

Farm Estate Planning Strategies

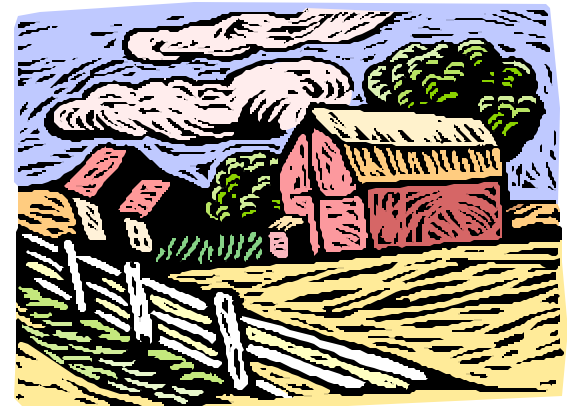


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A Farm Corporation

- Upon death of a farmer, all his assets, including his shares in the farm corporation, are deemed to be disposed of immediately before death. This triggers capital gains tax.
- 50% of all capital gains are added to the farmer's income in the year of the death.
- This tax is very substantial.



Shares of a Qualifying Farm Corporation

- **If the farm corporation meets all the tests, the shares may be eligible for an inter-generational roll over.**
- **If these shares are left to a child, who is actively engaged in farming, the child can inherit the shares at his father's tax cost, thereby deferring the capital gains tax.**



- **These shares could also be left to a spouse or spousal trust and qualify for a rollover, without triggering capital gains tax.**
- **The capital gains tax is deferred until the spouse dies or disposes of them.**



How to solve the problem if the farmer has other children not active in farming

- He can leave the shares of the farm corporation to his spouse if he dies. This will qualify for a tax free rollover to his spouse.
- If he or his spouse leaves the shares to all the children equally, **what might happen?**



Lets assume there are 3 children, with
only one actively farming:

- The children who are not farming decide to sell their shares to the child who is actively farming.



- When each child **not actively farming** inherits or is given the shares in the farm corporation, this does not qualify for an intergenerational rollover and substantial capital gains tax has to be paid to C.R.A.



•When each child **not actively farming** sells their shares to the child **actively farming**, the child purchasing these shares has to pay for them with after tax dollars.



- **With this plan, there will be a huge capital gains tax liability. Canada Revenue Agency (C.R.A.) will have to be paid.**
- **Also, where will the child actively farming obtain the funds to purchase the shares? These shares have to be paid with “After Tax Dollars”.**
- **If the bank loans the money, the interest would be tax deductible, but the principal is paid with after tax dollars.**



- **This debt burden could be crippling to the child actively farming.**



Lets consider a more practical solution,

where no capital gains tax has to be paid and the children not actively farming receive their inheritance tax free.

- While the child is actively farming with his father incorporate a holding company. This company will own the shares of the farm corporation.**
- Father and mother will own the shares of the holding company.**



- **The holding company purchases a large life insurance policy on the father. The holding company also purchases a Joint Last to Die policy on the mother and father.**
- **The premiums are funded by paying dividends from after tax profits of the farm corporation to the holding company. There is no tax on an inter-company dividend.**



- **The holding company is the owner and beneficiary of the life insurance policies.**
- **Upon death of the father, his shares can be left to the child farming **or** his spouse **or** both with **no capital gains tax payable.****
- **This would qualify as a “rollover”.**



- **When a corporation pays a regular dividend to a shareholder, tax has to be paid.**
- **When the father dies, the death proceeds of the life insurance policy are paid tax free to the holding company. This creates a notional account called a “Capital Dividend Account”. These proceeds can then be paid out to the father’s spouse as a “tax free” capital dividend.**



- **The father's spouse can keep her shares or give them to the child actively farming.**
- **There is no capital gains tax as this would be an intergenerational rollover.**
- **The spouse receives the life insurance proceeds as a tax free dividend. The spouse can keep adequate funds so she can live in dignity and give the balance to the other children tax free – CRA receives no tax.**



- **Upon her death, the Joint Last to Die life insurance policy pays the death proceeds tax free to the holding company. The holding company's charter should provide discretion as to the payment of dividends between classes of shares.**
- **A tax free capital dividend would be paid on her shares. These tax free funds can be paid out under the terms of her will.**
- **Perhaps they will be given to the other children tax free and her remaining shares given to the child farming.**



Why is a holding company used to purchase the life insurance and not the farm corporation?

- The Holding Company is used to purchase the life insurance and not the farm corporation because to qualify for a tax free intergenerational rollover, **90% of the farm corporation's assets must be "farm assets"**.
- The death proceeds would put the farm corporation off-side for this test.



