How should Farm Bureau help prepare its members—both young and old—for transferring operations to the next generation of farmers and ranchers? What is Farm Bureau's role in encouraging more transfers?

LEGACY PROJECT-Farm Journal
http://www.agweb.com/legacyproject/issues/?BrandId=3&IssueId=446

WHOLE-FARM DECISIONS- SUCCESSION
http://www.extension.iastate.edu/agdm/wdbusiness.html

Beginning Farmer Center
Iowa State University
http://www.extension.iastate.edu/bfc/

FARM/RANCH TRANSITION & ESTATE PLANNING
By Dave Goeller, Univ. of Nebraska
http://www-staging.exnet.iastate.edu/sites/www-staging.exnet.iastate.edu/files/files/Successor.pdf

STRATEGIC BUSINESS PLANNING FOR COMMERCIAL PRODUCERS
Module- Succession Planning
Purdue University
http://www.agecon.purdue.edu/extension/sbpcp/strat_succession.asp

Ohio State University – TRANSFERRING YOUR FARM BUSINESS TO THE NEXT GENERATION
http://ohioline.osu.edu/b862/b862.pdf

University of Minnesota Extension Service – TRANSFERRING THE FARM
http://www.extension.umn.edu/distribution/businessmanagement/M1177.html

"TRANSFERRING THE FAMILY FARM" - Chapter 9 from Kansas Farm Bureau Legal Foundation book, "*Securing a Solid Future*"
http://www.kfb.org/kfblegalfoundation/securefuture/ssfchapter9.pdf

Beginning Farmer Center

Objectives

- Coordinate education programs and services for beginning farmer efforts statewide.
- Assess needs of beginning farmers and retiring farmers.
- Develop, coordinate, and deliver targeted education to beginning and retiring farm families.
- Provide programs and services that develop skills and knowledge in financial management and planning, legal issues, tax laws, technical production and management, leadership, sustainable agriculture, human health and the environment.

Future plans for the center

- Continue the Farm On program that links beginning farmers with farmers desiring to transition their farms to the next generation.
- Continue the Ag Link seminar for farm owner/operators and their business successors.
- Continue supporting the individual farm financial analysis for beginning farmers through the Extension Farm Financial Planning Program.
- Conduct targeted research to on farm business succession planning, the needs for beginning farmers and other relevant topics.
- Provide educational materials to beginning and exiting farmers through a variety of methods including the internet, seminars, and publications.

Preparing the next generation of farmers in Iowa

Watch this short video on the next generation of farmers in Iowa:
http://www.youtube.com/watch?feature=player_embedded&v=e2wSObQcMIM

History

The Iowa Legislature created the Beginning Farmer Center in 1994. The Center is a part of Iowa State University Extension. The idea for a Beginning Farmer Center developed from a series of discussions with Legislators, Extension personnel, and others concerning what could be done to encourage new farmers. These discussions led to the conclusion that it was necessary to have a center to focus exclusively on the needs and issues facing beginning farmers. It was also determined that this Center should facilitate the matching of beginning farmers with existing farmers who wanted to transition their farm businesses to the next generation.

The law creating the Center is set out in Chapter 266 of the Code of Iowa and provides, in part, that the Center "shall... assist in facilitating the transition of farming operations from established farmers to beginning farmers". The law also provides that the Center is to develop "models to increase the number of family farming operations in this state". To meet these mandates the Center has funded a variety of programs, publications and research efforts.

What is The Legacy Project?

The Farm Journal Legacy Project is a concerted effort to address the succession planning needs of America's farm families. Utilizing all Farm Journal Media properties, the Legacy Project provides comprehensive succession planning information. Its mission: to cultivate multigenerational success in the agricultural community.

With the generous support of Pioneer Hi-Bred International, a DuPont Business, Farm Journal Media is expanding upon its original editorial commitment – which began in the spring of 2008 – to raise awareness surrounding legacy planning and will kick off the single largest education initiative of its kind in agriculture today.

