Time to decide what to do with the land

After years of renting out the land, this widow is ready to make her next financial choices

By Andrew Allentuck

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In southern Manitoba, a widow we'll call Eleanor, 73, wants to decide what to do with 420 acres of farmland she inherited two decades ago when her husband died. She never farmed the land, just rented it to a neighbour. Each of her three sons has a successful off-farm career. The decision? What to do with the land — either to maintain present income or transfer to her sons. The farmland is just part of a larger problem: to create an estate plan that would include her sons and four grandchildren.

Eleanor approached Don Forbes of Forbes Wealth Management Ltd. in Carberry, Man., for an assessment of her problem. It breaks down into generations. She can help her grandchildren by contributing to their Registered Education Savings Plans. The limit is $2,500 per year per beneficiary to qualify for the maximum Canada Education Savings Grant of the lesser of $500 or 20 per cent of sums contributed. There is a lifetime contribution limit of $50,000 per beneficiary and the CESG is capped at a maximum of $7,200 per beneficiary

Passing the land on to the sons is more complicated. Unfortunately, Eleanor, who has not actively farmed the land for decades, is not likely to be eligible for the Qualified Farmland Capital Gains Tax Credit of $1 million. She will, instead, be taxed on the current market value of the land when sold in relation to its cost. The flexibility of valuation in farmland tax credit will not be available.

BEING AN ACTIVE FARMER

The problem is that Eleanor is not a farmer as defined by the Income Tax Act. To quaify for the credit, the owner must have farmed actively for two years before the sale of the land. "Active" farming is defined as farming which makes up at least half of total gross income.

The definition of active farming has some flexibility, for example, just spending most of the crop season working on the farm and seeking to expand the farm will qualify the individual as an active farmer. In other words, it is application of oneself to the farm operation. Not making money for a few years does not automatically deny the qualification.

Eleanor, who has done nothing but lease the 420 acres, is not likely to be considered a farmer under the Income Tax Act. She can, however, continue the status quo. The land will generate $3,000 per month after tax. The land will be included in Eleanor's estate and any tax due on a deemed capital gain would be paid by the estate after her passing.

Or, she could sell the land to a third party and invest the proceeds. Using $5,000 per acre as an estimated value and given that $320,000 was the price of the land when purchased, she would receive $2,200,000 at sale less cost or $1,880,000 taxed at 25 per cent for a tax bill of $470,000. The remaining $1,730,000 could be invested. If Eleanor obtains a five per cent annual return, she would have $86,500 in annual pre-tax income. That exceeds her present her annual rent of $36,000.

Another option is for Eleanor to transfer the land to the son who would farm it. The Canada Revenue Agency would have the right to reassess the transaction if the curmet market value is not used for the transfer.

CREATING A COMPANY OR TRUST

There is another alternative, though it is both complex and dependent on changing federal government tax policy. The farmland could be transferred into a new company with payment by the company in the form of fixed value preferred shares. The tax liability would be deferred until the preferred shares are redeemed. All the value of the land would be in the shares, so the three sons would get common shares at nominal value. The sons would then have all future appreciation of the land conveyed in the common shares.

The net income of the farm rental would be distributed as preferred dividends to Eleanor.

This structure could be a problem. The federal government is revising its approach to small business taxation. The arrangement could create double taxation under some of the tax proposals. Best bet? Wait to see how new tax rules evolve, Don Forbes suggests.

Finally, Eleanor could create a family trust and transfer ownership of the land to the trust. It would be a flexible arrangement which could include grandchildren. There would be legal fees to set up the trust and annual accounting fees on top of personal income tax preparation costs.

INVESTING THE CASH

How much money the land would generate if sold will depend on an assumed rate of return. Using a five per cent assumed return before inflation of two per cent, leaving her to net three per cent, the $1,730,000 could allow Eleanor to net $7,866 per month before tax for 27 years to her age 100. On top of that, she would have her present Canada Pension Plan benefit of $540 per month, Old Age Security of $584 per month and a defined benefit pension from prior work of $420 per month. The total, $9,410 per month or $112,930 per year, would exceed the OAS threshold of about $74,000 per year. After 15 per cent tax on the $38,920 exposed to the clawback or $5,840, and 30 per cent tax on the balance, she would have $6,250 per month to spend.

Her potential spending could be enhanced by cutting the term of the assumed annuity to 20 years. In that period, it would generate $116,285 per year.

Provided that Eleanor leaves her house in town out of the land sale — it is not included in our calculations — she would have a source of capital in reserve. For the moment, it is her home and will be for many years. If she is blessed with long life and lives beyond our annuity calculations, she could sell the house at what is likely to be a higher price driven up by inflation.

Eleanor can also open a Tax-Free Savings Account. She has no TFSA now but any income she saves can be sheltered from double taxation to her 2018 limit of $57,500. She has no earned income and is too old for an RRSP, Don Forbes notes. That she could have used the RRSP for tax deferral decades ago is beside the point. "That time is past," Forbes adds.

"This plan has many alternatives," Forbes explains. "Eleanor's problem is to pick the one she thinks preserves her retirement income and provides for her children and grandchildren best. Tax postponement is a good thing, but one has to balance the complexity of arrangements with the result to be achieved."

CASH INCOME FROM THE SALE OF THE LAND

Purchase price:	$320,000
Potential sale price:	$2,200,000
Potential capital gain:	$1,880,000
Less 25% tax:	$470,000
Net cash:	$1,730,000
With 5% annual return:	$86,500

A final consideration is how Eleanor will manage her affairs if the farm is sold. She will have substantial cash requiring selection of financial assets. Her preparation for the task is limited. She would do well to find a professional portfolio manager who would select assets, collect dividends and interest, pay bills and taxes if need be, and ensure that the disposition of her land bears the results she wishes. She can hire a portfolio manager for perhaps one per cent of what could be $1.7 million of assets under management. Assuming the manager uses very low cost trading systems, her fees would be a fraction of conventional mutual fund fees. Trades would be done for her needs rather than the collective needs of other mutual fund investors, Forbes adds. GN

Andrew Allentuck's forthcoming investment guide, "Cherished Fortunes", written with Benoit Poliquin, will be published in 2018.