- **This strategy means a huge payment to CRA will not occur!**
- **Also, it is easier for the child farming to come up with a large life insurance premium while the farm is operating successfully, than to purchase the shares from his brothers and sisters with “after tax dollars” and carry large bank loans.**



ANOTHER REASON

- **It is prudent to form a holding company to hold the shares of the farm corporation.**
After-tax profits of the farm corporation can flow to the holding company as a tax free inter company dividend.
- **This means accumulated profits are not available to creditors of the farm corporation and not vulnerable to litigation against the farm corporation.**



- If someone is injured, while on the farm or there is a highway accident involving a vehicle owned by the farm corporation, there could be a large claim made against the farm.



WORKING CAPITAL

- **If the farm corporation needs money, the holding company could give a loan as a secured creditor, to the farm corporation.**



To Give You an Idea of the Capital Gains Tax Liability

Let's assume the capital gain on the shares
left to the children not farming is
\$2,700,000



**50% of Capital Gain added to
income of husband in year of death** **\$1,350,000**

**Income Tax Payable at a marginal
rate of 45%(depending on province)** **\$ 607,500**

**If the \$500,000 Capital Gains
exemption was available to husband
on the corporation's shares:**

Total Capital Gain	\$2,700,000	
Less exemption	<u>\$ 500,000</u>	\$2,200,000
50% added to income		<u>1,100,000</u>

**Income Tax Payable at a marginal
rate of 45%** **\$ 495,000**

FUTURE CAPITAL GAINS TAX?

Let's look at some
future values...



