Estate and Tax Planning for Succession

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Take Home Messages

- There are numerous personal and family issues confronting family farms relating to inter-generational farm transfers
- There are complex planning, tax and accounting issues relating to farm succession conveyance
- There are solutions, and there are rewards for confronting these difficult issues

Tradition

There is a tradition among farmers of transferring the farm from one generation to the next. One cannot help but think that our forefathers, when breaking the virgin sod, and young farmers borrowing money to buy their first quarter of land, both had a feeling of the heritage of the undertaking that they were commencing. Certainly they started the farm for themselves and their spouses, but they also recognize the concept of family, and the heritage of the farm passing from one generation to the next. What farmer working the fields or going to care for livestock does not have the thought in mind that the labour is really a family undertaking. What farmer has not thought about the joy of passing the farm onto his or her descendants? This is a great heritage shared by farmers throughout the world. That being said, the transfer of the family farm from one generation to the next is not an easy task.

The purpose of this paper is to first address personal family issues relating to the transfer of the family farm on an inter-generational basis. Then this paper will discuss the general taxation issues involved in a family farm transfer.

▪ Family Issues

The Decision to Transfer

Business taxation and accounting issues are purely secondary in determining the mechanics of the transfer of the farm. These concepts can be addressed and handled by professional advisors and sophisticated agricultural producers who becoming more and more knowledgeable about the rules relating to inter-generational transfers. The key is to properly address the decision to transfer the farm and all the issues that the decision entails.

In some situations the transfer of the family farm from one generation to the next is a necessity in that it is the only way that the farming parents could be able to afford retirement, as the sale of the farm to third parties might not generate sufficient funds to provide them with adequate resources to enjoy their golden years. Generally, however, the farm transfer is done for family and business reasons to provide the next generation with a life style and livelihood, and to maintain the retiring transferors in a reasonable manner.

Parents Needs

When considering the transfer to the next generation one has to primarily look at the concerns of the farming parents. The age and physical condition of the primary farmers are major issues. At what age is it appropriate to start or entirely see to the disposition and transfer of the family farm? Unfortunately, many farmers feel that they should hang on until they have to find a tractor that is wheelchair accessible. This is not an uncommon situation. The transfer of the family farm means that the family has to consider the mortality of senior farming members. It is difficult to admit that you or your loved ones are going to die.

Many farmers don't address the issue and adopt the philosophy that "my children are good children, they will decide what to do amongst themselves, there won't be any fights." This is probably the worst thing that any farmer could do to his family. Traditionally, estates bring out the worst in any family. It is doubtful that you will encounter a family where the family farm can be transferred at the discretion of the survivors in a way that will maintain equity and preserve the farm without causing some kind of family turmoil of a monumental scale. That being said, any transfer must be undertaken primarily to benefit the senior generation as it must provide them with both personal and financial security.

Children's Needs

The needs and concerns of the farm children are often overlooked. Consider the position of a 30-year-old farmer with a spouse and one or two children who has to get up every morning and work on "Dad's farm." Is he or she properly caring for the needs of their family? What if the child doesn't inherit the family

farm? How will his or her family be maintained? Can a child confront that child's parents and demand that some portion of the farm be transferred, or that some commitment be made so that he or she will inherit or take over the farm? Only rarely. When does the child make the decision that he or she has to either leave the farm or confront the situation and effectively demand that the farm be passed on? Should a child force its parents to admit their mortality? Many farmers just don't have the ability to confront these issues and make the difficult decisions that have to be made. Anyone reading this article knows of friends or associates who cannot make these difficult decisions. It is hard to say, "I am sorry" from the grave. These decisions are difficult, but they must be made.

Sometimes farmers have no confidence in their offspring. It is amazing how many senior farmers do not have sufficient belief in the capacity of their children. Because of their senior leadership role as the titular head of the family as well as the CEO of the agricultural operation, the father may feel that his children just don't have the business background and family leadership experience to make proper risk management and other decisions. Experience would indicate that responsibility and ownership enhance maturity and decision making ability.

