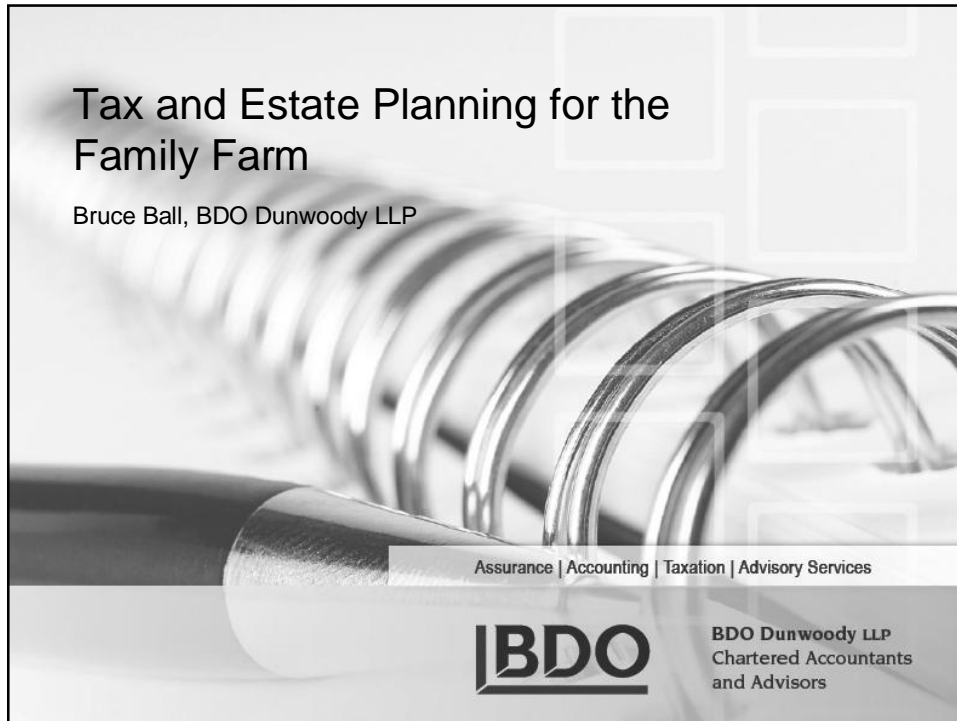


**Tax and Estate Planning for the Family Farm**  
**Bruce Ball, BDO Dunwoody LLP**



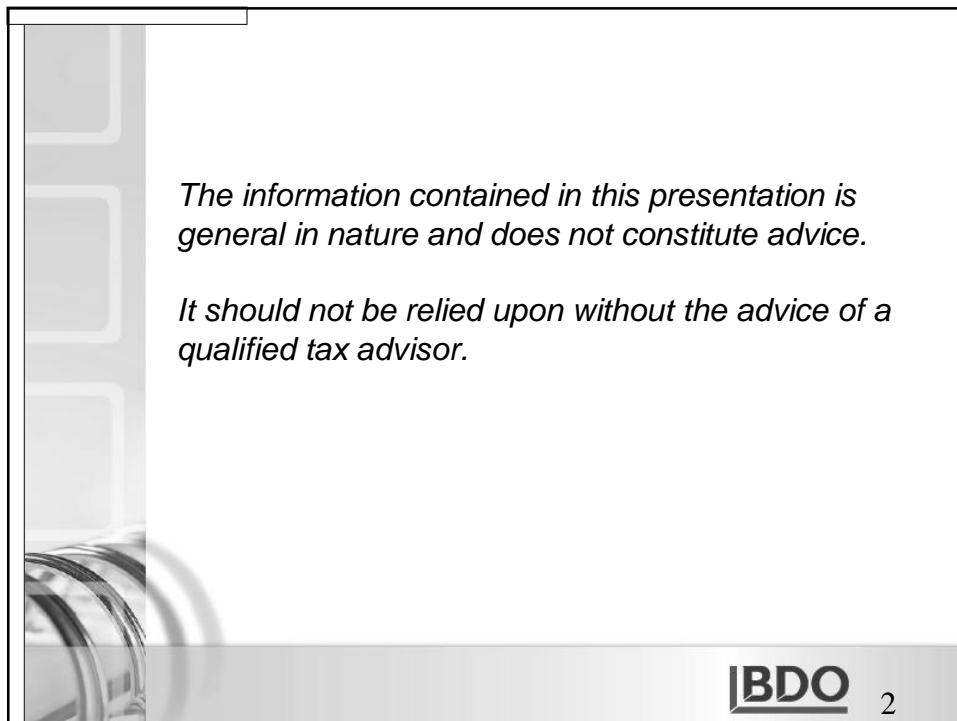
Tax and Estate Planning for the Family Farm

Bruce Ball, BDO Dunwoody LLP

Assurance | Accounting | Taxation | Advisory Services

**BDO**

BDO Dunwoody LLP  
Chartered Accountants  
and Advisors



*The information contained in this presentation is general in nature and does not constitute advice.*

*It should not be relied upon without the advice of a qualified tax advisor.*

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## What Exactly is Estate Planning

- Main Objectives

- Maximize the value of your assets, including the preservation and protection of property during your lifetime
- Minimize and defer tax and other costs arising on your death
- Allow for an orderly transition of assets to your beneficiaries, and
- Provide for your dependants, which can include decreasing their taxes where possible

## What Exactly is Estate Planning

- Estate Maximization/Preservation – Key Components

- Pay down personal debts and try to ensure borrowings are for business/investment purposes where possible
- Set a retirement plan, and use tax-assisted savings to the maximum extent possible
- Split income and capital gains with family members (and especially gains eligible for the capital gains exemption)
- Insure risks (business risks, disability insurance etc)
- Ensure all family members with assets have powers of attorney and a will
- Consider family law (for farmer and spouse, but perhaps more importantly, children where property transfers will take place)

## What Exactly is Estate Planning

- Minimize and defer tax and other costs arising on your death
  - Tax related
    - Dispositions of property
    - Collapse of deferred income plans
    - Probate tax/fees
  - We'll focus on a number of income tax rules and considerations:
    - The capital gains exemption
    - Rules for transfers of farm property within the family
    - Issues to consider for a sale

## What Exactly is Estate Planning

- Allow for an orderly transition of assets to your beneficiaries:
  - Will planning and will substitutes (we'll discuss probate planning as well)
  - The uses of life insurance
- Provide for your dependants, which can include decreasing their taxes where possible
  - Testamentary trust planning
  - Fair vs. equal – what to do

