Family farm succession

Estate and tax tips to help keep the family farm in the family

Every business has its own distinct features, but farming really is in a field of its own. The intimate connection between economic activity and family dynamics feeds into farming operations, and in turn, into farm succession.

This complexity presents both challenges and opportunities for farmers looking to transfer the farm in an effective and efficient manner. Fortunately, with astute estate planning and strategic application of targeted tax rules, a family farm can indeed be passed successfully down generations.

What's so special about farm succession?

Nature of the business

Farming is both capital and land intensive, together reinforcing the need for a long-term view and a long-term commitment. Arguably, it's the prototypical asset-rich/cash-poor business. But, adopting a positive planning perspective, it may be more helpful to think of it as a call to farmers to be vigilantly cash-conscious.

Like other businesses, the farm is usually both the main income source and the main store of a farmer's wealth. It's the classic goose and golden egg, with the added element that the farm is also traditionally the family home.

Three-legged succession planning

This intertwined nature may have a farmer feeling paralyzed at the prospect of having to corral everything into a cohesive succession plan. To make it manageable, it may help to approach it as three legs of a succession stool:

Retirement plan

- Will the farmer/couple continue to live on the farm in retirement, or is another living arrangement intended?
- What kind of retirement lifestyle do they envision, and how much income is needed to fund that?
- What non-farming savings will provide that income, and will it need to be supplemented by farm income?
- If there is a projected shortfall, will retirement be adjusted or might some farm assets have to be sold?

Farm management plan

- Have the successor(s) been identified, have they committed, and is there a clear transition timeline?
- Are there gaps in the successors' farming or management skills, and how long will those take to upgrade?
- Are there any critical employees, and how has their continuing involvement been assured?
- Has the business been analyzed and documented to make it as turnkey as possible for the successors?

Heir/ownership plan

- Will ownership transfer be by sale, by gift, by bequest out of a parent's Will, or a combination of these?
- Will the successors own the farm outright, or will non-farming family members also have an interest?
- If so, how and when will they get their part of income or assets, and what legal changes might facilitate that?
- If not, will the estate be equalized/'equitized' with other property, or will life insurance be used as a stand-in?

For each planning leg, the questions are openers to help organize thoughts and couch expectations of what lies ahead. As in any planning exercise, initial intentions will have to be balanced with practical constraints, possibly leading to difficult trade-offs among farmer, farm and family.

The goal is to make sure each leg is stable on its own, and that together they comfortably support the succession that rests upon them.

Estate planning foundation

Choosing heirs is obviously a key decision, but estate planning is much more than that. Ideally, it comes out of a focused review of a person/couple's own needs, available resources and wishes for others, followed by legal steps to carry out the plan.

For many people's estate planning, it can be sufficient to execute powers of attorney (or equivalent legal document for the province) to name someone to make decisions in the case of incapacity, and a Will to deal with property at death, possibly including some brief trust provisions to allow for unexpected contingencies.

For farmers, these core documents will likely need more detailed drafting, possibly accompanied by one or more trusts or corporations. In addition, intended successors may be asked/required to revise and coordinate their own estate planning, including executing domestic contracts to protect against potential marital claims if there is a future relationship breakdown.

This is particularly important with family farms, where financial viability can hinge on keeping the whole intact, and sustaining the scale and momentum of the enterprise.

Targeted tax rules allow flexibility in farm transfers

Alongside economic and interpersonal issues, a major concern in family farm succession is the spectre of tax. When capital property is transferred, tax is generally levied on the capital gain. Ironically, that could cause a profitable farm to be the victim of its own success. Having committed substantial time, effort and resources into the business, a farmer may have only one place to get the cash to pay the tax on its transfer – *the farm itself!*

Happily, there are a number of rules in our tax system designed to help farmers defer, distribute or eliminate the tax that would otherwise apply on farm property transfers. The key provisions are summarized below, understanding that the qualifying criteria are complex, both for the property and the people involved. Consider this to be a high level overview of options and issues to be explored in-depth with the farmer's own tax professionals.

Lifetime capital gains exemption

The lifetime capital gains exemption (LCGE) can eliminate tax on up to $1 million of capital gains when transferring qualified farm or fishing property. This is shared with the exemption on small business corporation shares which stands at $892,218 in 2021 (i.e., the combined maximum is $1 million). The latter is indexed annually, and once it exceeds $1 million, the two will index in lockstep thereafter.

