FARM FINANCIAL PLANNER

Lessening the sting of the AMT after land sales

With planning, retiring farmers can reduce the burden of the Alternative Minimum Tax

By Andrew Allentuck

A couple we'll call Herb, who is 67, and his wife, Mary, 60, farm 600 acres of grain and hay and another 500 acres of pasture in central Manitoba. They have put much of their effort into a 100 head cow-calf operation.

Their two children, Suzy, 32, and Astrid, 29, are married and have no wish to return to the farm. They want to keep the farm in the family. It looks like a stalemate, for the parents want to retire. Making a retirement plan is a challenge, but it's eased by the parents' net worth, $2.6 million, of which only $1.8 million is directly tied up in land. Financial assets include $427,000 in RRSPs and $85,000 in Tax-Free Savings Accounts.

Don Forbes and Erik Forbes of Forbes Wealth Management Ltd. in Carberry, Manitoba, met with Herb and Mary to advise on making the generational transfer work. In the planners' view, the goals of winding down the farm over a five-year period and perhaps selling three quarters of land and leaving two quarters each to their daughters would be a good strategy.

Sales of farmland above the price paid will generate taxable capital gains, but the Farm Land Capital Gains Tax Exemption of $1 million each for Herb and Mary will allow $2 million of gains to be received without tax. That's more money than the farm sale can raise, so the couple can literally take every cent to the bank.

Qualification for the Farm Land Tax exemption is straightforward. Anyone who has filed two years of farming profit and loss statements can qualify. There is, however, a catch. The Alternative Minimum Tax, AMT, will hit the couple in years of high income such as when farm assets are sold at a hefty profit. The Canada Revenue Agency will calculate and charge ordinary income tax, even though the farmland value gain will be sheltered by the $1 million per person farmland exemption. Because tax paid in excess of the AMT can be applied against future taxes for the next decade, the AMT boils down to a tax prepayment over a 10-year time frame.

The best move for Herb and Mary is to sell the first three quarters of grain land. That will trigger $1 million of gains. The AMT will be charged when the gains are realized. Next year, they can sell cattle at a profit to use up some of the AMT credit. Thus cattle profits taxable in 2018 can be offset by the AMT credit carried forward, Don Forbes says.

Some of the money realized from the land sale can be used to buy a home in town. The rest can go to the couple's Tax-Free Savings Accounts and then to non-sheltered accounts to generate investment income. The remainder of the pasture land can be kept as a family legacy and transferred to the two children over time. The object is to use up the remaining Farm Land Capital Gains Tax Exemption. It can be done conservatively by transferring one quarter each year after the cattle have been sold. One quarter would go to Suzy in Year 1, then another quarter to Astrid in Year 2. Slow transfer can avoid sufficient gains to trigger the AMT.

Each daughter, who would presumably rent the land to an active farmer, can use her own rent-to-own plan. With title transferred, the daughters would oversee the land and pay all taxes, then pass net income on to the parents as part of their retirement income. It is vital that a zero per cent interest payable promissory note for the full transferred market value be executed, forgivable on the last death of the parents. That note should be included in the terms of the transfer of title. This measure protects the parents' rental income in the event of either daughter's marital breakdown personal bankruptcy.

KEEPING IT ALL STRAIGHT

There is a good deal of bookkeeping needed to keep these transactions clear. All land transactions should be in separate accounts. Commingling of funds from different activities has the effect of clouding the concept of separating assets in the event of either child's personal financial or marital difficulties, Don Forbes cautions.

In this plan, each spouse would be entitled to any gain in value of the original transfer price, but the promissory note would constitute a debt against the original value and would have to be honoured ahead of other obligations. In the absence of the promissory note or other means of avoiding commingling of common property of the marriage, the spouse would be entitled to half of the land or its value, putting Mary and Herb's stream of rental income at risk of loss. GN

Andrew Allentuck is author of When Can I Retire? Planning Your Financial Life After Work (Penguin, 2011).