## Tax Consequences on Death: Capital Property

- Subject to rollovers, a deceased taxpayer is deemed to dispose of capital property immediately before their death at fair value
  - Land, shares of corporations and partnership interests
- Property is acquired by estate at the deemed proceeds amount
- For depreciable property – If accrued gain, combination of recapture and capital gain
- Farm property – Need to look at rollovers, and use of the capital gains exemption
- Spousal transfers – defers tax until death of both spouses

## Tax Consequences on Death: Eligible Capital Property (Quota)

- Good News/Bad News:
  - Good news – Quota and other eligible capital properties are disposed of at the cost amount on death
  - Bad News – There is no rule that allows an executor to dispose of the property at an amount in excess of cost to claim a remaining capital gains exemption

## Tax Consequences on Death: Deferred Income Plans

- Unmatured RRSPs
  - General rule - value of RRSP at time of death will be included in deceased's income unless a spousal rollover applies
  - Any increase in value after death is taxable to the estate or named beneficiary (decreases are not recognized as a loss)
- Matured RRSPs (Annuity or RRIF purchased)
  - Where an annuity has been purchased, and payments continue (to a spouse or partner under the terms of the annuity), survivor becomes annuitant, and is taxed on payments received
  - For a RRIF:
    - Spouse can take over plan, or
    - Value of plan assets taxed as income on death
- Are also rollovers involving disabled beneficiaries

## Estate Planning Tools

- We'll address following topics and pull it together at the end:
  - Tax benefits from incorporating
  - Income splitting and family trusts
  - Capital gain considerations for farmers:
    - The capital gains exemption
    - Spousal and intergenerational transfers
    - Principal residence rules & farm property
  - Retirement planning
  - The role of an estate freeze for farm property
  - Will planning



## Incorporating the Farm

***Main Benefits*** (we'll discuss each independently):

- Tax deferral – corporate tax rates are generally lower than personal rates, which creates a tax deferral
- Income splitting – Where direct income splitting doesn't utilize full income splitting benefits, look to splitting property income (e.g. dividends from a corporation) - discussed in income splitting section
- Use CGE to obtain cash from a farm corporation (discussed later in capital gains exemption section)

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## Incorporating the Farm

### ***Farm incorporation variations:***

- Pay-off debt faster – Where CGE is claimed on transfer of farm property into the corporation, corporation can assume debt up to proceeds triggered
  - Once debt is in the corporation, can be paid off with small business income, which is taxed at a lower rate
- If shares of a family farm corporation can be sold, certain income items will be converted into a capital gain (livestock proceeds, recapture, etc)
  - Purchaser though will be taxed in the corporation eventually, so they will presumably discount the proceeds


## Incorporating the Farm

### ***Farm incorporation variations:***

- Unlike non-farm businesses, you don't have to incorporate to get the capital gains exemption
- Can incorporate some assets, keep the rest outside the corporation (discussed later)
- Can still take advantage of other corporate benefits and hold property personally that qualifies for the capital gains exemption

## Corporate Tax Deferral

- Two corporate tax rates apply to farming income:
  - Small business rate – active income up to a threshold is taxed at a lower tax rate
    - Federal threshold is \$400,000 as are most provincial thresholds
    - Ontario, Alberta and Saskatchewan either do or will have a limit of \$500,000
    - Federal small business rate falls to 11%  
 January 1, 2008, provincial rates vary – (currently 2% to 5.5% in general, Quebec is 8%)
  - Other business income is taxed at a higher rate –  
 Federal rate on January 1, 2008 will be 19.5%, falling to 15% by 2012 (provincial rates from 10% to 16%)


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## Corporate Tax Deferral

- Both corporate rates provide a tax deferral (federal rates only):

|                    | General<br>Rate<br><u>(2012)</u> | Small<br>Bus. Rate<br><u>(2008)</u> |
|--------------------|----------------------------------|-------------------------------------|
| Top personal rates | 29%                              | 29%                                 |
| Corporate tax rate | <u>(15%)</u>                     | <u>(11%)</u>                        |
| Tax deferral       | 14%                              | 18%                                 |

- Material provincial tax deferrals usually on small business income only
- Not a tax saving – after-tax corporate income will some day be distributed and taxed (either as a dividend or a capital gain if the corporation is sold)

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## Corporate Tax Deferral

- Concept of integration and new dividend rules:
  - Tax integration – means that an individual receiving a source of income will pay the same tax whether:
    - They earn the income directly
    - They earn the income in a corporation and pay out that income (net of corporate income tax) as a dividend
  - With number of SMEs in Canada, dividend rules were set to ensure small business income was integrated
  - Problem – where corporate tax rate higher, integration didn't work – dividend tax credit was too low (was one reason for emergence of income trusts)
  - New rules (after 2005) – private companies will now track their high rate income and can pay dividends from this pool as eligible dividends

## Corporate Tax Deferral

- Concept of integration and new dividend rules:
  - Most provinces introduced similar rules
  - Exceptions – Nova Scotia and Newfoundland & Labrador – set rates that maintained the effective tax rate (i.e. providing integration was not seen as a goal)
  - New pool is called the general rate income pool or GRIP, and there are significant documentation requirements when paying an eligible dividend
  - What this means – an individual can (or will when rate cuts are fully implemented) use a corporation for a tax deferral on high-rate income without a tax cost down the road when the income is paid out as a dividend

## Incorporation Decision Process

- Decision process is different for farm businesses:
  - You don't have to incorporate to get capital gains exemption – most purchasers want to buy assets and not a corporation
    - Putting farm assets into a corporation that otherwise qualifies for the exemption may make things more difficult where a future purchaser wants to buy assets
    - What if capital gains exemption is increased again and all farm property is already in the corporation? (will have to sell shares to get extra exemption)
  - Common plan – put operations and inventory in the corporation, keep quota and real estate outside, and have the corporation pay rent for the use of the property

## Incorporation Decision Process

- Loss of flexibility in terms of cash basis rules and personal tax planning
  - Where an individual owns the farm, can do a lot of planning when tax returns are prepared in terms of how much income should be reported to maximize credits etc.
  - Once farm operations are incorporated, any personal income generally must be paid in the year to be taxed
    - Limits tax planning around personal income amounts

## Decision Process

- Decision process is different for farm businesses:
  - Estate freezes – With intergenerational rollovers, estate freeze tax issues are significantly different when compared with non-farm businesses
    - Look at other reasons – income splitting and allowing the family to participate in growth for business reasons
  - Once farm property is in a corporation, then intergenerational rollover must be used on shares of the corporation (i.e. the corporation can't transfer farm property to a child of the owner at cost).