Non-Farming Children's Needs

What about the child who is working on the farm and is expected to take over, but doesn't want to farm? What about the other children? Consider the issue of sibling rivalries. How do you make a decision to pass on the family farm onto one child and not equally divide it amongst all? The European example shows that the constant dividing of farm properties amongst family members results in the creation of multiple non-productive economically non-viable operations that cause family conflict, and economic hardship. Decisions have to be made to maintain the economy of scale. How can this decision be made? There are certain vehicles that can be used, such as providing payouts over time, using insurance funding, transferring non-farm assets etc. These can save the relationship, but are complicated steps.

Life Insurance and RRSP'S

For the purpose of providing fairness, farm families should probably spend more time considering the utilization of non farm assets including life insurance and annuities together with the utilization of RRSP's (which transfer usually creates hideous tax results) for the purpose of providing for non-farming children. Sharing premium expenses even amongst those children who will receive benefits and the utilization of companies is often worth a second look.

Extent of the Problem

The seriousness of this problem is such that it is quite likely that a majority of farmers will not confront the issues described above until it is too late. In April of 1994 a major study was done at the University of Western Sydney at

Hackberry in Australia of senior farmers with adult children. Forty two percent of those canvassed had not discussed inheritance of the family farm with their spouse. Sixty three percent had not discussed it with their children and eighty four percent had not spoken to their daughters-in-law. This issue is not restricted to farmers. The Canadian Imperial Bank of Commerce's Financial Health Poll conducted by Compas Inc. in September of 1998 polled 1,007 adult Canadians; fifty percent did not have a will.

▪ The Decisions Are Just Starting

Questions

Once a farmer has decided it is time to commence passing on a portion or the entire farm other issues have to be addressed. There are the questions of control, training, sharing of responsibilities, residences, financial contribution, matrimonial property issues, transfer timing, security, and cash flows. The list goes on and on. It is any wonder that these decisions are hard to make?

Control

One of the hardest decisions a senior farmer has to make is to pass some element of control onto the next generation. It is a rare farmer who has enough confidence in his children and feels that they can make intelligent business decisions without his or her input and ultimate arbitration. Unfortunately this is one of the key issues that has to be addressed. Inter-generational transfers cannot be undertaken unless the senior partners are prepared to pass substantial decision making opportunities onto the next generation. If this issue cannot be handled then it is likely that a transfer is not going to be effective or result in any degree of success.

Training

Part of a successful inter-generational farm transfer results in an exchange of knowledge between the generations. A young farmer can certainly learn from his or her parents. Senior farmers should not discount the ability and educational training that have been undertaken by their children. There could be an opportunity for learning on both sides.

Sharing

Sharing responsibilities, financial contributions and other issues have to be worked out on a day to day basis. If parents transfer the farm to their children, they are going to expect a greater physical and financial contribution from their children. The children have to agree to meet this obligation. In turn, certain degrees of responsibility have to be given up by the parents.

Business Reality

Can the farm support two or more families? This is a fundamental business decision. Due diligence must be carried out to the ultimate degree before any major decisions to transfer the family farm are undertaken. A father proposing to transfer the farm to his two children may have made a horrible decision if these families cannot maintain an adequate lifestyle on the farm operation that is being conveyed. Family conflict caused by financial instability is impossible to measure. While some families are able to pull together and struggle through; these are rare exceptions. It is unfair to put an extensive financial burden on the next generation if the economic realities aren't there.

Communication

Probably the hardest part about making the decision to proceed with an inter-generational transfer is to confront the issue of communication within the family. Parents cannot just assume that their children want to proceed to take over the family farm just because that is all they know. Children should not assume that they have to take over the family farm because that is what their parents want. Siblings have to confront the issue of the fairness of the transaction. What is fairness when transferring the farm? It has been said that a million dollars cash makes the recipient a millionaire but a million dollar farm makes the recipient a living wage during life and a millionaire on death. Is it fair to tie the farm up so it cannot be transferred by the next generation? These issues must be discussed in detail.

