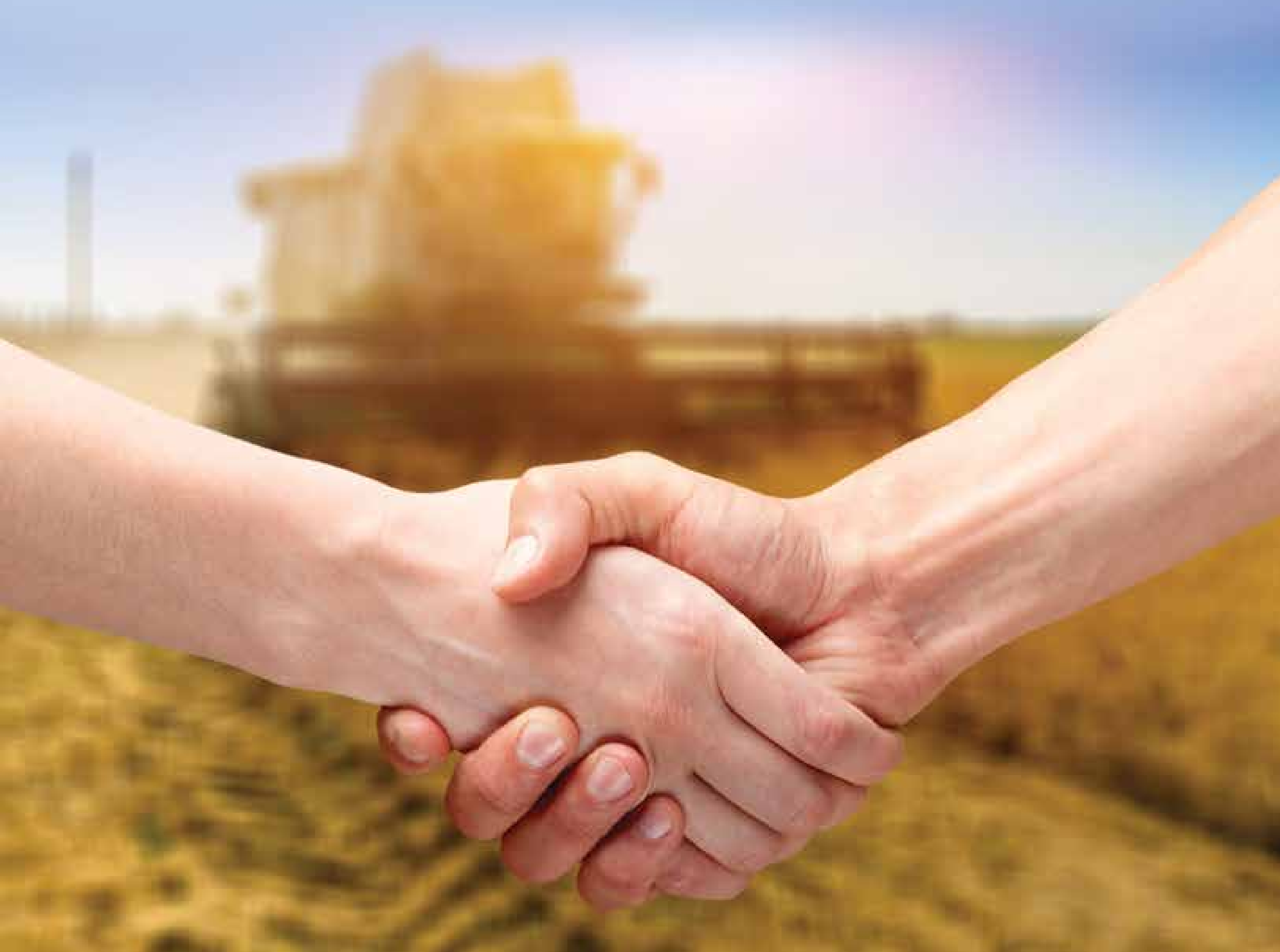
SELLING THE FARM

SUCCESSION PLANNING IS A DIFFICULT BUT CRUCIAL STEP FOR ANY AGING FARMER. AS THE ADAGE GOES, FAILING TO PLAN IS PLANNING TO FAIL. **BY MICHELE MANNEROW AND DEVIN J. MORRISON**