## Negative Factors

- Principal residence complications
  - Exemption rules don't apply to a corporation – gain on portion of property associated with the residence will be taxable if all land transferred to a corporation
    - For gain to incorporation – Amount of land needed to use and enjoy the residence isn't always clear – must decide now how aggressive one wants to be when incorporating (as opposed to when land is being sold anyway)
  - Benefit issues arise where personal use is made of corporate property
- Solution
  - Exclude the principal residence land (if land is in fact transferred to a corporation)

## Negative Factors

- Capital tax – Farm operations generally require far more capital to generate income when compared with many non-farm businesses – capital tax could be an (inappropriate) issue in some provinces
  - Note – capital tax in Ontario will be removed effective January 1, 2008 for corporations in selected sectors, including agriculture (prorated for non-calendar year-ends)
  - Although Federal capital tax was eliminated, corporations still lose access to small business deduction where taxable capital exceeds \$10 million
    - No small business deduction once taxable capital exceeds \$15 million

## Incorporating the Farm

- Other Negative factors:
  - Ontario corporate minimum tax – Applies where annual gross revenue exceeds \$10 million or total assets exceed \$5 million
    - Where corporation exceeds either threshold, pre-tax income based on generally accepted accounting principles is subject to tax at 4%
    - Problem – tax can become payable where corporation has eliminated or reduced regular tax through the use of the cash basis income rules (GAAP is based on accrual accounting)



## Income Splitting Planning

- Agenda
  - What is income splitting?
  - How is Income splitting achieved?
  - Income splitting obstacles:
    - Attribution rules
    - “Corporation attribution” (benefit) rules
    - Kiddie tax
  - Income splitting strategies
  - The new pension income splitting rules

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## What is Income Splitting?

- Process of redirecting income within a family group to take advantage of other family members'
  - Lower tax brackets, and
  - Tax deductions & credits
- How?
  - Pay family members for services provided
  - By transferring income-earning assets from high-income to lower-income family members
  - Making elections to transfer a stream of income – CPP splitting, pension income splitting

## Income Splitting Barriers

- If it were only this easy...
  - Individual gifts property to a trust set up for their minor child and the trust earns investment income
  - An individual loans money to a low income spouse on an interest-free basis and the spouse earns dividends and capital gains
  - A top tax rate individual wants to loan funds to a low-income adult child without charging interest so that the child will have investment income (and parent can save tax)
- In each case, attribution rules will apply:
  - Income isn't taxable to the person who received it, and
  - Person making the gift or loan is taxed on the income

## Income Splitting Barriers

- Income attribution rules
  - Where funds are loaned with inadequate interest or gifted to a spouse (directly or through a trust – no purpose test)
    - Capital gains *and* income deemed to be income of the spouse making the loan or gift.
  - Where funds are loaned with inadequate interest or gifted to a minor child (directly or through a trust – no purpose test)
    - Income but not capital gains are attributed to the parent making the loan or gift
  - Where funds are loaned with inadequate interest to an adult family member
    - Was one of the main reasons for the loan to achieve income splitting/a tax reduction?
    - If yes, then income but not capital gains will attribute to person loan or indebtedness is due to

## Income Splitting

- Exception – Prescribed Rate Loans:
  - Interest charged on the loan at government's prescribed rate - currently 4% (updated quarterly)
  - Interest must be paid during the year or during the first 30 days of the following year
  - If a payment is missed, loan is tainted, and the income splitting arrangement would have to be re-implemented (the loan can't be untainted)
- For prescribed rate loan planning, key will be to ensure interest is paid on time!

## Income Splitting With a Corporation

- What if...
  - Wife is top-rate and has income producing assets, husband is low rate
  - Husband sets up a corporation
  - Wife loans funds to his corporation without interest (or buys fixed value preferred shares without dividends)
  - Corporation earns investment income and pays out after-tax amount to husband as a dividend
- Result – Corporate attribution rules and double tax:
  - Husband will still be taxed on any income he receives as dividends
  - Wife will be deemed to earn a taxable benefit at prescribed rate on the amount of the loan or preferred shares
  - Corporation doesn't get a deduction for benefit reported by wife

## Income Splitting With a Corporation

- Situation on last slide will be a concern where:
  - The person someone wants to benefit is a spouse or minor who is non-arm's length or a niece/nephew,
  - One of the main purposes of the arrangement was to benefit such an individual, and
  - The corporation is not a small business corporation (which is essentially a corporation where 90% or more of its fair market value consists of active business assets, including farm businesses)

## Income Splitting With a Corporation

- Amount of benefit =
  - Prescribed rate on the outstanding loan or value of the preferred shares, less:
  - The total of:
    - Interest paid (if loan)
    - Taxable amount of dividends
      - Actual ineligible dividend x 1.25
      - Actual eligible dividend x 1.45
- “Corporate Attribution” problem is generally avoided by ensuring the corporation is a small business corporation
  - For example, original example is acceptable tax planning where loan is made by wife so husband can buy farm property

## Kiddie Tax

- Minor children (not 17 at end of previous year) will pay top-rate tax on:
  - Private company dividends
  - Any shareholder benefits
  - Income earned from a family trust or partnership that derives income from charging for the provision of property or services to a family business.
- Income not caught:
  - Dividends from public corps.
  - Arm’s length interest
  - Capital gains or capital gains distributions from a mutual fund trust
  - Reasonable salaries

## Income Splitting Ideas

What works?

- Children
  - Pay reasonable salaries for working on the farm – still easiest form of income splitting
  - Interest free loans to minors (or more likely a trust/in-trust account) to earn capital gains
  - Registered Education Savings Plans – income deferred until child pursues post secondary education, and taxed in their hands (also get CES Grants)

## Income Splitting Ideas

What works?