Residence

Will the senior farmers stay on the farm? There are a lot of techniques that will be discussed that can be utilized so that these senior partners can maintain their lifestyle, dignity, and their family home. That being said, does that put the next generation in a position where they are going to have to travel many miles to look after the ordinary day to day farm operation? Can they take up residence adjacent to the senior farmers home without causing conflict? Can they share accommodation? What about the ability of the senior farmers to afford new style seniors' housing? Will the senior farmers have access to sufficient funds to maintain themselves in some form of satisfactory residence during their declining years?

▪ Transfer Choices

Methods

Assuming the decision to transfer is made, farm property is generally transferred in two ways. One transfer method is at fair market value for consideration, but one has to consider various tax consequences. The other is

by rollover of certain property at existing adjusted cost bases (usually available but subject to some restrictions). Transfer of inventory has further restrictions.

Transfer on Death

Many times farm transfer issues can be addressed through a Will. It is important that the Will does not run afoul any tax problems such as tainted spousal trusts, or failing to have property vest indefeasibly within 36 months with an appropriate rollover beneficiary. But generally, as long as the farm children are satisfied with this type of an arrangement, a properly planned Will can be prepared so that the child can be reasonably satisfied that he or she will be inheriting the family farm on death. This is generally not the most satisfactory way of completing an inter-generational transfer because it fails to address a lot of the issues that relate to sharing responsibility, contributions and control, as the farm will continue to be "Mom & Dad's farm" until their death. In many cases the farm will not actually pass until the "farming child" is himself or herself approaching the age of retirement. That being said, Wills must be carefully drafted to ensure that all farm property, crops in the ground and other items will pass according to the provisions of the Will. In many situations and (assuming our legislation does not change) the ability to have access to the $500,000.00 enhanced capital gain exemption may continue to be available. This by no means a certainty. If nothing else there is a long honored tradition in Canadian tax legislation that farming children will at least take farming property at their parents adjusted cost base. This might not work for extended families. Where uncles are transferring to nephews and nieces etc. the problems are more extreme and must be addressed separately.

Transfer by Gift

Where there is no issue relating to the enhanced capital gain exemption or a question of a parent receiving fair market value consideration for assets being transferred, it is open for a parent to transfer by way of gift "farm property." This normally has less than satisfactory tax results as there often is no "bump" or increase in the cost base of farm assets, which does have tax advantages. Further inventory cannot be gifted without serious tax consequences.

Transfer by Sale

Senior farmers can transfer to the next generation by sale of any assets generally at any value between the undepreciated capital cost of the asset being transferred and to the amount of fair market value. On a transfer to a spouse care must be taken to elect out of the provisions of Section 73(1) of the Income Tax Act so as to avoid having the spouse take property at the adjusted cost base of the transferor. The impact of the attribution rules must be considered or transfers to spouses and their children. If the property transferred to a spouse is leased and the revenue is "inactive" then the income is attributed back to the transferring spouse. If the property is used in an active business then generally the income will be taxed in the hands of the recipient spouse. Capital gains will generally be attributed back. Often the spouse pays

for the property by way of a Promissory Note due 30 days after demand so that certain reserves can be set up to avoid the application of alternative minimum tax and claw back issues. Once that has been done there are still issues relating to taxation of any capital gains in the hands of the transferor pursuant to the provisions of the attribution rules. On transfers to children over the age of 18 the attribution rules can be circumvented as long as the child pays consideration for the property being transferred by way of payment of cash, exchange of cheques the providing a note which is often forgiven under the terms of a Will. This is a common method of carrying out a farm transfer.

Farm property can also be transferred to a company, a partnership, or a trust. These relationships are slightly more sophisticated but are not uncommon. Family farm companies are often the most favored of these vehicles.