by Michele Mannerow and Devin J. Morrison

Michele Mannerow: Retiring from farming is a big job — almost as big a job as farming itself, I imagine! To sell a farm properly — not just the land, but also the business — takes time and planning. Unfortunately, a StatsCan study from 2016 indicated that roughly 92 per cent of farmers have no transition plan. As I say to my clients when doing any form of retirement planning, your first steps are to determine where you are now. We refer to this as Point A; then you need to determine where you wish to be, better known as Point B. A team of professionals is often needed to help identify the points and to plan your best options to move between these two points.

The sale of a farm, possibly more than any other business, is complicated by the emotional attachment owners feel to the job, land and house. Often, children are involved, and some still live and work on the farm. It would seem that selling the farm to a child or children would be the natural evolution of events. With rapidly-rising land prices and varying abilities and levels of interest of the children, this strategy can be extremely challenging. Depending on the situation, selling outside of the family can be significantly more straightforward — financially speaking, at least.

Devin Morrison: For Boomers, attachment to the property and a hesitancy to consider what will be done when they can no longer use and enjoy it can result in delaying to a point where circumstances necessitate a sale outside the family on terms they are unhappy with. In some cases, the sale goes to a buyer who intends to use the farm for a purpose the owners oppose, or for a price that is less than fair value.

Developing a robust and flexible estate or succession plan that includes a frank and honest discussion between family members and other relevant stakeholders, is one of the best methods for reducing the risk of conflict or feelings of inequality and regret. This also goes a long way to allowing Boomer-aged farmers to enjoy a well-earned retirement.

This is often a difficult and uncomfortable process for many. Fortunately there are a variety of professionals, including lawyers, accountants, investment advisors and insurance specialists, who can assist. For the best chance of success, this shouldn't be a 'set-it-and-forget-it' exercise, but something that is revisited periodically to ensure everyone involved is still on the same page and that tax or other legislative changes haven't necessitated modification to the plan.

The Canadian tax system incorporates a number of rules and incentives that are particularly relevant to farmers. Some of these rules are designed to specifically facilitate the transfer of farm property from one generation of the family to the next on a tax-efficient basis. Others apply more generally to transactions both inside and outside of the family.

The most notable incentive that many farmers are familiar with is the Lifetime Capital Gains Exemption (LCGE), which allows each Canadian who disposes of 'qualified farm property' to pay no tax on a capital gain of up to $1 million. This can lead to a tax savings of more than $260,000 for an Ontario farmer. There are specific technical requirements to meet the qualified farm property definition as it is written in the Income Tax Act, but generally speaking, immovable property such as land and buildings — and other farming assets such as dairy quota, shares of a family farm corporation or an interest in a family farm partnership owned by a full-time farmer — will meet the definition.

Additionally, it is important to note that in many cases, non-farming spouses, children or grandchildren can also make use of the LCGE if they purchase, inherit or otherwise acquire the property and eventually dispose of it. This can potentially lead to a multiplication of the LCGE by allowing a number of different family members to utilize their individual $1 million exemption. This is a particularly useful planning opportunity for larger farming operations or farms located close to urban areas where land values have increased substantially.

A drawback of the LCGE that frequently surprises farmers when they dispose of their farm property is the Alternative Minimum Tax (AMT), which is a separate income tax that applies in a year when a taxpayer significantly reduces his or her taxable income using one of the Income Tax Act's various incentives, including the LCGE. This can result in an upfront tax cost of more than $50,000 in the year the farm property is disposed of, which is a frustrating result for a transaction that was intended to be tax-free.

The good news is, any AMT paid can be used to offset regular income taxes for the next seven years, meaning it can effectively be recovered as long as there is sufficient income in those years. This can be a problem for farmers for whom the bulk of their earnings over the years were reinvested in the farm and may enter retirement without significant pension, RRSP or other investment income. Without sufficient taxable income in that seven-year period, some or all of the AMT paid can become a permanent cost.

