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Keeping the farm all in the family

Andrew Allentuck, Financial Post

In southern Manitoba, a couple we'll call Fred and Roberta, both 55, farm 485 hectares of grain for feed they use to raise 3,000 hogs per year. The combined grain and swine operation form a business with a net worth of about $2.44-million. The couple's take-home income, $6,540 per month, supports a modest way of life in which personal income and business income are tightly interwoven. In time, Fred and Roberta would like to hand the farm over to their children. But they can't just make a gift of it. They need the income it produces and the shelter their farm house provides. It's a problem many older farmers share.

Unlike employees of urban corporations who can walk away from a job or just sell a business as a going concern, the couple's lives are closely bound to their farm. It's organized as a corporation for tax and management reasons, but job mobility or a swift sale of assets are not easily achieved. And they want to keep the farm going even after they retire. Their children, ages 27 and 24, expect to take over. A third child, age 22, is still in university and is undecided about a career. For now, they want to structure a transfer of ownership that eventually releases capital on which they can retire. But in the current market, with hogs selling for less than what it costs to raise them, it is tough to do.

The farm is in trouble as a result of those low hog prices. Raising animals is a value-added business in which relatively little land should support high cash flow. For now, the model is not working, but hog prices are cyclical and should eventually return to profitable levels.

Fred and Roberta plan to retire in five years. Their core problem is how to finance the takeover by the children. The family wants to begin now.

Family Finance asked Don Forbes, a farm expert and financial planner who heads Armstrong & Quaile Associates Inc. in Carberry, Man., to work with the couple to plan retirement and a way for the children to assume ownership of the farm.

"This is really a question of whether the next generation will have the acumen and discipline the parents used to build a financially successful farm," Mr. Forbes explains.

"The children have been involved in the farm part-time, but they have not been managers. When they take over the farm, their commitment and their capacity to manage will be tested."

FINANCING RETIREMENT

When Fred and Roberta retire, they estimate they will need $5,000 per month after tax to cover living expenses, including cash to replace food and services currently provided by their farm, Mr. Forbes explains. Some of their current disbursements, including $1,966 per month in registered savings, will no longer need to be maintained.

That $5,000 after-tax budget will have to come from their entitlements to Canada Pension Plan, Roberta's pension from a job she has in a nearby town, farm capital and their retirement savings. Without sale of the farm assets, that will work out to $570 per month for Fred's CPP, Roberta's CPP of about $600 per month, her civil service pension of $1,010 per month, Fred's RRSP withdrawals of about $800 per month and Roberta's RRSP withdrawals of $500 per month. That adds up to $3,480, which meets their target. At age 65, each will add Old Age Security benefits, currently $517 per month, for total income of $4,514 per month.

Fred and Roberta can boost their income by dipping more aggressively into their RRSPs or by selling part of the farm for relatively quick cash. A 65-hectare parcel could fetch $240,000. If that money were invested in dividend-paying utility stocks or perhaps a high-dividend exchange-traded fund that yields 5% per year, it would generate $1,000 in monthly income. That would boost income at age 65 to $5,514 per month. Any income gap could be closed either with part-time work in town or by trimming a few expenses. If they choose to delay selling the farm, the 65-hectare parcel in question would rise in value to $322,000 and then to $432,000, in 10 and 20 years, respectively, just by assuming a 3%

average annual rise in land prices driven by inflation. Income produced would rise proportionately. That amounts to indexation that can keep up with rising prices, Mr. Forbes notes.

CONTINUATION OF THE FARM

Can the farm remain a financially viable operation? Yes, Mr. Forbes says, because the corporation's costs are low. Fred and Roberta are prudent managers. They grow their grain, return manure to the land and feed the grain they produce to the pigs. They bought used farm equipment and maintained it well. Low debt gave them the ability to weather tough years like 2008 and 2009, when hogs weren't profitable.

Raising pigs has been a good business in the past, but the future of hog prices is cyclical, Mr. Forbes notes. Even if prices do not recover, the family could market its grain, though that would not pay as well as hogs. Fred and Roberta will decide within two years what to raise.

THE NEXT GENERATION

To build up cash for retirement, the farming corporation could sell land and machinery to each child. The children would borrow the money via a mortgage on the farm, pay proceeds to Fred and Roberta and pay back the loan from farm revenues. The sale would be made more certain by having life insurance to back the transaction.

At present, low interest rates favour borrowers. It is a good time for Fred and Roberta to start planning the transition, Mr. Forbes adds. They will need to work with an accountant to make sure that their steps are tax efficient. A lawyer will have to handle the land and business transfers to the children. The parents should be able to render most of their eventual sale free of capital gains taxes by use of the $750,000 lifetime personal exemption that applies to family farms.

"The plan can work because Fred and Roberta are resourceful in their business and careful in their spending," Mr. Forbes says. "They will put transfer of ownership of a viable farm ahead of extracting every penny of its value. That will help the kids get started with a farm that is not mired in unsupportable debt. They have a workable goal."

"We can live better in retirement than we have lived in the past," Fred says. "The transition could be a gradual buyout of our interests. Our kids, who live nearby, get the farming business. We convert land and machinery to cash and everybody in the family is quite well protected."

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SITUATION

Family farm owners want to pass the business to their children and retire

STRATEGY

Structure transfer to generate cash, use capital gains exemption for farms

SOLUTION

Cash for retirement for owners, management transition for children

THE PROFILE

AFTER-TAX MONTHLY INCOME $6,540

FARMING CORPORATION ASSETS

Land and house $1,290,000

Machinery, vehicle $1,029,000

Other assets $119,000

TOTAL FARM ASSETS $2,438,000

PERSONAL ASSETS

RRSPs $119,386

TOTAL ASSETS $2,557,386

LIABILITIES

None $0

PERSONAL MONTHLY DISBURSEMENTS

Mortgage None

Property taxes $1,000

Food $900

Restaurant $75

Entertainment $50

Clothing $150

RRSP $1,200

Tax-free savings account $766

Car fuel, repairs $160

Vacations $83

Car, home insurance $170

Life insurance $45

Charity and gifts $45

Misc. $200

Savings $1,696

TOTAL $6,540