▪ Capital Gains Exemption

$500,000.00 Exempts

When transferring farm property it is generally considered advantageous for tax purposes to access the enhanced capital gain exemption of $500,000.00 (CGE). When considering inter-generational farm transfers you should also look at the ability to multiply the access to the capital gains exemption. This multiplication is beyond the scope of this paper but must be borne in mind when considering any transfer issues. It is generally considered advantageous to utilize the enhanced capital gains as soon as possible. On April 6, 1998, the technical committee on business taxation (the Mintz Report) submitted a report to Federal Finance Minister Paul Martin recommending the ending of the lifetime $500,000.00 capital gains exemption for farm property and qualifying shares in small business companies. The report seemed to draw conclusions to the effect that since the capital gains exemption was available, farmers did not take advantage of RRSP opportunities. Since RRSP's are generally considered to be an expensive method of providing for retirement it is quite likely that the Federal Government will be giving some major credence to the report. The report did recommend that the capital gains exemption be grand fathered. However, utilization of the capital gains exemption now rather than when you are told to do it by the Government may be more advantageous.

Rules

The rules relating to the $500,000.00 capital gains enhanced exemption are complicated. The CGE is available only for qualified farm property and qualified small business company shares. If a taxpayer has used the $100,000.00 personal capital gain opportunity in past years that taxpayer only has $400,000.00 of the enhanced exemption available. The $100,000.00 exemption, as you may recall, could have been used previously but had to be claimed. If the $100,000.00 exemption was not claimed then the taxpayer has

the full $500,000.00 enhanced exemption available if certain qualifications are met.

Qualifying Farm Property

Qualified farm property includes certain real property, shares of most family farm companies, partnerships, certain trust interests and certain eligible capital property (quota) used in the course of carrying on a farming business in Canada by an individual, if the individual is a personal trust, by a beneficiary of the trust, the spouse, child or parent of the individual, a family farm company, or partnership of the individual, spouse, child or parent. Other farm assets are treated differently.

Two Types of Farm Real Property

If the farm real property was acquired before June 18, 1987 the property must have been used in the year of dispersal in the business of farming or used accordingly in any five years during the period when it was owned by the individual, spouse, child, parent or family farm partnership or meet the post June 17, 1987 rules. If the property is acquired after June 17, 1987 then in the proceeding 12 months the property must have been owned by the individual, spouse, child, parent or partnership, and gross revenue from farming had to exceed income from all other sources for two years of ownership, or the property had to be used by a family farm company or family farm partnership throughout a 24-month period during which time the appropriate individual was actually engaged in the business of farming. If the $100,000.00 exemption was claimed on farm land, this has the effect of causing the land to be treated as if it was bought after June 1987.

Family Farm, Company or Partnership

Further, substantially all (interpreted to mean more than 90%) of the property must be owned by a company or partnership and must have been used by it or other qualified users including the individual spouse, child, parent or family farm partnership in the farming business in which one of the other qualified users was actually engaged. Further, throughout the previous 24 months more than 50% of the assets must have been used in a qualifying farm business including active involvement of a qualified user. The test on the use of the property states that in the case of the company, it may include shares or indebtedness of other company's owned by that company and still meet the use of property test.

Eligible Capital Property (Quota)

This must be used by a qualified user in the business of farming with a similar use test for real property. There are substantial tests relating to the definitions of qualifying individual and issues such as “carrying on the business” and “actively engaged.” These are often referred to in Revenue Canada's Interpretation Bulletin 268R4.