The Legacy Project is a catalyst for families to begin the process and an essential go-to source for the tools to simplify the complex and daunting task of succession planning. Farm Journal Media has committed its expertise, reach and trust in farm country to help farmers take decisive action and secure the legacy of this generation and the ones to come. For the next decade, the Farm Journal Legacy Project will generate full awareness and tirelessly provide inspiration, practical tools and sound advice to underpin the steps to establish and formalize effective succession plans.

The Legacy Project will include:

- Hands-on training workshops with Farm Journal columnist and succession planning expert Kevin Spafford, author of Legacy by Design: Succession Planning for Agribusiness Owners. Spafford, a certified financial planner, owns Legacy by Design, a firm that guides farmers and agribusiness owners through the succession planning process
- Extensive editorial coverage in FARM JOURNAL, TOP PRODUCER and DAIRY TODAY magazines, on the "AgDay" and "U.S. Farm Report" TV shows and AgWeb.com, with case studies and comprehensive coverage;
- An annual special issue of FARM JOURNAL magazine dedicated exclusively to the topic
- Specific training and tools at www.FarmJournalLegacyProject.com;
- A monthly Legacy television show;
- A weekly eNewsletter
- And more

Legacy Project: Legacy Project 2011 Report

Case Studies

- Peace of Mind
- The Journey Begins
- One Step at a Time
- The Paper Chase
- Homecoming
- Succession Setbacks

Ag Business Management

University of Minnesota Extension

Informing farm families and ag businesses about management issues.

Transferring the Farm Series #1 9/2009

Preparing to Transfer the Farm Business

Prepared By:
Gary A. Hachfeld, David B. Bau, C. Robert Holcomb, & James N. Kurtz, Extension Educators

Introduction:

Transferring the farm business to the next generation is seldom an abrupt process. The transition generally takes place over a number of years. The entering generation needs to establish a firm financial footing as well as learning to manage the business. The retiring generation has to be willing to turn over control of the business and trust that the successor will do well.

Farming is a capital intensive business. Farms are made up of several classes of assets. Current assets include stored and growing crops as well as feed inventories. Intermediate assets include breeding and market livestock, machinery, and equipment. Farmland and buildings make up long-term assets. The total of all these assets can equal millions of dollars.

The transition process must be well thought out and implemented prudently, given the potential financial consequences to all involved. The following information will help you with this process.

Factors to Consider Before Transferring the Farm Business:

Your Financial Security in Retirement:
Complete a projection of your anticipated income and living expenses during retirement. Will you and your spouse have sufficient annual income to get you through the retirement years? Have you made provisions for higher than normal medical expenses or long-term care expenses? Remember, people are living longer and this requires more financial planning.

Financial Position of the Entering Farmer:
Give serious thought and planning to the financial position of the entering generation. Do they have some equity to put into the farm business? Can they afford the payments to you and to other creditors? Will they have a business of sufficient size and efficiency to generate an adequate living for them? If the answer to these questions is "no", you may want to delay transitioning the business. The entering generation needs to improve their financial position or you need to plan on making major concessions to get them started in the business.

You're Social Security (SS) Position:
Every individual is different regarding their SS contributions and status. Changes in SS rules may affect your plan to exit from the farm business. Contact your local social security office about your contributions and benefits before making any decisions about when to retire or how to sell or transfer the farm business assets.

Your Willingness to Let Go:
Transferring assets and management of the farm to someone else means you no longer will be in control of the farm business. If you cannot let go or stand to see someone else in the decision making role, do not retire until you can accept this change in your role.

Your Emotional Readiness to Transition the Farm:
If the farm has been the major focus of your whole life and you have spent nearly every day building and working on this farm - expect some challenges. Leaving the farm under these circumstances should be planned for well in advance.

If you can view the following statements positively you may be ready to leave farming.

"I have plenty of ways to use my time after I retire. I can golf, fish, travel, socialize and finally get at some of my hobbies."

"I can continue to feel fulfilled as a contributing human being by volunteering or helping my children after I retire."

