LEVERAGE

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Note from the editor

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Financial planning is financial planning, right? Wrong! Though the principles, process and six steps to conclude financial planning remain the same, there are certain factors that are relevant to a certain class of client depending either on their age, family structure or occupation. That is why we are focusing on farmers in this issue, to highlight certain aspects that you should be aware of when being confronted with a client who is a farmer.

I trust that you will enjoy the read, even if you never see a client who is a farmer – certain concepts will remain relevant to all clients.

Happy reading!

Farming for generations

By Sharon Hamman (née Teubes), Senior Legal Adviser: Advice and Wealth Management

Many farms are handed down from one generation to another and it is often a silent agreement that children will continue where parents left off. This is not always practical, as children might not be interested in farming, or there are multiple children and only one that wishes to farm or there are no children at all. Therefore, the continuity of the farming business is an important factor to consider, even if the 'obvious' continuity plan of children exist.

When faced with a continuity plan for a client who is a farmer, you have to remember certain issues that can have a real impact on the financial plan that is to be implemented. This includes, but is not restricted to:

- The Subdivision of Agricultural Land Act (SALA) determines that agricultural land cannot be subdivided. This means that only one person or entity may own a specific piece of agricultural land. Therefore, it can only be bequeathed to one person. This can be particularly challenging when a farmer has more than one child interested and capable of continuing with the farming operations.
- Farmers are often married in community of property, which can pose a problem when planning to transfer the farm on the death of the farmer while the spouse is still alive.
- In many cases, only one child is earmarked as the next generation farmer; however, there is a wish to distribute the wealth equally between the children – the 'wealth' being the farm.

Though there is no right or wrong financial plan for a farmer, the following strategies can be useful to determine the most appropriate course of action when planning for the continuity of the farming business.

Bequest price

A 'bequest price' is basically where the legatee must pay the estate a fixed sum of money to qualify for the bequest. For example, the will reads: "My son Jasper will inherit my farm on condition that he pays an amount of R5 million". The R5 million is what is referred to as a 'bequest price' and if this cannot be paid, then the inheritance will be forfeited.

Example
When using the continuity strategy, Jasper can insure his father for an amount equal to the bequest price (plus estate duty) to ensure that he has the money to pay the bequest price. The outcome is that his father's estate will receive R5 million that can be distributed among the other children as their share of the estate; alternatively, it can be invested to provide the mother with an income independent from the farm.

One-sided buy-and-sell agreement

In this case, a buy-and-sell agreement is implemented between the buyer and seller stipulating that the farming business and/or the farming property will be sold to the buyer on the death of the seller. The transaction is funded by a life insurance policy on the life of the seller of which the buyer is the owner. The transaction can work well where the farm is operated through a private company or close corporation (CC), business trust or even where the farm is owned by an individual.

As the farmer is generally the sole owner of the farming business or the farm, the buy-and-sell agreement is generally one-sided, which means that there is only an obligation to buy on the buyer and an obligation to sell on the seller. Since the buyer and seller are not co-business owners, the life policy funding the agreement will not be exempt from estate duty. Therefore, it is potentially subject to estate duty. It is advisable to make provision for the duty by adding the amount to the life cover.

This scenario is favourable where the farmer is married in community of property, as the spouse will also be part of the buy-and-sell agreement to sell their undivided half share upon the death of their spouse.

Example
Francois and his son, Frank enter into a one-sided buy-and-sell agreement which stipulates that Frank must buy the farm and/or farming operation (that is, the vehicles, equipment, etc.) from Francois on his death. A valuation of the farm and equipment is done to establish the purchase price. Frank takes out a policy on the life of Francois and pays the premium. On Francois' death, the policy proceeds pay to Frank, who in turn buys the farm from the estate in terms of the buy-and-sell contract. Therefore, the farm is 'swopped' for a cash amount which can be applied to support Francois' wife or alternatively distributed to Francois' daughters in terms of his will.

Conclusion

When faced with a farming business, you must not forget that it is just that: a business. Like with any business, you must assess the following:

- The business,
- The wish of the business owner, and
- The eventual, expected outcome of the financial plan.

That will allow you to assess the usual business continuity solutions and determine what is most appropriate for the client.

