

- Question of fact
- CRA position:
  - "an activity that is infrequent or activities that are frequent but undertaken at irregular intervals would not meet the requirement"
- If chief source of income not from farming, may be difficult to meet this requirement

Taxation at Death

- <u>Deemed Disposition</u>
  - Section 70(5)(a) – immediately before death
  - Amount from proceeds is the FMV of asset
  - Can be avoided by using tools available to farms
- <u>Probate Fees</u>
  - May want to *use inter-vivos* transfers

Tools in Effective Succession Planning

- *1) Inter-Vivos* Rollover
- 2) At Death Rollover
- 3) Capital Gains Exemption
- 4) Spousal Trust
- 5) Holding Corp/Subsection 85(1) Rollover
- 6) Freeze
- 7) Land Transfer Tax Exemption

1) *Inter-Vivos* Transfers

- Transfers during Owner's Lifetime
- Avoid application of paragraph 69(1)(b)
  - Deemed disposition at FMV
- Subsection 73(3) – property (e.g. land and equipment)
- Subsection 73(4) – shares of family farm corporation or interest in a family farm partnership

1) *Inter-Vivos* Transfers (Cont…)

- The requirements to take advantage of the rollover are as follows:
  - the farm assets must have been located in Canada *immediately* before the transfer;
  - the child to whom the transfer is made must have been resident in Canada *immediately* before the transfer;
  - the farm assets must have been used *principally in a farming business*; and
  - the taxpayer or taxpayer's spouse, child or parent was actively engaged on a *regular and continuous basis* in that farming business.

1) *Inter-Vivos* Transfers (Cont…)

- **Definition of Shares of a Capital Stock of a Family Farm Corporation - subsection 70(10)**
- Will be qualifying share if all or substantially (90%) of the FMV of property owned by the corporation is attributable to:
  - (a) property that has been used by
    - (i) the corporation or another family farm corporation in which the person or a spouse, child or parent of the person ("related family member") was a shareholder,
    - (ii) the person,
    - (iii) a related family member, or
    - (iv) a partnership, an interest in which was an interest in a family farm partnership of the person or of a related family member of the person,

    principally in the course of carrying on the business of farming in Canada in which the person or a related family member of the person was actively engaged on a *regular and continuous basis*;

  - (b) shares of the capital stock or indebtedness of one or more corporations all or substantially all of the fair market value of the property of which was attributable to property described in (c) below; or

  - (c) properties described in (a) and (b) above.

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1) *Inter-Vivos* Transfers (Cont…)

- **Definition of Interest in a Family Farm Partnership - subsection 70(10)**
- Will be qualifying interest if all or substantially (90%) of the FMV of property owned by the partnership is attributable to:
  - (a) property that has been used by
    - (i) the partnerhsip,
    - (ii) the person,
    - (iii) a spouse, child or parent of the person ("related family member"), or
    - (iv) a family farm corporation in which the person or a related family member of the person was a shareholder,

    principally in the course of carrying on the business of farming in Canada in which the person or a related family member of the person was actively engaged on a *regular and continuous basis*;

  - (b) shares of the capital stock or indebtedness of one or more corporations all or substantially all of the fair market value of the property of which was attributable to property described in (c) below; or

  - (c) properties described in (a) and (b) above.

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1) *Inter-Vivos* Transfers (Cont…)

- **Limits on Proceeds from Disposition**
  - For farm land, the maximum is the FMV and minimum is ACB;
  - For eligible capital property (i.e. agriculture quotas), the maximum is the FMV and the minimum is the amount determined in a formula in clause 73(3)(b.1)(ii)(BB) of the Act (cumulative eligible capital);
  - For depreciable property, the maximum is the FMV of the property and minimum is its undepreciated capital cost as determined by clause 73(3)(a)(ii)(B) of the Act; and
  - For shares in a family farm corporation or an interest in a family farm partnership, the maximum is the FMV of the shares or interest and the minimum is the ACB of the shares or interest.

1) *Inter-Vivos* Transfers (Cont…)

➢ Use of a Promissory Note

- Secured with the collateral mortgage registered against the land
- Asset base goes from land to debt instrument
- Any increase in value over sale price accrues to the child
- Taking security protects against:
  - Death of the child
  - Claims by child's creditors; and
  - Matrimonial property claims
- Therefore, dangerous to give a gift of farm land to child

1) *Inter-Vivos* Transfers (Cont…)

- **Accepted uses of *Inter-Vivos* transfers (CRA IT-268R4)**
  - a taxpayer may transfer farm property in stages or piecemeal (partial dispositions) over any number of years;
  - a taxpayer may sever and transfer to a child farm land upon which the child may construct a residence;
  - a taxpayer who is a sole owner of farm property may arrange for transfer of ownership of that property to a child in such a manner that the child becomes a joint tenant or tenant in common with the taxpayer in that property;
  - a taxpayer may transfer a farm property to a partnership if all the partner's are the taxpayer's children (cannot transfer to a corporation though); and
  - a taxpayer may transfer farm land to a child and retain a life interest in the land for taxpayer, for the spouse of the taxpayer or for the taxpayer and the spouse jointly.