"Although we will do many things together, I plan to let my spouse have her/his own space. I will establish my own friends and time independently of hers/his at times."

"I am willing to move off the farm and out of my home, so that the younger family can work and live at the center of the farm business."

You're Health:
Transferring your farm business to someone else can afford you time to do the things you have always wanted to do. Retiring early while your health is good may give you more time to travel, pursue hobbies, spend more time with family, etc.

Successful retirees are usually committed to good physical and mental health. They eat right, exercise regularly and keep mentally fit by reading, thinking and conversing. Are you ready to do the same?

Key Questions You Need To Ask Yourself:

Transferring the farm to the next generation is a complex and serious undertaking. If not done properly, there can be serious financial and family relationship consequences.

Answer the following questions honestly before you start the transition process:

1. Is the farm, in its current format, generating enough income to support an additional family?
2. If not, are there farm income expansion possibilities or viable off-farm income possibilities available to support the entering family?
3. Is there a way to transfer the farm and keep everyone in the family happy? That includes exiting and entering families as well as non-farm heirs and in-laws.
4. Can the parents afford to give some financial assistance to the entering family while still maintaining an adequate retirement income?
5. Is the exiting manager willing to transition management skills and management decisions to the entering manager?
6. Have the parties involved in the transition had a positive, respectful and considerate attitude toward one another in the years before entering a transfer agreement?
7. Does the entering manager have the ability, desire and willingness to learn the farm management skills needed to manage a high risk, low margin, highly competitive business?
8. Can the involved parties communicate openly and freely with one another?
9. Are all parties involved, willing to develop a written plan of transition and a business agreement prior to starting the transition process?
10. Are housing facilities available which will provide acceptable, yet independent lives for each family involved?
11. Are all participants, including spouses, willing to be involved in decision making regarding work tasks, hours, vacation, finances, and family expectations?
12. Are all parties willing to start with a trial period of working together, through a wage agreement or farming independently while sharing resources, for a year or two before starting a formal arrangement?
13. Are the parents willing to provide security to the entering parties by agreeing to a buy/sell agreement and allowing the entering party the right to purchase assets in the future? The agreement should be binding on the heirs.
14. Are the parents willing to sell, lease, gift or otherwise transfer assets to the entering party at perhaps less than current market values?
15. Are the parents not only willing to transfer farm assets but are they willing to transfer management of those assets to the entering generation?
16. Are the parents willing to eventually move to town or to a residence off the farm to allow the new manager to be nearer the center of farm operations?
17. Can and will both parties put together a tax plan which will be acceptable to everyone as they transfer assets?
18. Are the parents insurable and will they permit the younger generation to carry life insurance on them for financial protection in case of premature death?
19. Are all parties willing to provide protection from premature pay out to off-farm heirs by establishing purchase options with installment terms for sale of assets in their Will or trust?
20. Are all parties willing to pledge that they will not try to control any aspect of the other parties' business and personal lives?
21. Are entering children willing to pay parents adequately for work done on the farm after retirement?
22. Are entering parties willing to sacrifice standard of living and go the "extra mile" with work to get started farming?
23. Are entering parties appreciative of the farming opportunity given to them by their parents? Are they willing to "give and take" to make the transfer process successful?
24. Do the entrants wish to farm because they have prepared for it educationally and feel it is their chosen field? This is in contrast to those who enter farming because they can't find anything else to do, or nothing else worked out, or it is an expectation of their parents.
25. Do the entering parties have a realistic grasp of agriculture in the 21st century and what it takes to put together a profitable, competitive business?

If you can answer "Yes" to nearly all of these questions, you have a good chance for a successful transition of the farm. If you answered "No" to any question, you may wish to evaluate the situation before you proceed.

Establishing Goals:

Essential to the business transfer process is the establishment of individual, family, business, and retirement goals. These goals guide the transfer process and help validate decisions that are made. Without being clear and firm about these goals, the transfer process will not succeed.

