CASE IN POINT

Sales Tax Estate Planning Underwriting & Product Newsletter

Estate equalization for farming families

Clients who are business owners put a lot of importance and thoughts in transferring their business to the next generation. When it comes to clients who own a farming business, the Income Tax Act (ITA) provides special rules to facilitate these transfers of the business to the next generation. For those clients, complexity in estate planning arises when not all their children are involved in the farming business. The clients may want to benefit from the tax-deferred transfer of the business in favour of the child that will run it in the future but they may also want to make sure that a child who is not involved in the farming business sees his fair share of the family's estate.

Let's look at a strategy that advisors could propose to farming clients in the situation described above.

Our case study

Jim is a 55-year-old man who is the sole shareholder of a private corporation (hereinafter "FarmCo") that owns all the assets (e.g. land, machinery and equipment, inventory, etc.) of a farming business that he operates. The shares of FarmCo are currently worth about $2M. Jim has a daughter who is involved in the farming business and a son who is not and never will be.

Jim is approaching retirement and he is wondering what the best way would be to ensure the transfer of the farming business to his daughter while ensuring fairness between his children in terms of estate planning.

Alex Papale,
Tax Retirement & Estate Planning Services

Alex is a well-regarded Tax and Estate Planning specialist with a sought-after ability to analyze and articulate complex matters. He completed graduate studies in tax law which allows him to provide suggestions for comprehensive solutions to problems faced by Canadian residents and business owners. Before joining Empire Life, Alex worked for renowned accounting and legal firms, where he regularly advised clients on various tax and estate planning matters.

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Proposal

We believe that Jim's objectives could be met if:

1. Jim transferred all the common shares of FarmCo in favour of his daughter;
2. FarmCo issued a life insurance share in favour of Jim's son; and
3. FarmCo obtained a life insurance policy with a $2M death benefit on Jim's life.

Before we look in more detail at the different aspects of this proposal, let's look at some tax issues which would be relevant in this case.

Tax considerations

Transfer of shares

Subsections 73(4) and (4.1) of the Income Tax Act (Canada) ('ITA') allows the transfer of a share of the capital stock of a family farm corporation on a tax-deferred basis to a child of the holder of the share. The conditions to be considered a "share of the capital stock of a family farm corporation" are established at subsection 70(10) ITA and include, among others, that all or substantially all the value of the property owned by the corporation is attributable to property used principally in the course of carrying on a farming business in Canada.

If all the conditions are met, the shares of the corporation can be transferred to the child, while the parent is alive, without triggering a tax liability. Transfers made while the parent is alive are called inter vivos transfers.

Life insurance share

Life insurance shares are a way for a corporation to direct the benefits associated with a corporately owned life insurance policy (cash surrender values and/or death benefit) to a specific shareholder.

When the use of a life insurance share is considered, the timing of issuance of such share is important. More specifically, the timing of issuance of a life insurance share may have different tax consequences whether the share is issued before or after the relevant life insurance policy is in force.

In situations where a corporation is owner of an already in force life insurance policy, consideration in an amount equal to the fair market value of the policy should be paid by the shareholder to whom the life insurance share is issued to the corporation. If no consideration is paid by the shareholder, a shareholder benefit under subsection 15(1) ITA would arise and would lead to an income inclusion for the shareholder.

If the life insurance share is issued in favour of a shareholder before the associated life insurance policy is issued, the life insurance share could be issued in return for $1 without the shareholder incurring a benefit under subsection 15(1) ITA.

For more information regarding life insurance shares, we invite you to consult our newsletter "Understanding life insurance shares".

Back to our case

Jim has retained the services of independent tax advisors who have confirmed that the conditions for an inter vivos transfer of shares are met. Jim could then transfer all the common shares of FarmCo to his daughter without triggering a tax liability. After the transfer, Jim's daughter would be the sole shareholder of FarmCo and would benefit from the full value of $2M associated with FarmCo.

At the same time as the common shares of FarmCo are transferred to Jim's daughter, FarmCo issues a life insurance share in favour of Jim's son in return for $1. After the life insurance share is issued, FarmCo obtains a permanent life insurance policy from Empire Life on Jim's life with a death benefit of $2M. The life insurance share held by Jim's son will give him the right to any death benefit payable to FarmCo under the life insurance policy from Empire Life.

Meeting Jim's objectives

This strategy is interesting because it meets the objectives mentioned by Jim.

First, the transfer of FarmCo's common shares is done tax efficiently in favour of the child who will take over the farming business i.e., the daughter.

It is also a strategy that is fair for both children. The daughter will benefit from all the value that FarmCo will accumulate after the transfer. Since she will be working full time on the farm, it's fair that she benefits from her hard work. Jim's son will receive, at Jim's death by means of the life insurance share, an amount of money which is similar to the value of the business when it was transferred to his sister.

Therefore, even though the timing and the nature of the assets received by both children differs to reflect their involvement in the family business, the assets received should be relatively similar in value.

How we can help

Our tax and estate planning team can assist you and your clients in matters of tax and estate planning involving incorporated professional and small business owners. Contact your account manager to see how the team can help you and your clients.

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