Grant Thornton

Handing over the reigns

Succession planning can help secure the future of your farm.

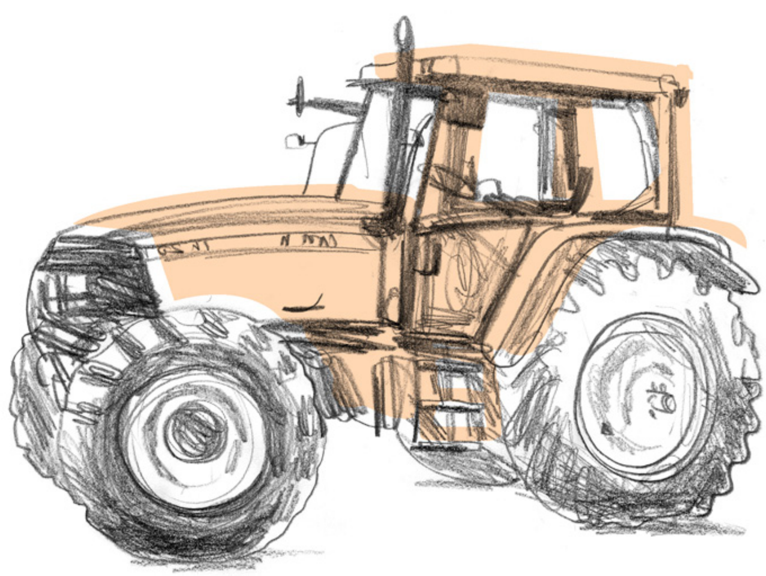
A Grant Thornton article for privately held businesses

Handing down the business you've spent most of your life growing can be one of the hardest things you'll ever do. And if that business is farming, the process has layers of emotional complexity that can seem difficult to face, let alone overcome. You're not just talking about a job or a building, but a lifestyle and a homestead. There are also concerns for your family, their futures and the future of the farm itself. Add in a range of tax implications to consider and the process can become a problem, even an obstacle, that many simply ignore.

With the proper approach and preparation, however, succession planning doesn't have to be an ordeal. Some issues particular to farm succession, such as family equalization, can certainly be difficult. Other issues, tax for example, can offer real benefits that aren't available to other businesses. The key is knowledge and preparation. Our goal here is to focus on the most important areas you'll want to think about:

- family concerns
- funding issues
- tax implications

And go from there.



Family concerns—some tough decisions to make

When you're considering family issues, remember, you're included. If some of the decisions you have to make are difficult for your family, they're even more difficult for you. And they will affect you. Succession is not a moment in time, it's a process, and you have to be comfortable with that process—as well as with the eventual results. Even if you're stepping away from day-to-day business, the farm's long-term success is probably very important to you, as your family legacy and possibly for your ongoing financial well-being. You want to be sure that you're well-looked after once your succession plan has been executed.

Selecting a successor

Two key criteria will determine if one of your children should, or can, succeed you: interest and ability. Interest must be the starting point. If a child is not interested—or feigning interest to please a parent—ultimate success in taking over the business is unlikely. If a child is interested, the question of ability must be addressed. Do they have the skills? The knowledge? The work ethic?

The process of selecting a successor can obviously be quite complicated. And if two (or more) children show both interest and capability, you'll have some challenging decisions to make. One option is dividing the farm between the capable parties. If none of your children emerge as likely successors, you may have to begin preparing for a third-party sale.

Equalization

The question of equalization—attempting to fairly distribute overall wealth between siblings—is one of the most difficult issues in succession planning. The most important thing to remember at this point is: fair doesn't necessarily mean equal. True equalization in a farm scenario is almost impossible. If a son who has worked the farm and wants to continue gets $2 million in farm assets and a daughter who isn't interested in the farm gets the house, it will clearly not be perceived by everyone as equal—but it may be fair.

The issue of farm valuation compounds the problem. An asset-based valuation may assess the business in the millions of dollars, but this is often hugely disproportionate to the farm's ability to produce cash and provide a living. The successor to the farm, despite the valuation of the farm's assets, is not really enjoying a multi-million dollar payday. In these cases, perceptions and expectations must be managed. Sit down with everyone who will be involved. Explain the situation and the financial reality, and try to get the family on board with what will happen and why.

Marital protection

Marital protection means trying to ensure that the farm, which may have been in the family for 100 or more years, remains in the family. This has recently become more of a consideration, possibly due to the rising mobility rate of farm children and the resulting tendency to marry outside closer-knit, trusted farming communities. There are a number of tactics you can look at to address this issue, including gifting agreements, marriage contracts and trusts.

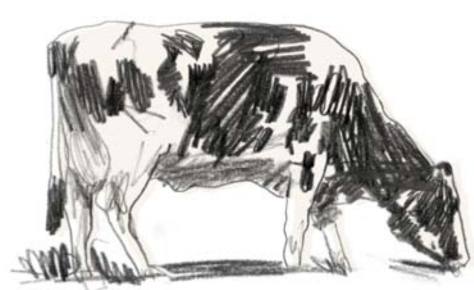
Farm family issues are challenging and mismanagement can create parental guilt and sibling dissension. This is a key area where a good adviser can help, not only with the technical Xs and Os, but as a facilitator of family understanding, goodwill and consensus.

Funding issues—are there enough pieces in the pie?

Funding is really the financial side of the equalization issue. When succession takes place, is there enough money to go around to interested parties? How is it distributed? Are there any techniques to develop additional funds? Consider the valuation problem discussed earlier: the farm is valued at $2 million but produces $80,000 of income annually. This is clearly not enough for the new farm family to live on, support retired parents and equalize siblings. What to do?