Planning points

- The LCGE can be claimed by individuals, or by partners when gains are allocated from a partnership. A corporation can't claim it, but shares of the corporation may qualify. (See "qualifying farm property" below.)
- The principal residence exemption (PRE) is available in addition to the LCGE. There are two methods for calculating the PRE when a home is situated on a farm, and the farmer may choose the method that is most advantageous. The PRE may be claimed by individuals and possibly by a partner, but not by a corporation.
- A large capital gain in one year (even if claimed/reduced using the LCGE) can affect eligibility for income-tested benefits in the following year, including Old Age Security, Guaranteed Income Supplement, Canada Child Benefit, G/HST refundable tax credit, age credit and possibly some provincial tax credits.
- Alternative minimum tax (AMT) is often triggered when LCGE is elected, as it brings the non-taxed half of capital gains into income. AMT is recovered as a credit against taxes payable for up to seven years.
- A parent realizes a capital gain when selling shares to a child, but historically this has been deemed to be a dividend (at higher tax) when selling to a child's corporation. Bill C-208 was passed in June 2021, amending this rule to allow capital gains treatment. Implementation legislation and potential amendments are pending.

Qualifying farm property

For the LCGE, qualifying farm property includes land and buildings, shares in a family farm corporation, an interest in a family farm partnership, as well as quota and other intangible assets used in the farm business.

The property must be principally used in farming by the individual, a spouse or common-law partner (CLP), child or parent, or by a farm corporation or partnership belonging to one of them. If the property was purchased before June 18, 1987, this requirement can be met if it is being farmed on the date of sale or had been farmed any five years while owned. The use rules are more stringent if purchased after this date, including having to show that gross farm revenue was more than all other income sources over a two-year period during ownership.

Planning points

- Equipment, machinery and inventory are NOT eligible for the LCGE if they are personally owned. However, if those assets are held within a family farm corporation or partnership, their value will contribute to the value of the respective corporate shares or partnership interest, which in turn may be eligible for the LCGE.
- According to the Canada Revenue Agency (CRA), it may not qualify as farm property if the land is leased or is under a sharecropping arrangement. Consult a tax advisor to determine how to meet CRA's requirements.
- When the $100,000 personal capital gains exemption was eliminated in 1994, individuals were allowed to increase their adjusted cost base (ACB) on their property by up to $100,000 that year. Even if farm property was owned prior to 1987, the owner would be deemed to have disposed and reacquired the property in 1994.

Tax-free rollover to a child

When farming or fishing property is transferred to a child, the parent may choose a disposition value between cost (ACB for capital property, or undepreciated capital cost for depreciable property) and current fair market value. This can postpone the tax until the child sells the property. The child must be resident in Canada, and the property must have been actively engaged in farming or fishing activity on a regular and ongoing basis before the transfer.

The transferee may be a natural or adopted child, grandchild or great-grandchild of the individual or of a spouse/CLP, or a spouse/CLP of that person. It may also be someone who, while under the age of 19, had been financially dependent and under the custody and control of the transferor.

Planning points

- If a parent dies before a transfer has occurred, the rollover may also apply on transfer from a parent's estate.
- If a child dies before a parent, the rollover will not be available to the deceased child's spouse/CLP.
- If a rollover to a child has been made and the child later dies, the property may be rolled back to the parent.
- If a child sells to a third party within three years of the transfer from the parent, that original transfer will be deemed to have occurred at fair market value for the transferor, effectively undoing the rollover.
- Though it is possible to use this rule to transfer to minor children, if the property is sold to a third party while the child is still a minor, the resulting capital gain will be deemed to be the parent's.
- An estate freeze is a technique used to shift tax on future capital gains to later generations. These rollover rules make it unnecessary to do an estate freeze for tax purposes, but a freeze may still be used to provide ownership certainty to the next generation, and to provide comfort of continuity to the parent farmer.
- The rollover can be used vertically between generations, but not laterally between siblings. Farmers should take this into consideration when deciding when and how to structure a succession.

Tax-free rollover to spouse

Any capital property (not just farm property) may be transferred by rollover to a spouse/CLP, but any income or capital gains arising out of that property will be attributed to the transferor under the spousal attribution rules.

Alternatively, if it is a purchase at fair market value, the spouse/CLP will be taxed on the year-to-year income and realized capital gains, achieving some family income splitting. Even better, when that property is later sold, this ensures that the capital gain is realized by that spouse/CLP, against which the LCGE may be claimed.

Extended capital gains reserve claim

Generally, a capital gain is recognized and taxed in the year of disposition. If payment is deferred, the taxpayer may elect to recognize the gain across as many as five years, being the year of closing plus four years.

For disposition of a family farm, a fishing property or small business corporation shares to a child (using the same extended definition of child outlined above), the reserve period may be as long as nine years following the year of disposition, spreading the tax liability across as many as ten years.

Seeking professional advice

Business succession planning can be a challenge, with farm succession being a breed unto itself. Add in family dynamics, and things can get especially complicated.

While there are many tax rules designed to facilitate family farm succession, they are most effective when applied in the context of each particular farmer, farm and family. Through early engagement of qualified legal and tax advisors – and with the commitment and participation of all affected family members – a farmer can be confident that the family farm succession will indeed be a success.

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