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Proposed Tax Changes May Hit Your Family Farm Hard!

On July 18, 2017, the Department of Finance released shocking changes to the Lifetime Capital Gains Deduction, Income Sprinkling and released other extremely complex rules involving corporations and trusts. These changes do affect your farm and I have tried to summarize the most significant farm tax issues. Trust me; it is time to visit your MP. While these changes will impact small business of every kind across Canada, this article focuses specifically on the farmers. The Department of Finance has given Canadians a short window of time to raise your issues, only until October 2, 2017. Hopefully this information will help to discuss your concerns with your MP. It is important to note that most of the historical proposed changes from the Department of Finance have become law and therefore these proposals cannot be taken lightly. Your lobbying efforts up to October 2nd are critical at this stage to shape the tax issues surrounding your farm and all Canadian farms.

Proposed Capital Gains Deduction ("CGD") Rules for Utilizing your Child's Capital Gains Deduction

After December 31, 2017, under the tax proposals, using your child's CGD on eligible farm property will be subject to various restrictions:

a. Children realizing a capital gain when they are UNDER 18 years of age will not be allowed to use their CGD on any property, including eligible farm property. For your information, eligible farm property can include qualified farmland, qualified interest in a farming partnership and qualified shares in a family farm corporation.

b. Children will not be able to use their CGD on the appreciated value of eligible farm property that built up before their 18th birthday. This means that for any eligible farm property that the farmer has not yet transferred to their child, they should plan ahead and consider using their own CGD up to the value of the farmland at the time the child turned 18 years old, since the child can never use their CGD on that portion of the value. There is no doubt that these rules will be difficult and expensive to follow in comparison to the current tax rules where there are no such restriction. For example, consider the cost of having a real estate appraisal or business valuation on each of your children's eighteenth birthday to satisfy these tax proposals.

c. All capital gains allocated from a family trust will no longer be eligible for the CGD. Moreover, this applies to all beneficiaries of the family trust including the farmer. Trusts often provide non-tax benefits helping transfer the farm to the next generation – accessing those benefits will require sacrificing the tax benefits of the CGD if these proposals become law.

d. All capital gains realized on farm partnership interests and shares in a farm corporation earned by an individual who is related to the farmer will be subject to a "reasonableness test". Any portion of the gain that fails the reasonableness test will be penalized and subject to tax at the highest tax rate, (highest tax rate in Alberta currently is 48%). The reasonableness test is the amount that would have been paid to an unrelated individual while considering their labor contributions, their past earnings, their asset contributions and business risks assumed. This will require analyzing all contributions made, and all compensation received, by the individual, over all the years they were involved in the farm. For any capital gains realized while the individual is between the ages of 18 and 24, the amount of their "asset contributions" and "risks assumed" will be heavily discounted in the reasonableness test. These rules will be difficult to follow.

Proposed Income Splitting Rules

After December 31, 2017, income splitting with your relatives will be subject to various restrictions. Splitting income with common relatives such as your adult children and with your spouse will be subject to a reasonableness test. The common sources of farm income such as wages, partnership income and dividend income from the farm corporation will be included in the reasonableness test. Income splitting with a non-active spouse or non-active children is not advisable under the new proposed rules. These rules are similar to the capital gains rules discussed above, requiring all historical contributions and compensation to be considered, and imposing the highest possible rate of personal tax on any amount determined to be "unreasonable".

Proposed Special Election in 2018

There will be a special election available until December 31, 2018 for an individual, like a child, to use their CGD on farmland under the current tax rules. However, there are a number of tax concerns:

a. If a child elected in 2018 to utilize the full $1 million CGD on eligible farm capital gains, they will unfortunately pay a very steep tax called the Alternative Minimum Tax ("AMT") in the neighborhood of $50,000. This tax is only refundable against a portion of the future personal income taxes owing over the following seven years. However, obtaining the cash to pay the tax will be difficult, perhaps obtain a loan on the land; followed by additional tax planning to allow the land loan interest to be eligible for a tax deduction.

b. Under the current tax rules, sometimes it is possible for an individual to recognize their CGD over multiple years, which allows them to reduce the size of the AMT. However, this is not the case under the proposed 2018 election since the elected gain and CGD will be recognized all in one year, creating the largest AMT amount.

c. After paying the AMT resulting from the 2018 election, the individual has to earn enough income in the future to recover all the AMT. For example, if they earned $40k in employment income over the next 7 years, they won't earn enough income to recover all of the AMT and will lose approximately $10,000 of AMT permanently. For young children, the likelihood of earning income sufficient to recover all AMT paid is even more unlikely.