**Capital Gains Tax in
10 years at 8% growth
Less Cost Base**

\$6,477,000
300,000
\$6,177,000

**Less Capital Gains
Exemption
(corporate shares)**

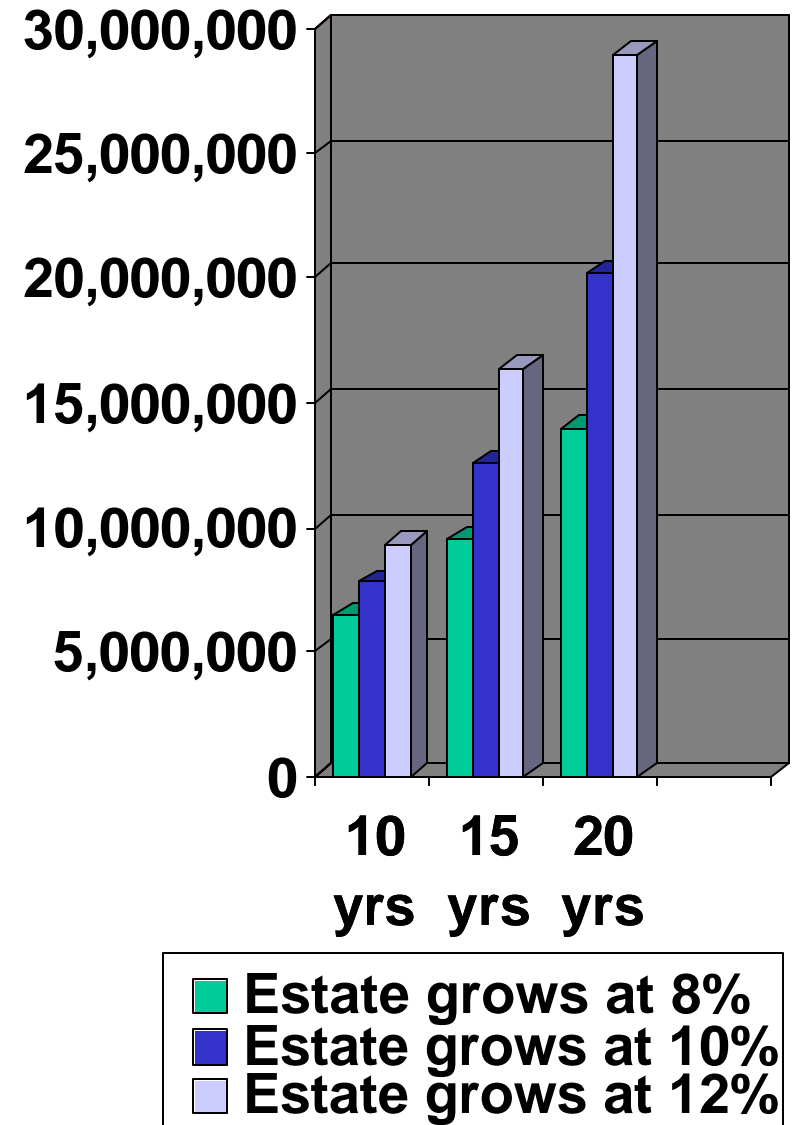
500,000
\$5,677,000

**50% added to income
in year of death**

\$2,838,500

**45% marginal tax rate
tax payable**

\$1,277,325



**Capital Gains Tax in
20 years at 10% growth
Less Cost Base**

\$20,181,000
300,000
\$19,881,000

**Less Capital Gains
Exemption
(corporate shares)**

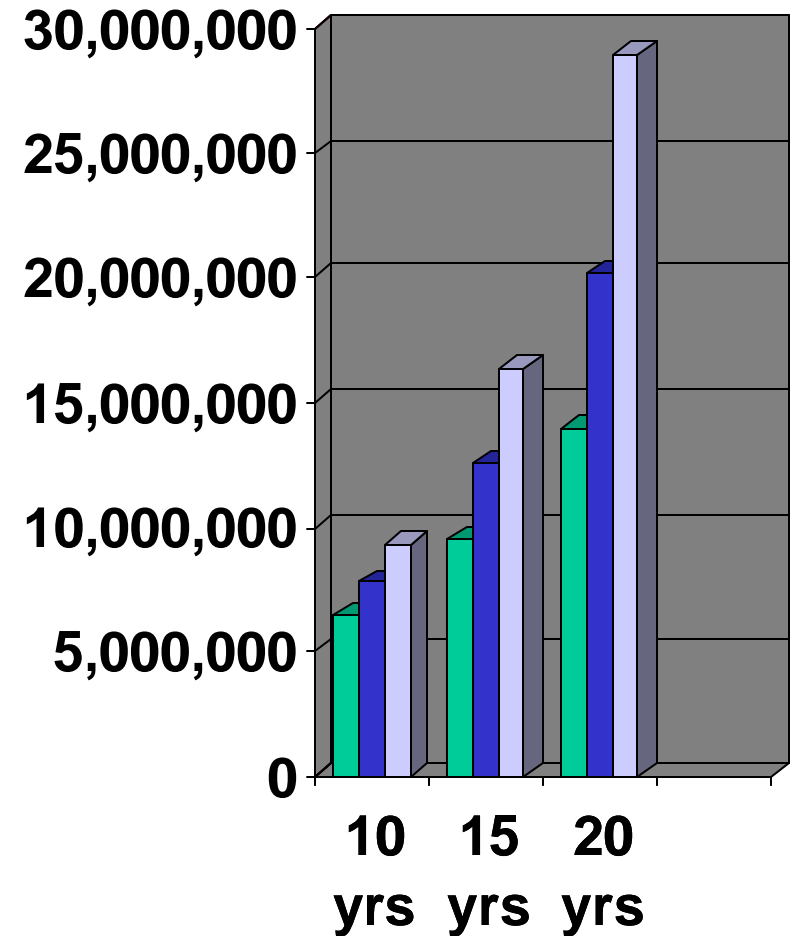
500,000
\$19,381,000

**50% added to income
in year of death**

\$ 9,690,500

**45% marginal tax rate,
tax payable**

\$ 4,360,725



How Does An Actuary Calculate the Life Insurance Policy Premium?

- **Step 1**
 - The actuary determines the “present value” of the death benefit.
 - Example
 - A \$1,000,000 death benefit may have a present value of \$100,000.
 - This means if \$100,000 was invested with interest this would be worth \$1,000,000 by the time the insured is expected to die.



Step 1– cont'd

- The \$100,000 is a single deposit.

If the policy is paid over 10 years:

- The \$100,000 payment is amortized with interest over ten years, similar to a mortgage.



- **Step 2**

- Many people cash out of and cancel their policies early, say, after 10 years.
- The insurance company gets off the risk of paying the death claims.
- So the actuary calculates into everyone's premium a large discount because the insurance company gets off the risk of paying death claims.



Example

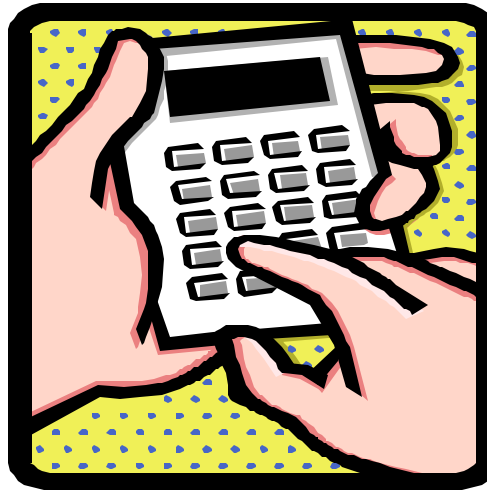
Male, Age 50, Non-smoker, lives to age 80.