The Negative Side

When considering any transfer of farm property and utilization of the enhanced capital gain exemption there is also the question of alternative minimum tax. This is a tax that can be triggered by a non-taxable capital gain but often results in a tax being paid and generally being refunded in the next or subsequent years. In many situations the tax can be avoided, but it has to be handled carefully. The ability to access the enhanced capital gain exemption is reduced by any cumulative net invest losses which are generally related to previous tax shelters or rental losses utilized by the taxpayer. The elimination of these cumulative losses is often complex and has to be addressed as it could reduce access to and the amount of the capital gain exemption available. Capital gains will often result in the claw back of pension benefits. It is generally considered advantageous for senior farmers to consider the utilization of the capital gain exemption prior to receiving pension proceeds so as to avoid claw back on old age security and other pensions. This is going to become a greater concern as the years pass and we approach the Federal Government's new pension claw backs era.

▪ Land

Transfer of Land

One of the most contentious issues in a farm transfer is the question of the transfer of farm land. Obviously, the land is the underlying basis of the farm. This can be done as described under the process of a testamentary disposition with a Will. A more common alternative when the decision to transfer has been made is to enter into some kind of an *intervivos* (during life) transfer of property. Land can be transferred on a rollover basis, or can hopefully trigger the advantages available under the capital gain exemption rules if certain tests are met. This has the effect of "bumping" the adjusted cost base of the land for the next generation.

When Land is transferred outright, parents can still retain a life interest in the property and ensure that they have the right to the benefits of the land during their life time and the right to stay on the property. This is generally treated as a disposition for tax purposes. Occasionally, parents will transfer land to children and enter into a long term lease where they lease the property on a crop share basis for a long term cash payment or other consideration so as to maintain control during their lifetime. Often joint ownership is a method that is used to transfer property and avoid probate issues. Great caution must be taken when using joint ownership. As you need to be sure that your intention is actually carried out and that inadvertent tax consequences do not result. Failure to provide proper trust deeds or registrations of transfers are problems that arise.

Security

If farmland is transferred, it is often important to take security in the form of notes or mortgages. If the capital gain exemption is to be accessed, such notes are important for the purpose of protecting the ability to have the child take the property at an enhanced adjusted cost base. Further, matrimonial issues can be addressed by taking notes so as to protect a child's matrimonial position in the event of a family breakup. It is often recommended that formal security be taken out (such as mortgages or general security agreements) so that the parents can often move in and take back the operation in the event of a terrible financial disaster.

▪ Quota

Eligible Capital Property

No discussion of farm transfers would be complete without addressing the issue of quota. This strange beast is referred to by Revenue Canada and accountants as "eligible capital property." Many business decisions of the agricultural industry cannot be carried out without consideration of quota. Some consider it as a sword, while others call it a shield. From an accounting point of view it is subject to depreciation with three-quarters of the purchase price added to the cumulative eligible capital account (CEC) and is depreciated up to 7% of its value. On an inter-generational farm transfer it can be subject to recapture on sale but can be transferred on a rollover basis.

Quota Value

Quota relates to the supply management system that has evolved in Canada over many years. It controls production and related costs, restricts importation of related products, restricts movement of products, and tends to set prices for products at the farm level to provide producers with stability as it relates to their production levels and their ability to carry on business. This stability is subject to the value of the quota, and potential tax, organizational and international obligations such as the North American Free Trade Agreement, the General Agreement on Trades and Tariff, and the World Trade Organization. In effect these outside sources, as well as the marketplace, can have a serious effect on the value of quota. Agricultural and economic pundits have long recommended that farmers take steps to salvage the value of their quota by selling their business or by transferring the quota to a company because there is no possibility that the value of quota could continue to escalate and grow over the coming years. This line of reasoning has been put forward time and again and has proven to be generally incorrect. Free Trade comes in and the value of other commodities plummet, and the value of quotas continue to rise. The value of softwood lumber rises and falls at the whim of the tree marketers and the American Senate, but the value of quotas continued to rise. This stock market collapse was with the fall of the Asian market and the problems in

Russia, but the value of quota still tends to rise. Is it ever going to end? No one knows.