d. If the child received any of the three common farm properties: farmland, farm partnership interest or shares in a farm corporation, after December 31, 2015 and they received this property under the existing farm rollover rules, and the child elects to utilize their CGD in the 2018 election on the eligible gain on these properties, there is an existing tax trap. To explain, there is a tax anti-avoidance rule that will reallocate the triggered gain in the 2018 election, back to the original parent that transferred the farm property to that child. I have discussed this issue with other tax professionals and they agree this is a serious concern potentially overlooked by the Department of Finance. This means farmers are being treated unfairly and at a serious disadvantage while using the 2018 election. For example, assume Farmer A transfers farmland at cost to Child A in 2016, thus transferring the gain to the child. In 2018, Child A elects under the proposed tax rules to claim their CGD against the gain on the land. The result is the gain on the land is transferred to Farmer A's 2018 tax return where Farmer A may not have any CGD left and now Farmer A has unfortunately triggered taxes owing on the gain due to an election filed by Child A.

e. The election will allow children under 18 to use their CGD on farmland and partnership interests. For gains on eligible shares of a farm corporation, children under 18 must sell their shares to use their CGD. Adults can use the election to claim CGD on shares, as well as land and partnership interests.

f. Electing to realize capital gains in 2018 will avoid the reasonableness test for capital gains realized until December 31, 2018. However, it may also attract AMT as described above, and impact other income-tested benefits including the Canada Child Benefit, Alberta Family Employment Tax Credit, Working Income Tax Benefit, Refundable Medical Benefit, Guaranteed Income Supplement, claw back of Old Age Security and the GST/HST credit. In other words, realizing a paper gain now to save tax tomorrow will cost you some lost benefits today.

Incorporating the Farm

As if these changes are not complex enough, the proposals also include a very broad anti-avoidance provision intended to prevent transactions that "converts" a dividend from a corporation to another form of income taxable at a lower tax rate. These proposals are broad enough that they could apply to common situations like selling farm assets to a corporation. These proposals will cause significant tax uncertainly for farmers incorporating their farm.

Planning Ahead

Under the proposed tax rules, here is a summary of areas where it is important to plan in advance:

a. If you believe your farm will have an issue under the proposed tax changes with managing your capital gains exposure on one of the three common farm properties: farmland, farm partnership interest or shares in a farm corporation, then first, it is important to review with your professional advisor to ensure your farm properties qualify for the CGD. If they don't qualify for the CGD, you have to plan ASAP and meet it by December 31, 2017. That way, the farm properties will be eligible for the special election by December 31, 2018 and you can avoid the restrictions under the proposed new CGD rules after December 31, 2018.

b. Assuming the "tax trap" raised in "d" above under the section titled "Special Election", is fixed by the Department of Finance, and you are already considering a transfer of some eligible farm property at a value below the current market value, to an active or non-active farm child, then consider transferring the eligible farm property before December 31, 2017. This should allow the child to utilize their CGD in the proposed 2018 election. Unfortunately, even if this tax trap is fixed, it may not happen until after 2017, so decisions may have to be made when the tax results are not certain.

c. If you have family trusts in your farm structure, consider unwinding the family trusts. However, you may have significant non-tax reasons for keeping the family trust. Review your options with your professional advisor.

d. Before transferring any farmland to an adult child or grandchild (C/GC) under the current farm rollover rules, the landowner should consider using their CGD up to the value of the land at the time the C/GC turned 18 years old. This is because the C/GC will not be able to use their own CGD up to the value of the land on their 18th birthday. Taking this one-step further, a landowner has to be very careful if they want to transfer their land to their grandchild, since a landowner may not have enough CGD for the land value appreciation up to when the grandchild turned 18 years old. Perhaps the grandparent should transfer the farmland to the next generation first, (the GC's parent(s)), to utilize the parent's CGD on the portion of land appreciation that occurred after the parent turned 18 years old. As a result, the landowner must carefully plan their CGD to avoid paying tax on eligible farmland. There is no doubt that these rules will be difficult and expensive to follow in comparison to the current tax rules.

e. If you are planning to restructure your farm business in 2017, discuss these proposed changes with your professional advisor.

f. If you have transferred farm property to a child or you have received farm property from your parent or grandparent, discuss these proposed changes with your professional advisor.

g. If your farm business operates within a farm corporation and built up significant sources of cash and related investment income, like a stock portfolio or GICs, be aware the Department of Finance is also considering additional complex tax changes affecting these assets. They are considering taxing investment income at significantly higher tax rates, or even applying a tax on excess cash to "encourage" shareholders to withdraw assets not directly used in the farming operation, resulting in income to the individual shareholders. As a result, they are discouraging corporations from good business practices such as retaining excess cash for a "rainy day" fund, to replace future assets, to expand the operations or to create their own pension plan or other business safety nets.

CONCLUSION

Overall, these proposed tax changes will ultimately lead to all of these tax results:

- more taxes paid by the family farm,
- more complex farm succession planning,
- more complex estate planning or,
- more farms caught by surprise by the new rules!

I would like to extend a special thank you to KRP's Director of Taxation, Hugh Neilson, FCPA, FCA, TEP, for his valuable contribution to this article.

I hope you take the opportunity to visit your MP to discuss the proposed tax changes that affect your farm and voice your opinion.

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