Transfer of Farm Property – The Tax Rules

Prepared For: Legal Education Society of Alberta

Family Farm Issues

Presented by:

Tracy Hanson

Walsh LLP

Calgary, Alberta

For Presentation In:

Red Deer – May 9, 2014

TRANSFER OF FARM PROPERTY – THE TAX RULES

INTRODUCTION

According to the most recent Farmland Values Report released by Farm Credit Canada (FCC)[1], farm land values nationally increased by an average of 22.1% in 2013. This is the highest increase since FCC began issuing this report in 1985, with the second highest increase seen in 2012 (at 19.5%). 1992 was the last time Canada saw a decrease in farm land values. While the increase in net worth is welcome, it nevertheless brings along certain challenges. Planning for the long term succession of the family farm business is, for many owners, a daunting task. Adding to this already overwhelming process, are very technical tax rules under the *Income Tax Act* that must to be considered when planning for the transfer of farm property.

The purpose of this paper is to provide an overview of the tax rules that apply on the transfer of farm properties, namely, the rollover rules and the capital gains exemption, and explore how these rules might be used and what issues can arise in relation to death, divorce and estate planning.

ROLLOVER RULES

As a general rule under the *Income Tax Act*, a disposition of property takes place (or is deemed to take place) at fair market value. Where the fair market value exceeds the tax cost of the property, there will be tax consequences to the transferor.

The rollover provisions provide an exception to the general rule on dispositions, and exist to assist with the transfer of farming businesses to the next generation. When applicable, the rollover rules provide a tax-deferred transfer of property to a spouse or child(ren). Essentially, a rollover deems the proceeds of disposition of a property to be at an amount that is equal to the transferor's tax cost rather than at fair market value. The person receiving the property assumes the tax liability, because he/she is deemed to acquire the property at the transferor's tax cost. The tax that would otherwise be payable under the general tax rules, is merely deferred until the subsequent owner disposes of the property. These rules are found under sections 70 and 73 of the *Income Tax Act*.

ROLLOVER TO A SPOUSE OR SPOUSAL TRUST – S.73(1) AND S.70(6)

Subsections 73(1) and (1.01) provide for an automatic tax-deferred transfer of capital property to a spouse or a qualifying spouse trust, during one's lifetime so long as the transferee and the spouse are resident in Canada at the time of the transfer. There is a corresponding provision in s.70(6) that

---

[1] 2013 Farmland Values Report , Farm Credit Canada, www.farmlandvalues.ca

allows for a similar tax-deferred transfer on death. In both instances, it is relevant to point out that *any* capital property can be transferred to a spouse on a rollover basis, unlike with children where only certain types of capital property are eligible to be rolled (discussed in more detail below). The broad scope of the spousal rollover provisions provides couples with flexibility and planning opportunities (without triggering tax consequences) for arranging ownership of property during their lifetime, division of property upon breakdown of a relationship and estate planning.

One important tax rule that comes into play when a rollover to a spouse is completed under s.73(1) (i.e. a lifetime transfer) are the attribution rules found in subsections 74.1 and 74.2. The effect of these rules is to attribute back to the transferring spouse (the "Transferor"), any future gains realized or income earned from the property. As a result, it is not possible to roll a property to a spouse and use the spouse's capital gains exemption on a subsequent disposition, when the Transferor is alive. In those circumstances, the proceeds realized on the sale of the property will be taxed in the Transferor's hands. The only means of preventing the attribution rules from applying is for the spouse to pay fair market consideration <u>and</u> to elect out of the application of s.73(1) as required by s.74.5(1)(c).

The attribution rules to not apply, however to business income – only to income earned from the property. While this may at first instance seem like a difficult distinction, the transfer of farm land to a spouse provides an example that helps understand the difference. Income arising through use of the land in a farming business is considered 'business income' rather than 'income from property'. Income from renting or leasing land on the other hand, is not considered a business, and therefore is income from property that would be attributed back to (and taxed in the hands of) the Transferor. If land is rolled to a spouse and the spouse earns *farming* income off of the land, that income would not be attributed back to the Transferor. It is only when the land is leased or rented that attribution will apply. For most farming couples, the attribution rules will typically not be an issue until they retire from actively farming and lease out the land.

The *Income Tax Act* also has provisions that apply on death, and allow for the tax-deferred transfer of capital assets (including agricultural capital assets) to a surviving spouse/common-law partner or spousal trust. These rollover rules are found in ss.70(6) and require the following conditions be met: