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Issues in Law You Need To Know

Succession and Tax Planning for Farmers

In Canada, farming is perceived to be significant business where thousands of farms are generating billions of dollars for the Canadian economy, and considered by many to be a cornerstone of the foundation of the traditional Canadian identity. More than a job or singular career, most farmers would agree that farming is a lifestyle and a life-long commitment in which they take great pride.

Often a family business, the knowledge of the business of farming, and ultimately the business itself, is passed from one generation to the next. For many farmers reaching an age of retirement, important decisions concerning the future of their farm must be made and the options available are limited.

That is why many farmers will agree that envisioning their farm succession is neither a pleasant nor an easy task. However, if farmers view their farm succession as a positive "mandatory" process instead of a disruptive isolated event, it may ease the transition.

In most cases three possible choices are considered:

1. Transfer the farm operation to the children and maintain the farm in the family;
2. Sell the farm to a third-party and use the after-tax proceeds of the sale for retirement;
3. Retain ownership of the farm and simply deal with the succession of the farm in one's last Will and Testament.

Each of these options has its own set of implications that require careful consideration in order to preserve the family's unity and ensure fiscal responsibility and stability.

1. Transferring the Farm Operation to the Next Generation

For this option to be viable, one must first determine whether a child or children are interested in succeeding the parents and whether they are indeed capable of running the farm operation. These are two quite separate and distinct considerations.

The key component of a successful farm succession is the creation and implementation of a succession plan that is tailored to the unique characteristics of the family, the farm business and the goal of all individuals involved.

Some aspects of the development of a succession plan are unavoidable such as identifying the successor, establishing a timetable, developing a retirement plan, and developing a retention plan for key employees. Getting experienced and knowledgeable professional advice is essential. Although these components are not exclusive, they ought to be carefully considered and implemented.

This succession plan must normally deal with three objectives;

1. the transfer of labour,
2. the transfer of management and decision-making (i.e. control), and
3. the transfer of ownership.

Implementing a succession plan sends clear signals to the child/children to become more involved with the family farm, to the farmer/parent(s) to begin to accept a gradual transfer of control of the farm business to the next generation and, ultimately, that the child/children acquire ownership of the shares (if the farm business is incorporated) or the assets.

The succession plan must also take into consideration the parents' financial position for their retirement; ensuring long-term financial stability and the ability to maintain the parents' lifestyle. The retirement financial components must identify where the retirement money will come from, establish sound and realistic retirement-income strategies and, last but not least, how it will be spent. This is where living and lifestyle must be considered.

Succession planning for the next generation involves tax considerations that cannot be avoided. Indeed, the Income Tax Act provides specific rules concerning the transfer of a farm business to children where it may be possible to defer taxes on the disposition.

For example, it may be possible to take advantage of the "intergenerational rollover" rules: transferring ownership of a qualifying farm property to children by gifting any accrued gain to them.

There are specific and complex rules to be followed but the benefit of the "intergenerational rollover" can only be realized if the transfer of ownership to one's children does not exceed one's tax cost. Such a strategy allows for the parents' capital gain to be deferred and "rolled over" to the next generation.

When dealing with farm succession, one must realize the concept of fairness is not necessarily synonymous with equality. The child or children who assume the farming operation will receive high asset value associated with the farm property to the detriment of those other children who opt for a different career.

How can one achieve fairness and equality in this context? Life insurance for the benefit of the non-active child/children is an option, although not perfect, and allows for some degree of fairness and equality in terms of value received by the non-active child/children.

2. Selling the Farm Business

If no children have demonstrated an interest in succeeding the farm business, then the only other option available may be to sell it. If that is the sole option, the succession plan may be easier although the issues will inevitably differ.

Finding a buyer for a farm business is not always simple (nor is it for any type of business for that matter). Hopefully, there is that long-time employee that may have shown some interest in the past or a neighbour who has expressed a desire to expand his existing farm business. Finding a suitable buyer is only the first step when one desires to sell their farm business.

Also, there is the question of whether to sell the farm inventory or to sell the shares of the business, where the farm business is incorporated.

a. Sale of Inventory

If the sale is by an individual, then the money received from the sale of inventories such as crops, supplies and livestock is included in the individual personal income just as other product sales are when reporting such a transaction. However, farmers have the choice of reporting their income for tax purposes on either a cash or accrual basis.