Income Tax Act (ITA), Section 9HA:
The impact on a deceased farmer's estate

By Ivan Matee, Legal Adviser (Financial Planning and Advice)

A simple definition of 'estate planning' is the management and arrangement of the client's estate to ensure that the client and their dependants enjoy the wealth created during their lifetime and after their death. Experts have written extensively on the effect of estate duty and capital gains tax (CGT) for estate planning purposes. Doing a proper estate plan will ensure that there is sufficient liquidity in the estate and achievement of succession to the heirs of the family business.

While significant savings may ultimately be achieved through estate planning mechanisms, caution must be exercised when doing financial planning for farmers operating as sole proprietors, since the effect of Section 9HA of Income Tax Act (ITA) may derail the effectiveness of the financial plan. For income tax purposes, this section has the following effect.

Revenue assets

- In a normal tax year (where the farmer is not deceased), the assets such as livestock are included in the calculation at the standard value – basically, the difference between the opening and closing values will be subject to income tax.
- The standard value may be much less than the market value of the asset and in some instances it can even be nil; for example, game.
- Therefore, during the farmer's lifetime, the income tax implication in respect of revenue assets is generally small.
- Where the farmer dies after 1 March 2016, the farmer is deemed to have disposed of all assets at market value (other than to their surviving spouse), which may be much higher than the standard value or tax value of those assets.
- The effect is that the difference between the opening value (which is the closing value of the previous year – at the standard value) and the market value upon death will be subject to income tax, which can be significant.

Capital assets

- A farmer that died on or after 1 March 2016 will have a disposal of a capital asset upon their death and a recoupment of allowances that was claimed on such capital assets, as required in terms of Section 8(4) of the ITA.
- Due to the exclusion applicable to bequests to spouses, there should be no recoupment in the hands of the deceased person in respect of trading stock or other business assets (on which capital allowances were claimed) that is transferred to a surviving spouse, while the capital gain or capital loss in respect of capital assets should be rolled over to the surviving spouse.

Conclusion

It is clear that this section can have a detrimental impact on the liquidity provisions in the estate. Therefore, it is important that a farmer should have a proper estate plan to address the liabilities and tax implications of the estate. Without proper cover in place, the assets of the deceased farmer will end up being sold to cover all potential costs and debts in the estate.

Fiduciary Corner

Usufruct or trust: Which option should you use when planning for the farmer?

As a general rule, a discretionary trust (either inter vivos or testamentary) is a more flexible option compared to a limited interest (for example, a usufruct). This can be seen by highlighting the following factors.

- The holders of limited interests (that is, usufructuaries) in property are legally obliged to maintain and preserve the property and to pay all rates and taxes. However, the holder is not obliged to pay insurance premiums or to incur capital expenditure to prevent the property from falling into ruin. If they make improvements, they are not entitled to compensation. With trust beneficiaries, all these issues are flexible and entirely subject to the trustees' discretion or the trust deed.

- A usufructuary may not alienate, mortgage or pledge the property without the consent of the bare dominium holder or the court (in the case of one of the bare dominium holder being a minor). The opposite will also apply; the bare dominium holder cannot do anything in respect of the property without the consent of the usufructuary. However, the power of a trustee to deal with the trust property in any of these ways is usually given to the trustees in the trust deed.

- A usufruct is inflexible and not suited to changes in circumstances (that is, the needs of the beneficiaries and their marital status). However, a discretionary trust can readily provide for such circumstances.

- Usufructuaries are usually taxed on the income generated by the property they enjoy the use of; whereas, trustees of a discretionary trust (through the exercise of their discretion) can decide when and how much income is distributed; thereby, providing flexibility depending on various beneficiaries' circumstances and tax profiles.

- Problems may arise when the holder of a limited interest ceases to be the holder at a time when it is inappropriate for the successor to acquire the interest (for example, the successor may be a minor). This problem does not arise with a properly-drafted discretionary trust.

- Generally, trust property can be used as security to raise a loan (for example, a mortgage bond) if provided for in the trust deed. However, property subject to a usufruct would generally not be available for this purpose, unless both parties agreed to it.

- Limited interests enjoyed by the testator at the time of death generally constitute property in the testator's estate and, accordingly, attract estate duty. By comparison, the right of a beneficiary of a testamentary discretionary trust is not property in the estate; therefore, there are no estate duty implications.

There is not necessarily a right or wrong answer when weighing up the usufruct with the use of a trust; however, you should generally opt for the most flexible, user-friendly option to ensure that the client remains committed to the solution.

About Leverage

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