- Spouses
  - Pay a reasonable salary
  - Make a loan to a spouse to buy business/farm assets – business income as a proprietor is not subject to attribution
  - Run the farm through a general partnership where both spouses are active (must ensure division of income is reasonable)
  - Ensure investment funds for low-income spouse maximized:
    - High income spouse pays expenses
    - High income spouse makes non-interest bearing loan to pay off personal debt of low income spouse
    - Exchange income and non-income producing property at fair market value

## Income Splitting Ideas

### What Works

- Corporations

- Corporate attribution is not a concern where 90% or more of assets are used in a farming business or other active business
  - Do an estate freeze to lock in value of current owner, or transfer unincorporated farming assets to a corporation as part of an estate freeze
  - Spouse/children (adults) or trust buys new growth shares
  - After-tax income paid to low-income family members as dividends
  - Ensure that at least 90% of the value of the corporation's assets at all times is related to farm or other business assets

## Income Splitting Ideas

### What Works

- Retirement income splitting:

- Saving for retirement - Use Spousal RRSPs (where one spouse does not have earned income)
  - Will still have more flexibility if spouses have RRSPs of approximately the same amount on retirement despite new pension income splitting rules
- Once retired:
  - Split CPP benefits (spouses elect to pool retirement benefits and each will be paid equal amounts)
  - Use the new pension income splitting rules – notionally split income when tax returns are filed

## Family Trusts

- Useful income splitting tool
  - Rather than having children/spouse buy shares directly, can hold these shares in a family trust for their benefit
  - Trust is usually discretionary, meaning:
    - Division of income decided each year
    - Division of the property held by the trust – property distributed or capital gain allocated at discretion of trustee
  - Powerful succession tool – when integrated with an estate freeze (farmers have more options given intergenerational rollovers)

## Family Trusts

- Main issues to consider:
  - Deemed dispositions – A typical discretionary family trust will have a deemed disposition every 21 years
  - Assets can be rolled out to beneficiaries at their tax cost
  - Most types of income/gains retain their character when allocated to beneficiaries (other than business income)
  - Reversionary trust attribution rules can apply without care (where person transfers property to a trust and can get property back or control ownership of it)
    - Income and capital gains belong to person who transferred the property, and therefore, can't be allocated to trust beneficiaries

## Pension Income Splitting

- Beginning with 2007 for Canadian residents
  - Can allocate up to one-half of income that qualifies for the existing pension income tax credit to their resident spouse/common-law partner
  - Allocated amount deducted in determining net income of the recipient and included in computing the net income of spouse or common-law partner.
  - They must both agree to the allocation in their tax returns for the year in question.

## Pension Income Splitting

What are the benefits?

- Amount split may be taxed at a lower rate if the spouse has less income
- Amount transferred to a spouse is deemed to be from the same source
  - Eligible for the pension credit if the spouse does not have pension income
    - \$2,000 for federal purposes
    - Generally \$1,000 (or an indexed amount) provincially

## Pension Income Splitting

What is “eligible pension income”?

- Annuity payments from a pension plan; and
- If received as a result of the death of a spouse or common-law partner, or if the pensioner is age 65 or older at the end of the year:
  - RRSP annuity payments
  - RRIF payments
- Note: Old Age Security and Canada or Quebec Pension Plan payments do not qualify (CPP splitting is possible under different rules)

## Capital Gain Rules for Farm Property and Tax Planning

## Capital Gain Rules

- Agenda
  - Will review two key rules for farm property:
    - Capital gains exemption
    - Intergenerational rollover
  - How to take advantage of these rules
  - Principal residence issues

## Capital Gains Exemption

### ***2007 Federal Budget Change***

- Under the pre-budget rules, up to \$500,000 of capital gains realized on the disposition of qualified property is eligible for the lifetime capital gains exemption (CGE)
- The budget proposed to increase the limit to \$750,000 for dispositions that occur on or after March 19, 2007
- Where multiple dispositions, determine how must arose on or after March 19, 2007
- For capital gains reserves, amounts that are taxed in 2007 and subsequent years that relate to dispositions before March 19, 2007 are limited to a \$500,000 exemption

## What Property Qualifies?

- Who can claim the exemption:
  - A Canadian resident individual or a spousal trust, having a capital gain on qualified capital property or qualified eligible capital property
  - Eligible taxable gains earned by other personal trusts can flow out to beneficiaries and retain their character for the purposes of the CGE
- Qualified farm property:
  - Real property or eligible capital property (ECP)
  - Shares of a family farm corporation of the individual or the individual's spouse or common-law partner
  - Interest in a family farm partnership of the individual or the individual's spouse or common-law partner

## What Property Qualifies?

- Real Property or ECP owned by **you**
- Is qualified farm property if it is **used** in a Canadian farming business by any one of the following:
  - you, your spouse or common-law partner, or any of your parents or children;
  - the beneficiary of a personal trust, or the spouse or common-law partner, parent, or child of such a beneficiary;
  - a family-farm corporation where any of the above persons owns a share of the corporation; or
  - a family-farm partnership where any of the above persons (except a family-farm corporation) owns an interest in the partnership
- “Use test” depends on when the property is acquired
- Child includes grandchildren and great-grandchildren plus children, grandchildren great-grandchildren of your spouse

## What Property Qualifies?

### ***“Use Test” – Pre-June 18, 1987 Property***

- Farm property that was used by a qualified user principally in the course of carrying on the business of farming in Canada by a qualified user either:
  - in the year you disposed of it, the property was used principally in a farming business in Canada, or
  - the property was used principally in a farming business in Canada for at least five yearsby any of the persons listed on the last slide, a family-farm partnership, or corporation, or by a personal trust from which one of the above individuals acquired the property
- Can be any 5 year period (not the last five year period).

## What Property Qualifies?

### ***“Use Test” – Post June 18, 1987 Property***

- Throughout the 24 months to sale, you, your spouse (partner), a child, a parent, a personal trust from which one of these persons acquired the property, or a family-farm partnership (in which any of these persons has an interest) must have owned the property; and meet one of the following two tests
- **Test 1:**
  - The property was used mainly in a farming business in Canada in which any of the above persons was actively engaged on a regular and ongoing basis, and
  - In any 24 months of ownership, the person's gross income from the farming business was larger than the person's income from all other sources in the year

## What Property Qualifies?

- **Test 2:**

- A family-farm partnership or corporation used the property for at least 24 months, mainly to carry on a farming business in Canada, and
- During this time, you, your spouse or common-law partner, any of your children, or your parents must have been actively engaged on a regular and ongoing basis in the farming business.