If one opts to report income on a cash basis, they must report the income when payments are received and they will be taxed at the gradual tax rate. If the sale of inventory is spread over several years into the future (documented by the appropriate debt instrument), then the cash basis allows the farmer to defer the income until the year received.

b. Sale of Shares or Qualified Farm Property

If the farm business is incorporated, selling the shares or qualified farm property might be preferable for tax-related reasons. First, it may be possible to claim the $750,000 capital gains exemption on the sale of shares or qualified farm property . Qualified farm property includes:

1. farm land and buildings
2. shares in a family farm corporation
3. an interest in a family farm partnership or quota

Taking advantage of the $750,000 capital gains exemption requires careful tax planning as the rules to be complied with are complex. However, if the capital gains exemption is available for both parents and the children it makes sense that each claim their own capital gains exemption so that the tax liability on the sale of the farm business can be significantly reduced.

c. Sale of Quota

The sale of quota is taxable in the year of sale. Recapture of CCA Quota can be taxed as a capital gain if a §14(1.01) election is filed, or, if no election is filed, as business income that is eligible for the capital gains exemption.

It is important to note that the $750,000 capital gains exemption can be used, if available, as long as the quota is owned for at least a 24-month period. A reserve may also be available for quota if an election is filed, however, alternative minimum tax is payable on quota when the election is used.

3. Succession Through Your Last Will and Testament

In the author's opinion, this option should not be considered by itself. Rather, it should be combined with one of the preceding two options. However, it is unquestionable that proper estate planning and a carefully drafted Will that addresses potential estate issues will go a long way to maintaining the farm business operation and/or avoiding litigation over the estate.

The spousal rollover should be considered within the estate planning. Indeed, if you transfer ownership of assets to your spouse, either during your lifetime or on your death, such transfer can be done at cost thus deferring any capital gains until the death of your spouse.

If one child is to "inherit" the farm business, the Will ought to properly address the issue of unequal distribution if such arises.

As mentioned above, it is also advisable at the estate planning stage to consider alternatives for those children who will not be involved in the farm business and life insurance is often employed in this regard. The goal is to achieve a satisfactory perception of equality and fairness, even if imperfect.

Testamentary trusts are also tools that may be employed as part of the will planning allowing for strategic tax savings. Indeed, testamentary trusts can be used to take full advantage of graduated tax rates, to split income, to allow for designated income in the trust and for the preferred beneficiary election.

It is the author's opinion that testamentary trusts should always be part of the estate and will planning in any instance where such trusts may translate into significant tax savings for the beneficiaries.

As mentioned above, an ideal farm succession plan includes proper estate planning. Moreover, whether one opts to deal with one's farm succession only through a Will or through one of the two preceding choices, we highly recommend professional advice from both a lawyer and tax adviser who are proficient in this area. There are many important issues that require a variety of professional expertise for a farm transfer to be explicitly and effectively dealt with in a Will.

If you opt not to complete your farm succession while living, sound professional advice should ease the process of estate planning while ensuring that all needs are met and any potential for litigation minimized.

Conclusion

The foregoing raises the significant issues and options available to most farmers faced with the dilemma of retiring and passing their farm business to another. All options ought to be carefully considered and, regardless of which option one chooses, we highly recommend one seek professional advice to ensure enjoyment of the most fully informed and beneficial short and long term planning.

Tierney Stauffer LLP would be glad to assist you with your succession plan and the tax implications involved. If you have any questions, please do not hesitate to contact us.

If you have any questions concerning the taxation of damages, please do not hesitate to contact me directly at 613.288.3220

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PRACTICE SUMMARY:

Sébastien joined Tierney Stauffer LLP as an Associate in the Wills, Estates & Trusts Planning & Administrative Practice Group in 2009. His practise focuses on estate planning, will drafting and personal and corporate taxation. Sébastien has experience in resolving disputes with the Canada Revenue Agency (CRA), filing voluntary disclosures, assisting individuals with their tax related issues and tax planning for families and businesses. Sébastien is bilingual and practices in both official languages.

He has spoken at various seminars on estate, trust and tax matters. Sébastien has also appeared on radio and television discussing legal issues. He is a tutor for the Law Society of Upper Canada for the Estate Practice section.

Prior to joining Tierney Stauffer LLP, Sébastien practiced with another Ottawa law firm where he gained experience in tax law, charity law, estate planning and will drafting.