Non-liquid assets

The essential problem is that there's too much asset value and not enough cash to go around. Other types of businesses may be able to sell off redundant assets or borrow against commercial property. A farming operation, however, represents an aggregate asset that is largely non-liquid, that is, not readily convertible to



cash and mostly indivisible, even though it usually accounts for the largest part of family wealth. The problem is clear, and a good succession plan must look for other means to generate funds and promote family understanding of the situation.

Retirement

You may be prepared to fully fund your retirement, but that isn't always the case. You may have lived with the expectation of being supported by the farm in some way for life, but you may also find that there just isn't enough to go around once your succession plan is executed. If this is the case, you'll need to look for other ideas to generate or preserve income.

One preservation option is to execute an estate freeze. This basically means you would freeze the value of any farm or non-farm assets you hold and transfer any future gains to newly created shares held by—or in trust for— your heirs. This is normally done for tax deferral reasons, but it does have the further advantage of segregating the value you've accumulated during your lifetime from any future gains resulting from the hard work of your successors. Not only can this help ensure an identifiable, easily justifiable source of retirement funds, it can also provide heirs with a way to specifically identify their contribution to the business as they work to grow it.

Other funding options

There are a few other options you might want to consider to increase available post-succession family funding. Insurance can offer a way to limit any bad feelings that might arise from perceived unfairness. If there just isn't enough money to equalize all siblings, insurance can be used to provide for those who don't work in the business. There are a number of ways this can be structured depending on your particular needs.

In some situations, it may be possible to sell off some land. Refinancing the farm is also an option. But sometimes the only solution is to set expectations with the other children beforehand. If you simply can't find a way to satisfy all parties, your adviser can help to mediate the situation. In the end, you may have to say, "That's just the way it is."

> More than 30% of Canadian business owners who expect an ownership change within 10 years are **still not planning for it.**[1]

Tax implications—learn where the system works in your favour

Income tax opportunities are more substantial and more flexible for family farm businesses than they are for most other businesses.

There are more benefits, and there are great opportunities to defer tax and generate tax savings during the succession process. Most farmers are aware of this basic situation, but there are many things to consider before taking advantage of a "better" tax opportunity. What may appear to offer a significant gain may not always be the best choice in the long term.

Property rollover/capital gains

Normally, when an individual sells or gives property to children, it's treated as if they sold the property for its fair market value. This means they must pay tax on a capital gain (the difference between the original cost and the current fair market value). For farming businesses, however, there are "rollover rules" that allow a parent to transfer certain farm property to a child with no immediate tax consequences:

> **Scenario 1**
> A farmer transfers farm property to his son. It originally cost $10,000 and is now worth $2 million. Rollover rules allow the farmer to transfer the property to his son for any amount between $10,000 and $2 million. If the farmer decides to transfer the property to his son for cost ($10,000), the farmer's capital gain will be considered zero, and he will not have to pay a capital gains tax. The original cost is also transferred to the son, so if the son sells the property in 10 years for $2 million, he would at that time report a capital gain of $1,990,000 ($2 million - $10,000) and would be liable for the capital gains tax on that amount. Capital gains taxes are deferred, however, if he retains ownership of the property or transfers it to his own children tax-free, and could even be reduced by using his own lifetime capital gains exemption.

This seems like (and often is) a great way to avoid a big tax hit. But it's not always the right choice. For example, if you're carrying a capital loss from previous years, you may want to sell the property to your child for an equivalent amount rather than transfer it at cost, then use the loss carry-over to offset any gain.

Another option is to make use of the lifetime $750,000 capital gains exemption on qualified farm property that's available to everyone:

> **Scenario 2**
> The farmer in the above scenario has never used his lifetime $750,000 capital gains exemption. Since rollover rules allow the farmer to transfer the property to his son for any amount between $10,000 and $2 million, he chooses $760,000 and uses his $750,000 exemption to reduce his capital gain to zero. The child receiving the property would inherit the transfer amount of $760,000 rather than the original cost of the property—thereby reducing his future capital gain—and can use his own lifetime exemption if he sells the land in the future.

[1] Grant Thornton International, Grant Thornton International Business Report 2010. http://www.grantthorntonibos.com/survey/IBR.aspx?id=10001&pg=6&mode=r&year=2009&countryId=10&btId=1 (accessed August 11, 2010).

Other tax considerations

There are numerous planning opportunities available to farming businesses:

- Create a partnership or corporation to realize tax savings and creditor-protection.
- Introduce compensation tools, such as individual pension plans or employee profit-sharing plans.
- Implement family trusts for tax and estate planning purposes.

Succession planning tax scenarios for farming businesses can become quite complex, particularly when multiple strategies are used. Carefully assess your situation and get some good advice to decide what delivers the best combination of advantages for you and your family.

Get your plan in place

Someone will eventually take over the farm. It's in your power to decide who and on what terms. A well-thought-out succession plan may make all the difference between successfully preserving your family legacy and a number of undesirable outcomes, including third-party sale or outright failure of the business.

As Canada's population continues to age, business owners, including farmers, must face this transition in increasing numbers. Putting it off only invites trouble down the line. And since this process can be very difficult emotionally—with farm-specific issues adding further complications—why not work to make it as simple as possible? This requires knowledge, preparation and good, solid advice. Succession is part of continuity. It's part of your legacy. Start planning today.

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