Protecting Quota Value

One business decision that can be made is to sell the quota to a family farm company. Quota is generally eligible for the capital gains exemption subject to limits and tests. It is possible to sell it into a company so as to cause the company to owe promissory notes to the transferor. The advantage of this will be discussed shortly. The Notes can be secured by a General Security Agreement so as to provide security to the transferor. The value is then locked in as far as the transfer value to the transferor is concerned. On a roll or sale into a company there is no bump in the cost base of the quota as far as the company is concerned. That is, although the company is effectively paying to the farmer a Promissory Note equal to the fair value of the quota the company cannot depreciate the quota at the accelerated amount. If the quota is subsequently sold there is no tax on the transaction until a transfer value in excess of sale value is encountered at which time the excess will be taxed at income rates. There could be depreciation to both the transferor and the transferee in the event of such transactions. An interesting aspect of quota is that is does not appear to be subject to alternative minimum tax.

▪ Corporate Advantages

Family Farm Company's

A company is a person at law. It is treated as a separate entity and has generally all the legal rights and entitlements as an individual for tax and accounting purposes. Companies are not for everyone. They can add complications to an agri business and often are difficult to undo in the event there is a need to wind up the corporate operations. Generally a wind up is not an insurmountable task but there can be complications which can make it more difficult.

Control and Growth

By using different kinds of shares, a senior farmer can pass the growth of the family farm onto the next generation and retain the benefit of the value of the farm up to the time of the transaction for the farmer and that farmer's spouse. The farmer can retain control of all or some aspects of the operation, can run the board of directors, and can control the voting of most of the shares. Most of all of the growth shares can be owned by the younger generation. A practical variation of this arrangement could result in a situation where the transferor farmer decides to set up a board of directors where one of the parents and the child or two parents and two children are on the board of directors and have to make business decisions. The board of directors makes the decisions of the company so that on a day to day basis the farmer and his child may stand on

an equal footing. In the event of a conflict there is no question the senior farmer would retain control and he could replace the child on the board of directors. Obviously this would be undertaken in the event of a serious problem.

Tax Rate Benefits

Generally in Canada we have a concept called "integration." This means that income earned through a company and flowed out an individual will be taxed at the same rate as that individual. There are frequently marginal advantages to using a company for a tax rate advantage where monies are earned by a company, and paid out for living expenses of the individual.

The major advantage of companies is the ability to defer tax personal tax and take advantage of the lower corporate tax rate, which in Alberta is 19.12%, as long as the company is a Canadian controlled private company subject to small business status. This low tax rate is advantageous and essential when it comes time to paying back substantial farm debt or leaving cash in the company to increase inventory, or to buy equipment, or to simply save.

Major inventory sales are generally more advantageous when undertook by a company. The first $200,000.00 of corporate profits is generally taxed at the low rate. On a major inventory dispersal in Alberta the farmer would be looking at an initial cost of 19.12% as opposed to 44.62% for personal sales.

Repayment of Debt

For debt purposes, consider for example, a farm operation that owes a bank $500,000.00. If the company is to repay the debt out of net after tax profits, assuming normal rates, the company is going to have to earn over time $619,000.00 to net $500,000.00 to repay the bank. That same bank loan would need earnings of $910,000.00 by an individual to pay back the loan at a normal personal tax rate of 45%. The individual rates could be reduced if the payment was over many decades, but generally the calculations would indicate that simply using a farm company could save approximately $300,000.00 lowering the tax cost of paying back this amount of debt.

Insurance

At times companies are useful when it comes to insurance premiums. Insurance premiums (subject to certain "stop loss" rules) can be paid using after tax corporate dollars which again means that 80.88 cents of every net earned dollar of an Alberta company can be used to pay a premium whereas only 55 cents of every net earned dollar earned by an individual at the top rate could be able to be paid toward premium coverage.

