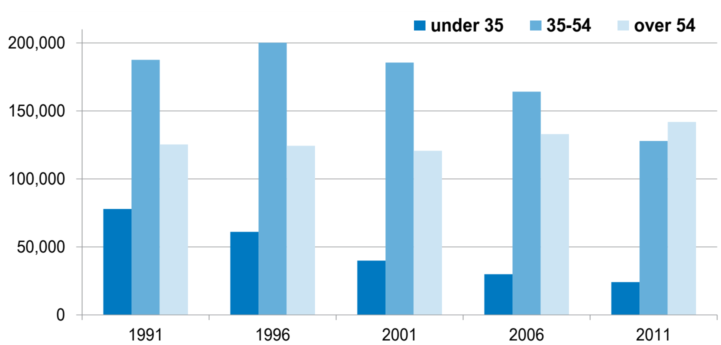
Succession Planning for the Family Farm

For farming families, the farm is its most important asset, requiring thoughtful consideration and proper planning with respect to the next generation who, may or may not, carry on the family business. As a result, succession planning needs to take place well in advance and must take into consideration the needs of the business and the capabilities of the family. Whether the farm is retained within the family, expanded by acquisition or sold to a third party, proper planning will ensure that the family's goals and objectives can be met.

Today, the traditional family farm is facing demographic challenges. As illustrated in the following chart, Shifting Age of Farmers, between 1991 and 2011, the average age of the Canadian farmer rose, while their actual numbers fell. This would indicate that more families need to prioritize succession planning for their family farm.

Shifting Age of Farmers



Source: Statistics Canada, Table 004-0117

What needs to be transitioned?

Planning for the succession of the farm involves transition of both the ownership and the management of the farm to the next generation, who will eventually own and operate the family farm. It's therefore important that the current generation mentor the next generation of family farmer to make sure they are ready to take control. This includes making all of the day-to-day decisions, as well as determining the longer–term strategic direction of the farm and its management.

The most successful transitions are based on open and frank communication between both generations. Each party needs to be able to discuss their concerns openly and listen to the other's point of view. They must respect each other and have an open mind.

Tax tools available

There are a number of tax incentives available to assist in the succession planning process, including:

1. **Capital gains exemption**
The party(ies) selling the qualified farm property can each get the first $1 million of capital gains realized on the sale of the property, tax-free. In terms of planning, the party selling the farm should:
    - Ensure that their farm property qualifies for the exemption;
    - Consider the strategy of crystallizing each generation's capital gains exemption into the adjusted cost base for the next generation; and
    - Investigate the possibility of multiplying the capital gains exemption by using the exemption of other family members on the transfer or sale of the farm property.

2. **Farm property rollover**
The farm owner can choose to "sell" the farm property to the next generation family farmer, such that income taxes are minimized, the capital gains exemption is optimized

Continued

and retirement income is secured. However, the selected selling price has to be within a prescribed range, though there is usually sufficient room for planning. Selling in this manner allows the current farm owner to set some capital aside to secure their retirement and provide for any children who will not be inheriting the farm. In terms of planning, the current farm owner must ensure that the farm property qualifies for this special treatment. It should be noted that the qualification for a rollover treatment is not necessarily exactly the same as the qualification for the capital gains exemption.

3. Estate freeze

A farmer looking to pass along the farm property to a succeeding generation can crystalize their equity in the farm and introduce the next generation into an ownership position by using an estate freeze strategy. There are several methods of accomplishing an estate freeze and the option chosen will depend on the situation. In general terms, the current generation would hold fixed value preferred shares, and the next generation would hold new common shares. The benefits of an estate freeze are to introduce the next generation into ownership, recognize the next generation's contribution and limit the value that would be shared with other family members.

Case study – The Smith farm[1]

The Smith farm was owned though a farm corporation by three brothers, Tom, Dick and Harry, who had taken it over from their parents over 30 years ago. All three brothers were married, had children of their own and held an equal number of common shares in the corporation. The farm was very successful and had supported all three families over the course of the years.

The following is an overview of the three brothers and their respective children:

- Tom aged 65, had two children;
- Dick aged 63, had three children; and
- Harry aged 60, had four children.

When the time came to discuss estate and succession planning for the family farm, the brothers came to the following decisions:

- All of their children would be given the opportunity to stay on the farm, and eventually take over the farm's operations;
- The children who wanted to stay on the farm would eventually have 100% equal ownership of the farm; and
- The children who chose another career path would receive an inheritance equal to their siblings who chose to remain in the family farming business.

From here, the brothers developed the following succession plan:

- All of the brothers froze their positions in the farm corporation by exchanging their common shares for fixed value preferred shares. New common shares were issued to a discretionary Family Trust, where all of the next generation children were listed as beneficiaries. The trustees were instructed to distribute the common shares to those children who were going to remain actively involved in the farm operation.
- A shareholders' agreement was drafted that included a provision that allowed the active farming shareholders to buy out the non-farming shareholders by redeeming their shares.
- The farm corporation purchased life insurance on each of the brothers, such that it could redeem their preferred shares in the event of any of their premature deaths.
- Upon their passing, each brother would bequeath their preferred shares to their children. The corporation would collect the life insurance proceeds and use the funds to redeem the preferred shares from the children. Because the redemption was funded with life insurance, most of the redemption proceeds would be designated as a capital dividend and received tax-free. In this fashion, all of the children were treated equally and fairly.

Continued

Seek professional advice

If you own a family farm and are contemplating its transition to family members, developing a formal succession plan is crucial. Planning should involve the whole family, including those living on and off the farm. Being inclusive allows the current generation to communicate their goals and objectives, as well as their issues and concerns. If all family members know the plan, they will be more likely to accept the plan and participate as required. Professional advice is recommended in developing your succession plan and implementing solutions that fit your particular circumstances and personal objectives.

Please speak to your BMO financial professional for more information.

[1] Based on actual client case; however, the names have been changed to protect the family's identity.

BMO Wealth Management

ID1016 (03/17)