## What Property Qualifies?

- **Family Farm Corporation/Partnerships** (you are trying to claim the CGE as holder of the particular shares/interest) – Conditions to be met:

- 50% or more of corporation/partnership's assets used to carry on the business of farming in Canada throughout any 24-month period prior to disposition
- 90% of the fair market value of the underlying assets must be used in the course of carrying on the business of farming in Canada at the time of the disposition
- Farm business had to be carried on by the corporation/partnership, you, your spouse, and certain other entities

## Some CGE Issues

- Before claiming the exemption, there are a few considerations:
  - Loss of OAS – A taxable capital gain (even one against which the exemption is claimed) will increase your net income for tax purposes and potentially reduce OAS benefits (threshold for 2008 is \$64,718)
  - Loss of credits – similarly, many credits are based on net income including the age credit, GST credits and provincial credits.
  - Alternative Minimum Tax (AMT) – A large capital gain may trigger an AMT liability on your tax return.
- Tip – If selling, consider taking back debt – gain can be spread over 5 years (10 years if purchaser is a child)

## Some CGE Issues

- Before claiming the exemption, there are a few considerations:
  - A Cumulative Net Investment Loss (CNIL) or an Allowable Business Investment Loss may block your access to the exemption.
  - Remember the \$100,000 capital gains exemption ...
    - Any claim now is net of whatever portion the individual claimed under the old \$100,000 exemption
    - When it was eliminated in 1994, there was the ability to elect to create one final gain
      - If election was made on pre-June 18, 1987 property, you now have a post property

## Transfer to a Spouse

- No special rules – usual spousal rules apply
  - Rollover applies in respect of any capital property
    - Does NOT apply to
    - Farm inventory
    - Eligible capital property (quota) during spouse's lifetime
  - Capital property deemed to be transferred at cost base and therefore no capital gain or income triggered. The rollover is automatic
  - You can elect out of the rollover, so transfer happens at FMV
    - Can elect FMV transfer on asset by asset basis
    - Can't elect at an amount between cost and FMV the same way you can with a child (discussed next)

## Transfer to a Spouse

- No Special rules – Usual Spousal Rules Apply
  - Spousal transfers will be subject to attribution unless the transfer occurs at FMV and the transferor receives full consideration

## Intergenerational Transfers

- Rollovers are available where property is transferred to a child
  - Rules apply for transfers during the farmer's lifetime or on death (rules vary somewhat)
  - Child – same meaning as before
  - Eligible property for both rules:
    - land and buildings, or other depreciable property used in a farming business
    - shares of the capital stock of a family-farm corporation
    - interests in a family-farm partnership
    - NOT INCLUDED – Inventory
  - Eligible capital property (quota) eligible for inter-vivos transfer, rule is different on death

## Intergenerational Transfers – During Farmer's Lifetime

- For a tax-free transfer during the farmer's lifetime, there are two conditions
  - your child is a resident of Canada just before the transfer, and
  - the farm property is used mainly in a farming business in Canada in which you, your spouse or common-law partner, or any of your children were actively engaged on a regular and ongoing basis before the transfer (parent part of group after May 1, 2006)

## Intergenerational Transfers – During Farmer’s Lifetime

- Proceeds for a particular asset will be the greater of:
  - The cost amount of the property, or
  - The amount paid (not exceeding FMV)
- Can’t get a rollover where a child pays more than the cost amount, but can spread the gain on capital property out over 10 years if the purchase price is unpaid (i.e. debt taken back on transfer)
- Can’t trigger a partial gain to use the capital gains exemption if the child pays nothing – must issue a note for the proceeds amount you want to trigger

## Intergenerational Transfers – During Farmer’s Lifetime

- Example
  - Father wants to transfer some farmland to his son and does not need/want proceeds (he will have no farm property after the sale)
  - Father has not claimed his capital gains exemption
  - Cost of the farm property is \$400,000 and FMV is \$1.5 million
- Proceeds will be the greater of cost and the amount paid (not exceeding FMV)
  - Gift – proceeds will be cost, can’t lock in CGE
  - To claim full CGE of \$750,000, can transfer property in exchange for a note of \$1,150,000. Should not forgive the loan – settle the issue on death in the will

## Intergenerational Transfers – On the Farmer's Death

- Conditions for rollover:
  - the child was resident in Canada just before the parent's death.
  - the property was used mainly in a farming business in Canada on a regular and ongoing basis by the deceased, the deceased's spouse or common-law partner, or any of the children before the parent's death (parent added to user list after May 1, 2006)
  - the property was transferred to the child no later than 36 months after the parent's death (longer periods may be allowed with CRA permission if there are valid reasons)

## Intergenerational Transfers – On the Farmer's Death

- Comments:
  - Should the child predecease the surviving parent, it is possible to transfer the property back to the parent and then to a surviving child (i.e. a sibling of the deceased child)
  - But, it is not possible to transfer the property on a tax deferred basis to a sibling
  - Can create a capital gain on real property
    - Transfer of quota and other eligible capital properties are an automatic rollover on death – if deceased's exemption will be claimed on quota, must ensure this happens before death

## Intergenerational Transfers – On the Farmer's Death

- Watch estate equalizations!
  - Example – Plan is to transfer farm to one child, but that child is also suppose to pay toward the farm and the asset created goes to the off-farm child. Will simply splits the property equally
  - No Rollover?
    - Active child buys farm from estate for \$1,000,000 note payable over 10 years (farm worth \$2 million)
    - \$1,000,000 distributed to off-farm child
    - Unclear – was transfer as a consequence of death given will was silent?
  - May make sense to transfer property during farmer's lifetime and give the passive family members an ability to participate in an arm's length sale

## Claiming the Exemption – Combining the Intergenerational Rollover Rules

- Goals
  - Transfers within the family:
    - Ensure farm owner claims CGE on accrued gains when property is transferred to next generation (or before)
    - Access capital gains exemption of spouse
    - Parent can sell farm property to a child as a gift or by way of note or through will
    - Amount is equal to tax basis plus \$750,000 if no exemption has be claimed in the past (can't be a gift if inter-vivos)
  - Where property will be sold outside of the family, try to maximize the CGE's belonging to all family members (spouse and children) – planning in advance definitely needed

## Accessing a Spouse's CGE

- Where spouse does not own property, getting a CGE for your spouse during your lifetime will be difficult
- Problem – Attribution – where property is transferred to a spouse, gains will attribute to you
  - Exception – Where property is transferred at fair market value (and consideration is paid)
  - Problem – spouse can only claim CGE on economic growth after the transfer
  - Having spouse as original owner will be beneficial

## Accessing a Spouse's CGE – On Death

- Where farmer dies – Property can transfer to spouse, and spouse can claim CGE
  - Issues:
    - What if spouse predeceases the owner?
    - Must make sure property vests with spouse (carefully examine situations where someone else has already agreed to buy property on your death or you have agreed that the property will go to a child)