2) Disposition Upon Death

- Rollover provisions:
  - Subsection 70(9) deals with farm property
  - Subsection 70(9.2) deals with transfer of shares of family farm corporation or interest in a family farm partnership
- Similar requirements to *inter-vivos* rollover except for four main differences

2) Disposition Upon Death (Cont…)

- *1) Eligible capital property not eligible for a rollover*
  - Only applies to farm land, depreciable assets, interest in a family farm partnership and shares of a family farm corporation
  - Could transfer eligible capital property using:
    - *inter-vivos* rollover or
    - transfer into a family farm corporation or partnership

- *2) Transfer must be as a consequence of death*
  - Cannot have provision in will that assets are sold to child (sale as a consequence of sale, not death)

2) Disposition Upon Death (Cont…)

- *3) Estate may elect to report proceeds of disposition greater than the ACB*
  - Subsection 70(9.01)
  - Subject to same deemed disposition limits with *inter-vivos* rollovers
  - Applies on a property-by-property basis
  - Could use in order to use parent's CGE

- *4) Farming asset must vest indefeasibly in child within 36 months after death*
  - May make a written application for an extension of 36 month limit – must be made within 36 month period
  - If mortgage on land to satisfy cash gifts – yes
  - If child must make payments to other beneficiary first – no
  - If third party holds a mandatory purchase option - no

3) Capital Gains Exemption

- Section 110.6
- Every resident has $750,000 CGE on qualified farm property
- Could experience “clawback” of benefits or liability for Alternative Minimum Tax

- *Qualified Farm Property* (subsection 110.6(1))
  - Real property (for example, land and buildings);
  - Eligible capital property;
  - Share of the capital stock of a family farm corporation (as defined in subsection 110.6(1) (as opposed to subsection 70(10)); and
  - Interest in a family farm partnership (as defined in subsection 110.6(1) (as opposed to subsection 70(10)).

- The CGE does not apply to depreciable property such as a gain realized on the sale of farm equipment.

3) Capital Gains Exemption (Cont…)

- **Real Property and Eligible Capital Property**
- Two Tests
- "Specified Persons"
  - Taxpayer
  - Spouse, child or parent of taxpayer
  - Beneficiary of a personal trust or estate
  - Spouse, child or parent of beneficiary
  - Family farm partnership

3) Capital Gains Exemption (Cont…)

- **Real Property and Eligible Capital Property**

- **Test 1** - Property last acquired before June 18, 1987 or after June 17, 1987 under an agreement in writing entered into before that date

  - Specified person must have owned the property for a minimum of 24 months *immediately* preceding disposition; and

  - Either
    - 1) In the <u>year</u> the property was disposed of by the taxpayer, the property must have been used *principally in the course of carrying on the business of farming* in Canada by the taxpayer, a spouse, child or parent of the taxpayer, a beneficiary of a personal trust and a spouse, child or parent of the beneficiary, a family farm corporation or a family farm partnership owned by any of the aforementioned individuals or a personal trust from which the individual acquired the property (an "eligible person").

    Or

    - 2) In at <u>least five years</u> during which the property was owned by a "specified person", the property was used *principally in the course of carrying on the business of farming* by an "eligible person".

3) Capital Gains Exemption (Cont…)

- **Real Property and Eligible Capital Property**

- **Test 2** - Property last acquired after June 17, 1987

  - Specified person must have owned the property for a minimum of 24 months *immediately* preceding disposition; and

  - Either
    - 1) "Gross revenue test" must be met by a specific person in at least two years while property was owned, the property must have been used *principally in a farming business* and the specified person must have been *actively engaged on a regular and continuous basis* in the farming business throughout a period of at least 2 years

    Or

    - 2) The property must have been used by a family farm corporation or a family farm partnership *principally in a farming business* throughout a period of at least 24 months. In addition, a specified person must have *actively engaged on a regular and continuous basis* in the farming business in which the property was used.