- \$1,000,000 level annual premium \$10,820
- \$10,820 invested each year, annual compound interest for 30 years to age 80.

Value

Interest net after tax 4%	\$631,112
Interest net after tax 6%	\$906,734
Interest net after tax 6.5%	\$995,326

- **The above calculation does not take into account the cost of Insurance. If the insured died prematurely after only 5 years, the policy will pay out \$1,000,000.**



- The actuary has to deduct the cost of insurance from the \$10,820 (in case of early death) before the money can be invested.
- The amount at risk (insurance), from early death decreases as the fund increases.
- The following is the premium for \$1,000,000 of Insurance based on yearly renewable term premiums.

AGE		AGE	
50	\$1,695	55	\$4,775
51	\$2,335	56	\$5,585
52	\$ 2,885	57	\$6,505
53	\$3,435	58	\$7,565
54	\$4,075		



- **This means the people who cancel their policies before death substantially subsidize the people who keep their policies (most of the policies which cancel early are of a smaller size).**



EXAMPLE:

- Male- age 50, Female- age 50, non-smokers, Joint Last to Die policy, last dies at age 80.
- \$1,000,000 Level annual premium \$4,500.
- \$4,500 annual deposit for 30 years to age 80.

VALUE

Interest net after tax = 8% \$550,556

Interest net after tax = 11% \$994,109

*does not include cost of insurance if they both died early in an accident.



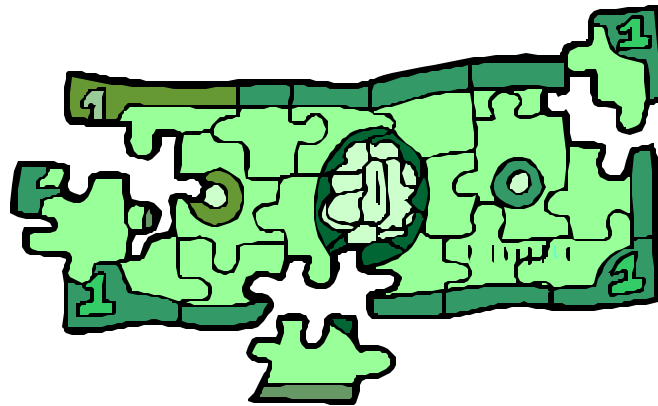
**It is really amazing you can
provide these funds with such a
large discount !**



- This means the business man who keeps the policy to pay taxes at death gets a discounted premium.
- He is buying **TAX FREE DOLLARS** exactly when it is needed with **DISCOUNTED** dollars.



- **The holding company is really purchasing money, payable in the future, at a huge discount.**
- **This money is tax free to the corporation and is paid out to shareholders as a tax free dividend.**



SUMMARY

- **Buying discounted dollars, when it is needed, using a life insurance policy is far better than paying Canada Customs and Revenue Agency large amounts of capital gains tax.**
- **It is much better than having the bank on the backs of children taking over the farm.**
- **The children, not farming will also receive their inheritance tax free.**



Collateral Term Life Insurance

- Many corporations and farm corporations purchase creditor term life insurance from a bank when they borrow money.
- The bank owns the group policy and gives the borrower an insurance certificate, not an insurance policy.
- The bank is the beneficiary of this insurance certificate. Upon death of the borrower, the bank loan is paid off.



This is Costly for Two Reasons

- **Your Ten Star advisor can obtain coverage for substantially less premium.**
- **Your corporation will own the policy (it is not a certificate) and your corporation will be the beneficiary.**
- **A collateral assignment of the policy in favour of the bank is made.**
- **The premium is tax-deductible to your corporation for an amount of insurance equal to the bank loan.**



- Because your corporation is the owner and beneficiary of the policy, upon death, a notional account in your corporation is created, called a **“Capital Dividend Account” (CDA)**.
- The amount of this account is equal to the insurance less the **adjusted cost basis (ACB)** of the policy (the **ACB** is very small).



- **Insurance company sends a cheque to the bank to retire the loan with the balance paid to the corporation tax free.**
- **Going forward, the surviving shareholders can be paid dividends from the corporation **tax free** (up to the amount of the CDA).**
- **A \$1 Million CDA will save approximately \$300,000 in tax. This benefit is not available with a bank insurance certificate.**



As tax rules change, you should have this reviewed by your tax lawyer and accountant on a regular basis.