Repayment of Promissory Notes

A major advantage of a farm company is to repay farmers for assets transferred by redemption of Promissory Notes. The individual can receive proceeds tax free from a company. The company can use after tax corporate dollars taxed at the low rate to repay the senior farmer who has transferred in assets. This will result in their ability to maintain their lifestyle during their retirement years without facing major tax costs. In 2002 pension claw backs are going to be extremely significant for retired farmers. Farm families could repay senior farmers $20,000.00 to $30,000.00 a year and farm companies could conceivably repay senior farmers substantial repayments on their outstanding loans without affecting claw backs. This could save the individual farming parents many thousands of dollars on tax and claw backs on an annual basis. From a practical point of view the reduction of debt by a company where the growth is passed on to the next generation results in enhancing the benefit to that next generation. For example, if the company owes Mom and Dad $500,000.00 and it is able to pay down the debt over the course of many years to $200,000.00 without the actual net value of the company declining, (the parents would be paid out of profits in the farming operation), the benefit of that $300,000.00 escalated growth will pass on to the holders of the growth share who are generally the children.

Income Splitting

A recent Supreme Court of Canada decision, *Melville Neuman v. H.M.T.Q. 98 D.T.C., 6297 (S.C.C.),* indicates that income splitting through companies is going to be an accepted standard of Canadian tax practice. Companies can then be utilized so as to split income amongst family members (including income to non-farming family members) subject to future revisions made by the Government of Canada. This appears to be an interesting opportunity. Besides being able to control income and split income; companies can also be used for the maintenance of family trusts for further split income.

Liability

Last but not least is the liability protection that a company affords. A company is only liable for the value of its assets subject to certain restrictions such as directors liabilities for things like personal guarantees, source deductions, GST and environmental liabilities. At times a company's liability can be further limited by taking security devices to protect those who put money or assets into the company. If security is a major issue, farms can use holding companies so as to create a separate vehicle to hold the shares of the family farm company where they transfer the shares that they previously held into a holding company. The possibly of claiming benefits of certain capital gain exemptions which may be available and can create a scenario whereby retained earnings of a company are dividended up to the holding company and then lent down to be secured by that holding company so as too further enhance and perfect the liability situation. Dividends are then declared on an annual basis to the holding company and are lent back down as are needed by the company and secured

so as to provide a more or less perfect security package to protect the families farm assets.

▪ Asset Transfers to Family Farm Companies

Assets

Different categories of farm assets are handled differently for tax and accounting purposes when transferred into a family company. These are all non-arm's length transfers.

Land

Land can be transferred into or kept out of a family farm company. Often land is transferred in so as to cause the creation of a capital gain, which is eligible to receive Promissory Notes as consideration. This creates substantial tax advantages to the recipients as described. Land can be leased to the company and the capital gain issue can be deferred. Land can be transferred to other family members and then leased to the company.

Inventory

Inventory subject to certain optional and mandatory inventory adjustments is generally transferred into a company at the tax cost to the tax payer and the company compensates the transferor by paying for the tax cost by way of a Promissory Note or cash. Where there is a difference between the tax cost and the fair market value of the inventory. The seller would get shares in the capital stock of the company (usually which are preferred fixed value shares) and will only be redeemed subject to certain tax liabilities.

Equipment

Equipment is transferred into a company at fair market value with the transfer price being equal to a Promissory Note or cash for the undepreciated cost or book value for tax purposes of the equipment. The difference between that amount and fair market value would be compensated by the same preferred shares as described below.

Buildings

Buildings which have escalated in value and have not been subject to depreciation may be generally considered to be transferred in for a consideration of Notes, or if there has been depreciation, then on the same basis as equipment.

Land and Quota

The situation regarding the transfer of these assets into companies has been previously discussed and generally relates wherever possible to using the accelerated capital gain exemption. They can also be transferred in by way of a rollover.