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3) Capital Gains Exemption (Cont…)

- **Definition of Shares of a Capital Stock of a Family Farm Corporation**
  - Definition different than one in subsection 70(10) for a rollover
  - Same requirements as subsection 70(10) but CGE requires that
    - Through *any* 24-month period preceding the date of death, more than 50% of FMV of property used by the corporation must be used by an appropriate person
    - Furthermore, the property must have been used *principally in the course of carrying on a business of farming* in Canada in which the taxpayer, beneficiary of a personal trust or spouse, child or parent of the taxpayer or beneficiary was actively engaged on a *regular and continuous basis*.
  - Cannot have too many "non-active assets"
  - Same test for interest in a family farm partnership

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3) Capital Gains Exemption (Cont…)

➢ Leveraging the Capital Gains Exemption

- Watch out for subsection 69(11) - anti-avoidance provision
  - Prevents a taxpayer from dispoing property for less than fair market value
  - If the disposition is part of a series of transactions or events and the main purpose of the transactions or events is to obtain the CGE.
  - Parent’s proceeds of dispostion are deemed to be the fair market value of the property at the time of the transfer (this amount would also be the child’s cost of acquisition).
  - The child must wait three years before disposing of the property if he or she wishes to use his or her CGE.

3) Capital Gains Exemption (Cont…)

- **Leveraging the Capital Gains Exemption**
  - CRA Interpretation 2002-0143635
    - CRA objected to an *inter-vivos* transfer
    - However, CRA did not comment on if the purpose of the transactions was for estate planning
  - Could use the following to leverage the CGE:
    - Death rollovers;
    - Spousal trusts;
    - Family trusts; and
    - Freezes.

4) Use of a Trust

- Alternative to a direct *inter-vivos* transfer or rollover upon death
- Advantages to using a trust:
  - Parent can explain rationale and intention
  - Maintain confidentiality
  - Protect against claims by creditors of a beneficiary or matrimonial claims
- *Inter-vivos* trusts are taxed at highest marginal rate, testamentary trusts are not
  - Must file tax return if testamentary trust
- Settlor cannot retain any control

4) Use of a Trust (Cont…)

- **Spousal Trust**
  - Subsection 70(9.1) – farm land and depreciable property
  - Subsection 70(9.3) – shares of corporation and interest in partnership
  - Eligible capital property cannot be transferred to spousal trust
  - Taxpayer can transfer property to spousal trust on a rollover basis using subsection 73(1) election
  - Transferee spousal trust receives ACB for capital property and undepreciated capital cost for depreciable property
    - If there is no election, then FMV
  - Cannot sell property for some value between ACB and FMV
  - No requirement

4) Use of a Trust (Cont…)

- **Spousal Trust**
  - The taxpayer or taxpayer's spouse, child or parent do not need to be "actively engaged" on a "regular and continuous basis in farming" during the period between the transfer of the property into the spousal trust and the death of the spouse
  - Only requirement is that the property must be used in a farming business
  - The land can therefore be rented to arms length tenants or leased to a third party
  - In addition, similar to the rollover upon the death of the taxpayer, the estate may elect to report proceeds of disposition greater than the adjusted cost base

4) Use of a Trust (Cont…)

- **Spousal Trust – Farm Land and Depreciable Property – Requirements:**
  - The farm property must be in Canada;
  - The property must have been transferred by the deceased to an *inter-vivos* or testamentary spousal trust;
  - The child must have been a resident of Canada *immediately* before the death of the spouse;
  - The property must have been used in the business of farming *immediately* before the death of the spouse;
  - The property must be transferred to the child as a consequence of the death of the spouse; and
  - The title to the property must vest indefeasibly in the child within 36 months after the death of the spouse or within a longer period stipulated by the Minister that is reasonable in the circumstances (for dispositions prior to May 2, 2007, there was no 36-month limitation).

4) Use of a Trust (Cont…)

➢ Spousal Trust – Family Farm Corporation or Partnership– Requirements:

- Shares or interest must meet the definition in subsection 70(10) discussed before with the following rules:
  - Immediately before the transfer from the *taxpayer (transferor) to the spousal trust*, the taxpayer, the spouse, the parent or child need to be actively engaged in the farming business (same as subsection 70(10));
  - Immediately before the transfer from the *spousal trust to the child*, it is only necessary that the corporation used all or substantially all its property in carrying on a farming or fishing business in Canada.
- The child must have been a resident of Canada immediately before the death of the spouse;
- The property must be transferred to the child as a consequence of the death of the spouse; and
- The title to the property must vest indefeasibly in the child within 36 months after the death of the spouse or within a longer period stipulated by the Minister that is reasonable in the circumstances.