One strategy for minimizing or even avoiding AMT entirely is to receive some or all of the proceeds from the sale of farm property over a number of years. The Income Tax Act contains rules that allow a taxpayer to claim a "reserve" on their tax return that can effectively split the recognition of a capital gain over up to five years. As a simple example, a Grey/Bruce Boomer who sells a piece of farmland to an unrelated individual for $1 million could split the resulting gain over five years by taking back a mortgage on the property that is paid back in five annual payments of $200,000.

Splitting the taxable capital gain over five years reduces the benefit of the LCGE that is recognized in any particular year which is likely to avoid the application of AMT. The obvious downside to this strategy is that the seller does not have use of the unpaid balance of the mortgage over that five-year period, and it exposes them to the risk that the full amount of the mortgage may not get repaid should the borrower run into financial difficulties. To mitigate these issues, splitting the gain over two or three years instead of five can still lead to a significant reduction in any AMT liability.

In order to help preserve the family farm, the Income Tax Act contains special rules that allow for qualified farm property to transfer from parent to child in a way that can avoid both regular income tax and AMT. Normally, when property is sold or otherwise transferred from a parent to a child, the transaction is deemed to occur at the fair market value of that property for tax purpose regardless of what (if any) amount is actually paid.

To illustrate, a parcel of non-farm land that was originally purchased for $100,000 that is now worth $500,000 on the open market can't be sold by the owner to his or her child for $100,000 in order to avoid paying tax on the $400,000 capital gain. Even though they would only receive $100,000 on the transfer to their child, they would still be required to report the full $500,000 value on their tax return and pay the associated tax. There is an exception to this general rule, where the property in question is deemed qualified farm property.

In that case, the transaction can be reported for tax purposes at any amount between the taxpayer's cost of the property and the fair market value. Using the previous example, the parent could use the $100,000 cost amount in reporting the disposition for income tax purposes, which results in no capital gain and therefore no income tax consequences. Alternatively, the parent could select $300,000 as the amount to report as proceeds of disposition on their tax return, which would result in a $200,000 capital gain ($300,000 proceeds minus $100,000 cost). The LCGE could then be used to avoid paying income tax on the $200,000 gain (although AMT may still apply as discussed above).

Michele: Another challenge facing the retiring farmer is wrapping their head around how to transition from owning a hard asset like a farm to an investment portfolio consisting of stocks, bonds, Guaranteed Investment Certificates (GICs), or mutual funds in RRSPs, Tax-Free Savings Accounts (TFSAs) and investment plans. How do all of these accounts combine with government pensions to provide a comfortable retirement income? For some, it can be a whole new world of uncertainty and acronyms in which a farmer will need to become comfortable. Do your research, talk to your friends and meet with professional advisors until you find someone you are confident will make recommendations that are in your best interest. We'll say it again: Selling a farm is a big job. But the job doesn't get any easier by ignoring it. Having a checklist can often help reduce stress around these sorts of topics.

Here is a checklist that touches on many (but not all) of the things you will need to consider as you approach retirement:

- Communication with family and professionals about your initial intentions to retire.
- Define goals and objectives for you and your family.
- Identify to whom you may wish to sell the farm, either within or outside of the family. Gather and analyze technical and financial information for the farm and family to this point.

- Generate options for:
  - How the sale will be financed: internal or external, partial or full?
  - How will the business be structured: sole owner, a partnership, or a corporation?
  - Use of strategies including principal residence exemption, capital gains exemption and "qualified farm property" status.
  - Sources and amounts required for retirement income.
  - Insurance needs for death, disability or equalizing bequests.
  - 'What if' scenarios including possible disagreements, disasters, death, disability and divorce.
  - A professional and capable advisory team.
- Make preliminary decisions based on above options.
- Design, develop, write and review the plan.
- Implement and monitor the plan within given time frames.

A hard copy of the OMAFRA Farm Succession Planning Guide is available by contacting *m.mannerow@manulifesecurities.ca* or can be seen online at *omafra.gov.on.ca*. ■

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