## Accessing a Child's CGE – External Sale

- It is possible to use intergenerational transfer to a child, and have the child claim the CGE
  - Attribution won't apply, but there is an anti-avoidance rule to watch:
    - Where property is rolled over to a related person (other than a spouse) to take advantage of that other person's CGE, the rollover is "rescinded" retroactively where the other person claims the CGE
    - Exception – Where the property is held for 3 years or more by child/trust
  - Should also review farm property rules to ensure that property qualifies in the hands of the child/trust (i.e. apply rules, from perspective of child)
  - So - Farm succession by way of outright sale should be begin at least 3 years before the sale

## Using the CGE on Incorporation

- Where a farm proprietor owns farm property that qualifies for the capital gains exemption (CGE), can utilize CGE on incorporation
- On the transfer (using a tax rollover)
  - Elect to trigger a disposition with proceeds equal to the cost of the property plus the CGE available
  - Proceeds from the corporation – debt equal to proceeds amount selected plus shares for the rest of the value of the farm property
- As income is earned in the corporation (presumably at the small business rate), the earnings after corporate tax can be paid as a note payment

## Using the CGE on Incorporation

- Once the note is paid off, future after-tax earnings could be paid out as a dividend.
- Alternative – could have corporation assume debt you have now as non-share consideration and use small business income to pay off the debt faster
- **Won't work** – On a transfer of shares of a family farm corporation to another corporation controlled by the family and certain other corporations

## Using the CGE on Incorporation

- Example – qualifying farm property has a cost of \$200,000 and is worth \$1.2 million. Farmer has not used CGE.
  - Property is transferred to corporation, under rollover rules, select proceeds of \$950,000.
  - Gain is \$750,000 (\$950,000 - \$200,000) and CGE is claimed to offset
  - Consideration received - \$950,000 note from Farmco and shares of Farmco worth \$250,000
  - As Farmco earns small business income, it can be paid out as a debt repayment.
  - Corporation has higher cost base of \$950,000 that is available on a future sale

## Some Final Comments

- The definition of eligible property for the intergenerational rollover rules are not the same as for capital gains exemption rules
  - Full-time farmers likely don't need to worry, but watch periods where the property isn't actively farmed
  - Example – Bought land in 1985, farmed it actively until 1992, rented to unrelated neighbour from 1992 to 2007
  - Result:
    - No rollover to child allowed – wasn't used actively by owner/family member before time of sale
    - Can meet the "old" 5 year CGE rule – was used in a farming business for 5 years

## Some Final Comments

- Even with CGE (and ability to multiply potentially), rollover rules still important:
  - Depreciable real property – a rollover avoids recapture of tax depreciation
  - Quota – Cost of quota can be amortized – a rollover of quota will again avoid recapture
- Where exemption is claimed on an asset that can be depreciated/amortized, a family member's/corporation's depreciation base will be reduced by exemption amount

## Principal Residence Issues

- Farmers allowed same exemption as all individuals (where the home is held personally)
  - Main issue will be how much of the land was used for the use and enjoyment of the residence
- Also allowed to use an alternative method where farmland is sold with a residence – can basically reduce the capital gain on real property by \$1,000 for each year since the property was last acquired.

## Principal Residence Issues

### ***Determining the value of the residence***

- Since there is basically no market for the residence “as is”, the CRA allows two ways to administratively determine the value:
  - Method 1 – use comparable residential lot
    - Determine the FMV for a comparable residential lot in the area and use that as an approximation of the value of the land
    - Determine the value of the house
  - Method 2 – Use the average value of the farmland being sold as an approximation of the value of the residential portion of the farmland and then add the value of the house
- Note – CRA expects that the same method would be used to determine the cost as well (i.e. can't use method 2 for the cost and method 1 for the proceeds), since the idea is to estimate appreciation

## Principal Residence Issues

### ***How much land?***

- Rules refer to ½ hectare (CRA farming guide talks about approximately one acre)
- Can attribute more provided that you can prove the extra land was required for the use and enjoyment of the residence
- Cases very fact specific – much of the analysis now based on what can factually be conveyed/how much land required to be held legally to reside on the property
  - One common factor – what is the minimum lot size in the area under municipal by-laws?

## Estate, Retirement and Succession Planning Revisited

## Planning Requires Effort to be Successful

- The objectives of the current owner and next generation must be determined
- Structure the succession of the farm business around the family's vision for the future
- Tax and estate planning will be a very important component, but ...

*Tax should not be the motivating force*

## What Exactly is Estate Planning

- Main Objectives
  - Maximize the value of your assets, including the preservation and protection of property during your lifetime
  - Minimize and defer tax and other costs arising on your death
  - Allow for an orderly transition of assets to your beneficiaries and
  - Provide for your dependants, which can include decreasing their taxes where possible.

## General Issues to Discuss

- Will the parents transfer complete ownership?
- How will management decisions be made?
- If the parents are retiring, what are their income expectations?
- Can the farm afford to pay off any debt the parents take back on the transfer of ownership?
- How will off-farm children be treated?

## General Financial Considerations

- Evaluate cash needs
  - Tax payable (if any) on death plus probate fees where applicable
  - Equalization of inheritances to off-farm children (passive assets required)
  - Retirement income for parents – Can farm support two families?
  - Funds required to provide a viable farming operation
  - Funds for expansion of farming operation
  - Payout of existing indebtedness

## Estate Freeze

- How an estate freeze works (in general):
  - Common method of freezing involves founder's tax-free transfer of shares of an operating company or other property to a holding company in exchange for fixed-value preferred shares of the holding company (or transfer of business assets as a proprietor to a new corporation)
  - Alternatively, could exchange existing common shares for new fixed-value shares of the same corporation
  - Founder's heirs then subscribe for growth (generally common) shares of operating company

## Estate Freeze

- How an estate freeze works (in general) – con't.
  - As value of business grows, growth accrues to common shares held by family members (or a trust)
  - Freeze locks in tax liability so you can plan more effectively
  - Founder's preferred shares can be voting or founder may take back a separate class of voting shares – this allows founder to retain control
  - Once freeze in place, a business owner may then acquire insurance to pay the liability that will arise on death (being tax on the accrued gain to date)
  - Will often combine with a crystallization of the capital gains exemption

## Estate Freezes: Integration With Farm Rules

- Premise for estate freeze will be different for farm property, given that it can be transferred to a child on death at cost
- That said, there are still reasons for an estate freeze:
  - Income splitting with a non-active spouse – Due to the attribution rules, income and capital gains attribute where a property is transferred at cost
    - With an estate freeze, spouse uses own funds or funds borrowed from a third party to acquire shares from treasury at an affordable price
    - Future sale of the shares will not attribute either, allowing a capital gains exemption

