Purchasing the family farm

Three sons want to buy the family farm. Purchase costs could ruin the plan

By Andrew Allentuck

A couple we'll call Jack and Terri, both 63, have farmed in south central Manitoba for the last four decades. Their farm started with 320 acres; now it's 600 acres of grain with modest profits. The problem? How Jack and Terri can migrate to retirement while accommodating their three sons' wishes to follow Mom and Dad on the farm.

One son, in his mid-20s, and two in their early 30s, are eager to take over. But money is the problem. Jack and Terri are millionaires on paper, but almost all their wealth is tied up in their land and equipment. They can't afford to give their sons a terrific bargain in the land transfer and still have enough capital to support their retirement income goal — $4,000 monthly after tax.

Jack and Terri recognize their problem. To help resolve it, they consulted with Don and Erik Forbes of Forbes Wealth Management Ltd. in Carberry, Manitoba.

"Emotionally, the parents want to help their sons start farming, but today's high land prices make it very hard to start a farm," Don Forbes explains. "Land prices put a profitable operation out of reach. The better approach would be for the sons to have off-farm jobs and farm on a part-time basis."

For their own retirement income, Jack and Terri have several choices. First, sell the land for its market value, about $2.2 million after tax. This choice would reap a handsome gain for the parents and make it impossible for the sons to take over the farm profitably. The second option: sell a quarter to each son at a major discount from market value. It would help the sons but reduce the parents' retirement income. Third choice: form a partnership with the sons and have them pay land rent for the parents' retirement income. As we'll see, this is the best of the three alternatives.

THE ANALYSIS

The first choice, just sell the land, would generate $2.1 million with 600 acres priced at $3,500. The land has a book value of $612,000, resulting in a capital gain of $1,488,000. That gain would be offset by the federal farmland tax credit. There would be no federal tax, though there would be $20,000 Manitoba provincial tax and a $40,000 alternative minimum tax bill of $40,000. The net after-tax proceeds would be $2,040,000, Don Forbes calculates. The AMT would amount to a pre-payment of future taxes.

The farm's machinery would be sold for an estimated $200,000. Its present book value, $30,000, would leave net proceeds of $170,000 with a 40 per cent estimated tax of $68,000. The net after-tax cash proceeds would be $132,000. Remaining grain inventory would be sold for $140,000 less 40 per cent tax of $56,000. That would leave $84,000 after tax.

Adding up the gains after tax, the parents would have $2,256,000 in cash. If this sum were invested at five per cent, it would yield $112,800 per year in pre-tax retirement income. The choice of this option requires that the land sale occur first and the farm machinery sale and sale of gain inventory should take place the following year. That way, the alternative minimum tax charged on the land sale could be used as a credit against federal tax owing for the machinery and grain sales, Don Forbes emphasizes.

The second choice is to sell a quarter to each son. Each would pay $3,500 per acre for 150 acres or, effectively, $2,000 per acre times 450 acres, total: $1,575,000. The parents could discount the price by $225,000 per son, for a total of $675,000 leaving $900,000 to be financed by a land mortgage or $300,000 per son, Erik Forbes explains. Payments on $300,000 at four per cent would cost $19,000 per year or $120 per acre. If the cost were five per cent, the payments would be $21,000 per year or $132 per acre. These costs would make farming uneconomic for the sons. Moreover, banks would be unlikely to lend on these numbers, Don Forbes says. FCC could provide a vendor takeback with recourse of land reversion to the parents if the sons did not meet their obligation, but the costs of financing would make the venture uneconomic.

A final option is a partnership with the sons. They would pay land rental for the parents' retirement income. If land rental at $100 per acre were discounted by $30 and expenses of $20, it would leave $50 per acre times 600 acres or $30,000 a year for the parents' retirement income. That would be $15,000 for each parent before tax.

If Jack and Terri sell their land outright, each would qualify for a $1 million personally owned farm land capital gains exemption and an exemption for their primary residence and one acre. That would be a $100,000 credit, so the first $2.1 million of gains on personally owned farm land would be tax-free.

The transfer to the sons would be at any price between book value and present market value. That would cover land, equipment and grain inventory. The object would be to use up all tax credits and tax exemptions while not claiming the entire value on the farm and having to pay tax on the date of transfer, Don Forbes emphasizes.

Assuming that the parents make the transfer, Jack and Terri would take back a zero per cent interest promissory note on the land. This would protect future income if one or more of the children were to be in financial difficulty through divorce or insolvency. Creditors or an estranged spouse could seek to capture assets but the promissory note would ensure that the parents are paid first. This measure gives title to the land to the children while allowing the parents to retain control.

THE OUTCOME

Assuming that Jack and Terri monetize their farm through sale or a partnership with their sons, then in 2019, when both parents are 65, they would expect gross income of $5,387 per month consisting of $1,250 monthly land rent for each parent, total $2,500 per month, plus two Old Age Security benefits of $600 each, CPP payments based on contributions of $687 in total and $1,000 per month for income from the AgriInvest contributory program for five years. Take off $750 for tax and the parents would have $4,637 left, well ahead of their $4,000 monthly after-tax retirement income target. Money saved from sale of grain inventory could be used to fund RRSPs and to establish TFSAs.

In 2024, when the parents are 69, the AgriInvest payments would stop but higher CPP and OAS benefits would offset some of the decline. If gross income were $4,600 per month and taxes still $750, the parents would have $3,637 to spend, a little less than their target income but easily covered by draws on the parents' Registered Retirement Income Fund accounts that would start payments on or before their 72nd years. At that time, the parents would have $120,000 in RRSPs and $22,600 in their TFSAs, assuming that they do not draw on RRSPs before 72.

"This plan is workable for the sons and the parents if they choose the partnership route. GN

Andrew Allentuck's book, "Cherished Fortune: Build Your Portfolio Like Your Own Business," (with co-author Benoit Poliquin), will be published in November, 2018.