Partnership Interests

One of the major advantages available to farmers in Canada from a tax point of view is the ability to transfer certain partnership interests into a company so as to cause the transfer and disposition of a capital asset (which may be eligible for the capital gain exemption) and to receive compensation by way of Promissory Notes for such transfer. This transaction is extremely complicated and must not be undertaken without extensive work by well-trained professional advisors who can carry out this undertaking. The advantages are substantial. Effectively, many items which would be eligible for eventual tax costs such as preferred shares would have to be dealt with on the death of a tax payer (as described above) can be effectively converted to Promissory Notes which will not be eligible for any tax costs in the hands of that tax payer. The issue is complicated but should be addressed. This can only be undertaken in the event there is a bona fide partnership that has been existing in the past between spouses or partners or father and son and such partnership must have existed for some time and must be bona fide in all respects. The tax advantages on this transaction cannot be overlooked and the question of a transfer of the partnership interest into a company should be reviewed carefully, as this is an extremely advantageous way of handling a farm transfer.

Preferred Shares

Preferred shares are consideration normally taken back for the deferred tax component of any assets transferred into a company. They have often been referred to as “time bombs” in that eventually their redemption will result in a tax cost to the recipient. Generally they are treated similar to a dividend being received on redemption of a preferred share. In Alberta, a deemed dividend resulting from a repurchase of a preferred share which may be held by a farmer transferor at top marginal rates could result in a tax of 31.08% on the deemed dividend received. However the marginal tax rate on dividends under for example $23,000.00 where there is no other income earned by the taxpayer is extremely low. Preference shares are often redeemed on a regular basis on a transfer into a family farm company. Each circumstance has to be considered on a separate basis.

▪ Partnerships

Farm Partnerships

A simple method of handling a farm transfer is to utilize a farm partnership. Partnerships are a traditional method of operating a farm and sharing fixed costs and income or losses. Effectively, a parent can transfer farm property into a partnership and take back a partnership interest. The partnership would take the parent assets on a rollover basis, and in certain circumstances where cash is available, cash could be transferred to the parent so as to trigger a capital gain exemption. Partnerships can involve many members of the family and are used for splitting incomes. There are certain restraints on income splitting that are prescribed by Revenue Canada and partnerships are not generally considered as flexible as a company. Partnerships are often considered an intermediate step where farm property is transferred into a partnership. This can occur when parents and children may run a farm business and eventually transfer the partnership interest into a company, when children may buy out the senior's partners' capital account over a period of time, and as the senior partner's involvement in the company winds down and the capital interest declines the obligations to pay income allocations to those senior parents also declines. Partnerships are often overlooked as a simple method of providing for a transfer of farm interests.

▪ Trusts

Farming Trusts

Family trusts are considered to be a more appropriate vehicle for splitting income and providing for the transfer of farm operations. The family trust can run the farm or it can hold shares in the family farm company. Profits can then be paid out to beneficiaries, often on a tax-free basis after the initial corporate tax is paid, subject to certain restrictions and requirements. Parents can retain control of the trust and can control decision making abilities in the future if they don't feel that the children are at the time capable of actually being recipients of certain capital assets or interests in property. Decisions can be made on a piece meal basis or all at once either during the life or on the death of the senior farmers. Family trusts can be setup to actually receive farm assets directly and these can operate independently with companies or jointly with companies or through companies. Family trusts are frequently considered to be the vehicle of the future for farm operations.

▪ Security

General Security Agreement

A farmer transferring capital property into a company partnership or trust can and should take security in the form of a General Security Agreement on the assets being transferred into the company.

▪ Purpose

The purpose of this paper was to firstly present a challenge to farm families to address the question of inter-generational transfer, and secondly to provide limited guidelines as to the methods by which the transfer could be undertaken. It was not the intention to confuse or cause extreme concern to the reader as to the complexities of the undertakings that would have to be carried out so as to provide for succession. Professional advisors can be retained so as to reduce the stress of these issues and to provide advice as to how these can be best undertaken. The most important issue to address is the question of making a decision to proceed with an inter-generational transfer and to be certain that the family intentions are best met by such an undertaking. Each farm family must set up their goals and objectives. The task is difficult but the rewards are substantial.