## Estate Freezes: Integration With Farm Rules

- Desire to allow children to participate in growth
  - An estate freeze allows the senior generation to lock in value, and future growth will go to next generation
  - Gives those working on the farm an interest in the business
  - Difficult/expensive to transfer a direct interest in farm on such a basis
  - Can use same concepts in a partnership, although legally easier in a corporate settling

## Estate Freezes: Integration With Farm Rules

### Is corporation only doing farming?

- Example: Corporation owns vineyards and grows grapes. Originally, the corporation sold the grapes to local wineries. However, over the past 5 years, the company has opened its own winery and 30% of its assets are now associated with this activity
- Issue – Good chance it is not a family farm corporation – considerations:
  - Would have made sense at time to separate the winery operation in a new corporation (and this still may be possible)
  - If not separated (or too difficult to separate now), an estate freeze can make sense before value grows
  - Company can still qualify for capital gains exemption as a qualifying small business corporation

## Retirement Planning

- Two schools of thought:
  - Try to put aside funds while active to fund retirement
    - You will be less of a drain on the farm during your retirement
    - May provide some surplus funds to deal with estate diversification on death
    - RRSP/individual pension plan allow deduction for money put aside
    - Reinvest small business income at the corporate level (perhaps by way of a holding company)
  - Leverage off of the value of the farm during retirement
    - Most consider inadvisable to rely on this for non-farm businesses where the business value is goodwill – lack of security/guarantee – will value still be there when you need it
    - For farm business, similar security issues exist – value of quota for example can change significantly due to market issues for underlying commodity

## RRSP Limits

| RRSP Contribution Limits |   |   |
|--------------------------|---|---|
| Year                     | Maximum contribution allowed for the year | Earned income required in preceding year (for maximum contribution) |
| 2007                     | \$19,000                                  | \$105,556   |
| 2008                     | 20,000                                    | 111,111   |
| 2009                     | 21,000                                    | 116,667   |
| 2010                     | 22,000                                    | 122,222   |
| 2011                     | Indexed                                   | Indexed   |

## Sources of Earned Income

- From perspective of a farmer:
  - Direct farming income
  - Rental income from the rental of farmland/quota (losses must be netted against other sources of earned income)
  - Farm income allocated by a partnership
  - Salaries and other remuneration from a family farm corporation

## Retiring Allowances and RRSPs

- Pay a Retiring Allowance
  - Corporation/employer can pay:
    - \$2,000 for each year of service before 1996, plus
    - \$1,500 for each year of service before 1989, if not a member of a company pension plan
  - Deductible to the corporation/employer
  - Can be rolled into an RRSP by the recipient
- Considerations
  - For farmer - must have a corporation, and corporation must have been in place for each year of service (years as a proprietor or partner won't count)
  - Could pay a retiring allowance to a spouse if spouse had been an employee of the farmer
  - CRA generally won't question a retiring allowance's deductibility when limits above are not exceeded and employment was bona fide (even if remuneration wasn't paid in a given year or was low)

## Individual Pension Plans / IPPs

What is an IPP?

- Defined benefit RPP set up for one person
  - Where farmer has incorporated, can use an IPP based on the salary paid by the corporation
- Profile
  - Earns enough income to make maximum RRSP/IPP contributions (currently \$111,111) as an employee
  - Is actually making maximum RRSP contributions
  - Generally age 45-50 minimum (or better, over 50)

## IPPs - Advantages

- Higher contributions compared with RRSP and money purchase RPP
  - Possibility of contributions for past service
- Better asset protection when compared with RRSP
- Ability to correct for poor investment return
  - Can ensure there is enough money in deferred plan for retirement – specified level of retirement income is guaranteed
- Longer contribution window when compared with RRSPs

## IPPs - Disadvantages

- IPPs are subject to pension standards legislation
- Compared with nominal or no costs for an RRSP, IPPs have more substantial set up and annual costs (although these amounts are deductible)
- Future contributions reduced where investment performance exceeds expectations
- RRSP contribution restrictions – basically all but \$600 of RRSP room eliminated
- No spousal contributions (but new pension income splitting rules available)

## Retirement Funding – From the Farm

- Sources of income/funds:
  - Reasonable wages or director's fees (must be reasonable compared with services provided)
  - Debt repayment – where assets transferred to a child
  - Dividends where you have incorporated
    - If you did an estate freeze, could actually have freeze shares redeemed:
      - Dividend amount is the same anyway, and
      - Reduces the accrued gain that someone will pay tax on eventually (i.e. if someone sells shares)
  - If a family farm partnership is used – reasonable share of profits when compared with services/capital provided
- All dependent on ability of farm to support the cash flow

## Estate Diversification: The Fair vs. Equal Issue

- Problem for most businesspeople, issues generally harder to deal with for a farm (where multiple children)
  - High concentration of assets in the business
  - High asset value needed to generate income
    - Income may only support one family
  - Family home is on the farm
  - What if farm successor sells the farm shortly after parents death? (issue – how do you protect other children while ensuring you get the intergenerational rollover?)

## Estate Diversification: The Fair vs. Equal Issue

- Suggestions:
  - If you plan far enough ahead – insurance
    - Provide liquid assets on death
    - Whole life/universal policies have a savings component that basically accumulates tax-free
  - Are there redundant/nonessential farm assets?
  - Lease the farm property with purchase options
    - Passive children hold asset, active child pays rent and farms the property
    - Many business advisors don't like separating a business asset from those running the business
  - Variable ownership could work better with a corporation – non-active children could get a non-voting interest that can be liquidated over time?
  - Inter-vivos farm transfers vs. transfers on death

## Will Planning

- Always important that Will coordinates with succession plan, but especially for farming
  - If no succession planning, assuming there is a will, it may leave the “wrong property” to the “wrong people”
    - Family issues – in terms of disharmony
    - Tax issues – there isn't a rollover between siblings to reallocate assets among the children
- Needs to be updated regularly to reflect:
  - Changes in succession plans/business arrangements
  - If farm property is sold – dynamics/issues and general plan will change substantially for most
  - Children becoming old enough to take over farm
  - Change in marital status (any family member)

## Will Planning

- Things to consider
  - Executors empowered to make any tax election or decision
  - Assets can be distributed in kind
  - Compare where asset is going and where any related tax is being paid
    - Watch – direct beneficiaries of RRSP/RRIF/Insurance
    - Farm property passes without tax, other assets will attract tax – ensure tax burden shared appropriately
  - What if child getting the farm decides to sell it?
    - Can try to impose restrictions or purchase options through will, but this may mean property doesn't vest with child, and no rollover

## Will Planning

- Consider testamentary trusts - to access low tax rates
  - Testamentary trusts pay tax at graduated rates and can have a non-calendar taxation year
  - One trust can be set up for each beneficiary's share of the estate to provide a saving (where they are paying tax on their income at a higher rate).