5) Use of a Holding Corporation / Subsection 85(1) Rollover

- Farm Assets or shares can be rolled over to a family farm corporation or holding corporation using subsection 85(1)
- Using CGE on depreciable property
  - Use 85(1) to rollover farm equipment on a tax deferred basis to controlled corporation
  - As long as you meet definition of family farm corporation can use CGE indirectly for depreciable property
- Estate freeze

6) Use of an Estate Freeze

- Allows future growth in the value of assets to accrue to someone else
- Taxpayer can accomplish the following:
  - Quantify tax liability;
  - Take steps to reduce liabilities over a period of time; and
  - Reduce exposure to probate and other estate settlement costs
- Use estate freeze if you expect growth for the farming business
- Pension/cash flow for parent
- Parent must surrender control

6) Use of an Estate Freeze (Cont…)

- Subsection 85(1) - Rollover to Corporation
  - Transferor issues freeze shares and a trust for the beneficiary can subscribe for the common shares
  - Principal shareholder exchanges his common shares for other preferred shares of the corporation
  - Both shares valued at FMV of the farm
  - Value attributable to parent is in preferred shares
  - New common shares bought by child for a nominal amount and future growth accrues to child
  - Transfer to a corporation does not necessarily mean new corporation is a “family farm corporation” – be careful

6) Use of an Estate Freeze (Cont…)

- Subsection 85(1) - Rollover to Corporation
  - Creates one of three structures:
    - *1) Holding company freeze*
      - Creditor proofing but must maintain another corporation
    - *2) Internal freeze*
      - Simple but no ability to creditor proof
    - *3) Drop-down freeze*
      - Creditor proofing and greater flexibility if partial freeze
      - However no potential for crystallization in the transfer of assets, must maintain another corporation and complicates future sale transactions

6) Use of an Estate Freeze (Cont…)

- Reserve Rules – 10 Years v. 5 Years
  - One of the simplest ways to freeze an estate is to enter into a taxable sale with the intended beneficiaries for the farm assets
  - The general reserve rules in subparagraph 40(1)(a)(iii) deal with the situation where the sale of an asset creates taxable income, and the owner may be entitled to claim a reserve from the resulting gain.
  - This subparagraph normally allows the gain to be recognized over a five year period.
  - Notably however, if the property is:
    - land in Canada or depreciable property used by the taxpayer or his or her family in the business of farming,
    - a share of a family farm corporation,
    - an interest in a family farm partnership, or
    - a share of a small business corporation,
  - then subsection 40(1.1) allows the owner to recognize the capital gain over a ten year period.

7) Land Transfer Tax Exemption

- Legislative exemption from Land Transfer Tax for farm land
- Available where:
  - farmland changes ownership between members of the same family;
  - farmland is transferred from a Personal Representative of an Estate (for example, the Executor) to a family member;
  - farmland is transferred from a family member into a family farm corporation; and
  - where farmland is transferred from family farm corporation to one or more family members.
- Transfers from an estate to a corporation or from one corporation to another do not qualify

7) Land Transfer Tax Exemption (Cont…)

- **Eligible "family members" include:**
  - the spouse (including common-law spouses),
  - children,
  - parents,
  - brothers, sisters, aunts, uncles, nieces or nephews of the transferor.
  - grandparents, certain spouse's relatives and the transferor's same-sex spouse are also eligible family members.

7) Land Transfer Tax Exemption (Cont…)

- **Claiming LTT Exemption:**
  - In order to claim the Land Transfer Tax Exemption, an "Affidavit Regarding the Exemption for the Conveyance or Disposition of Farmed Land" must be filed with the conveyance tendered for registration.
  - The Affidavit and the corresponding instructions can be found at Ontario Ministry of Revenue website.
  - In addition, a statement must be included in paragraph 5 of the Land Transfer Tax Affidavit based on the identity of the transferor or transferee.
  - For a complete list of the applicable statements to be included in paragraph 5 of the Land Transfer Tax Affidavit please refer to the instructions to the "Affidavit Regarding the Exemption for the Conveyance or Disposition of Farmed Land"

7) Land Transfer Tax Exemption (Cont…)

- **Refund:**
  - Even if Land Transfer Tax has been paid on a conveyance of farmland and the conveyance meets the requirements for the exemption, a refund application can be made within four years from the date the tax is paid.
  - The following documentation must be sent to the Ministry of Revenue's Land Resource Taxes Section:
    - A copy of the registered instrument on which land transfer tax was paid (in the case of electronic registration, please include a copy of the docket summary which relates to the transaction);
    - A copy of the agreement of purchase and sale and statement of adjustments;
    - A properly completed Regarding the Exemption for the Conveyance or Disposition of Farmed Land;
    - A copy of the shareholder registers of the transferor corporation and any of its corporate shareholders, and
    - A copy of the financial statements for all corporations.

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