## Probate Tax

### Planning Techniques in General

- In general terms, probate tax reduction is achieved in one of two basic ways:
  - Transfer ownership of property before death - reduces value of assets held on death where probate does have to be sought with respect to certain assets, or
  - Use a will substitute to convey the property so that there is no estate property where probate is needed
- Main issues for farmers:
  - Will other steps reduce probate at the same time (for example, a transfer of farm property to a child)?
  - Will any probate steps taken impact farm property rollovers or any other income tax rules in general?

## Probate Planning

- Main Probate Tools:
  - Outright gifts/sale of farm property for less than FMV
    - Reduces value of estate in general
    - Probate would be a secondary benefit through – ensure that such a transfer makes sense in general and for income tax
  - Joint Ownership
    - Idea is that asset passes to joint owner(s) on death outside of Will
    - Issues:
      - Could cause an income tax disposition
      - May cause legal uncertainties around who has beneficial ownership (transfer could be to family member in trust or as a gift) plus exposing asset to legal issues
      - Use with caution!

## Probate Planning

- Main Probate Tools:
  - Special purpose trusts (alter-ego trust or a joint partner trust)
    - Allow individuals to put assets in a trust, and future distribution will be governed by trust when one/both beneficiaries deceased
    - Act as a will substitute
  - Issues
    - These trusts are not part of the farm property rollover rules – rollovers for property once it is in the trust could be problematic
      - Could be useful however for non-farm assets
    - Can't benefit from a testamentary trust

## Probate Planning

- Direct designations – Insurance/RRSPs/RRIFs
  - Name beneficiary directly in policy/plan, asset transfers to beneficiary outside of the will
    - No distinction here for farmers
  - Issues:
    - RRSPs/RRIFs – Estate bears the tax but doesn't get asset, so will cause issues where RRSP/RRIF value not distributed in same pro-rata share
    - RRSP/RRIF beneficiary is jointly liable for tax, but concern is that CRA will try to collect tax from the Estate first.
    - RRSP/RRIF – no testamentary trust
    - Insurance – appears possible to name unfunded trust as beneficiary, trust will be testamentary

## Probate Planning

- Ontario and Multiple Wills
  - Wording of Ontario rules imply that probate tax only applies to assets covered by the will and ownership of shares of a private company can be transferred without a probated will
  - Use one will (probated) for most assets, use second will for private company shares (not submitted for probate)
- For farmers:
  - Could be useful where a family farm corporation is used.
  - Presumably would be one factor to consider, and not reason for incorporating specifically

## **Case Study – Estate Planning**

George is a 57 year-old dairy farmer and his wife Mary is 53. They have 3 children:

- John – Age 28, who with his wife Emily, lives on the farm. They have 2 children and Emily is a full-time mom.
- Amanda – Age 21, who currently has a retail position in a store in a nearby town (she still lives on the farm). She started her job when she graduated from high school. Her income is fairly low.
- Cheryl – Age 17, who will be going to university to study law.

Most of the farm assets have been acquired by George alone – most of which was acquired from his father. He has also bought quota over the years, and has claimed amortization of about \$150,000. The farm assets are as follows:

|                      |             |
|----------------------|-------------|
| Land                 | \$2,500,000 |
| Buildings            | 400,000     |
| Equipment            | 350,000     |
| Livestock, feed etc. | 300,000     |
| Quota                | 3,000,000   |

A friend and neighbour just transferred the farm to his son, and this has prompted George to begin thinking about whether he should do the same thing.

The couple has not accumulated much in the way of other assets and they hold only a small amount of life insurance.

What are the estate and tax planning opportunities available to the family?

## Case Study

- First thing George (and the family) needs to do is determine what his long-term goals are
  - When does he want to retire?
  - How do George and Mary want to divide their estate?
  - Does George want to pass on the Farm to John? (does John want to work on the farm on a long-term basis?)
  - How will George be fair to his daughters if John takes over the farm?
  - Should he provide more financial support to Amanda given Cheryl's career path?

## Case Study

- Potential Opportunities/More Information Needed
- Income Splitting
  - What is George's income? If he is in a higher bracket, there should be some income splitting opportunities:
    - Mary (no information on her income)
    - Cheryl – who will presumably be low income for a few years (non-active)
    - Emily (non-active)
    - Amanda (non-active, low-income)

## Case Study

- If Income Splitting makes sense:
  - Ensure family members paid (reasonably) for any services they provide
  - Could incorporate
    - Transfer inventory and business assets other than quota and land – will make claiming the capital gains exemption easier
    - George would take back estate freeze shares plus voting shares to retain control (or estate freeze shares with votes)
    - Family members, or a discretionary family trust could subscribe for common shares
    - Dividends could be paid to low-income family members (watch issues around Cheryl's tuition at university and tuition carryforwards/transfers)

## Case Study

- Incorporation and Capital Gains Exemption issues
  - Should quota and land be transferred to the corporation?
    - Exemption can be claimed without incorporation
  - Could transfer land to corporation for debt and claim the capital gains exemption
    - Quota – if CGE claimed on it, will trigger a recapture of prior amortization
    - Keep outside the corporation if possible and use exemption later
    - Will need to determine what the accrued gains are and plan ahead for CGE claims

## Case Study

- Farm Transition issues
  - Current Farm property plus shares of a family farm corporation (if set up) can be rolled to children
  - Capital gains exemption planning:
    - Will depend on the goals of the family – family succession vs. outright sale
    - Planning does need to be done in advance, so you need an idea of what will happen
    - For example, if a sale:
      - Transfer property to spouse so value can appreciate?
      - Set up possibility of creating an eligible gain in the hands of the children – must happen 3 years or more before a sale

## Case Study

- Farm Transition issues
  - Should farm be transferred during George's lifetime or at death?

## Case Study

- Other Issues
  - What is George doing for retirement?
  - Has he looked into estate diversification
  - Is probate planning possible?
  - Does George have a will and is it tied into his succession/estate plan?
  - Does he have disability insurance and a POA?