When developing your goals, think about all the issues listed earlier in this document – parent's willingness to turn over control and management of the business, the ability of the business to support multiple generations, the ability of the entering generation, etc.

In addition, goals need to be in writing in order to bring life and meaning to them. Goals should list specific actions and specific results of those actions. Goals need to have a timeline. Goals need to be attainable and realistic while also being flexible.

To help begin this process, think about the following questions:

1-What do you want from or for your farm or ranch business?
2-What do you want for your family?
3-What do you want for yourself?
4-What do you want in your retirement?

One approach to establishing goals is to utilize a three step process outlined below:

Step #1: Each person involved in the business should list their individual short-term goals (3 years or less) and their long-term goals (4 years or more) for three areas. The three areas include your individual or personal goals (what do you want for yourself), family goals, and business/career goals (entering generation) or retirement goals (retiring generation). This process is done as an individual, by you, with no one else involved.

Step #2: Each generation (retiring generation alone and entering generation alone) comes together and using their individual goals list, prioritize those goals onto one list for their generation, within the three areas (individual, family, business/career-retirement goals).

Step #3: Both generations involved in the business come together and using their Step #2 lists, prioritize their goals under the three areas – individual, family, and business/career-retirement goals. To help with this final process, there are a few questions that may be useful. Those questions are:

1-Which goals are most important for family well-being, business success, and or retirement success?
2-Which short-term goals, if attained, would help us achieve our long-term goals?
3-Which short-term goals conflict with or may impede our long-term goals?
4-Which goals are so important that they should be attained even if it prevents us from reaching other goals?

Once your final list of priority goals is established, it becomes your road map for the transfer process. This list of goals becomes the foundation for your written business transfer and personal estate plan. It should include all the things you want to have happen to your personal and business assets, while alive and after your death. It should also include what you do not want to have happen to your personal and business assets, while you are alive and after your death. Each action you take, each decision you make, you do so based upon your list of goals. Check it every time you make a decision. Does your decision help to fulfill your goals or does your decision violate your goals.

Once this list of goals is complete, take it to your transition and personal estate planning team. Their responsibility is to put into place what it is you want, based upon the list of goals. These actions, on your part, will complete the development and implementation of your business transfer and personal estate plan.

For more information, see *Transferring the Farm Series #9-Developing a Written Transition Plan Outline.*

Ag Business Management

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Transferring the Farm Series #2 9/2009

Farm Business Transfer Strategies

Prepared By:
Gary A. Hachfeld, David B. Bau, C. Robert Holcomb, & James N. Kurtz, Extension Educators

Introduction:
Transferring the farm business from one generation to the next can take several years. This is due, in part, to the large amount of capital involved. However, this time of transfer can also be used to share knowledge, shift responsibilities for management of the business, and become a trial period for the entering generation.

During this initial beginning period, parents can step back a bit from the farm business. The generation taking over can determine if farming is really what they want to do as a career.

For two generations to farm together or implement a transfer of the farm business there are several considerations. Those items are outlined in this information piece.

Communications:
In any joint operation it is vital that good communications exist between all parties. Cultivating good communications throughout the initiation, implementation and completion stages of a transfer is highly desired. Loss of communication leads to lack of trust and can eventually lead to devastating consequences.

Good communication in family farming arrangements is a vital link in the success of the farming business. Here are some suggestions to improve communications:

- When speaking, be brief and be specific.
- Don't accuse, insult or blame.
- Don't label, moralize or judge your business associates.
- Try to be positive, constructive and willing to compromise.
- When listening, listen intently. Focus and try to understand what is being said. Try to interpret it as the speaker intended.
- Disregard negative statements. Paraphrase what you hear. Find points of agreement and state them.
- Explain your motives honestly and truthfully. Apologize when needed and admit your mistakes.

Implementing these suggestions is not a simple task but can greatly improve communications and avoid unintended, negative consequences.

Sole Proprietorships:

Farming Together - A Trial Period: This may be the best way to begin testing compatibility and commitment. With this approach, parents would hire the aspiring entering generation on a simple wage or incentive plan for a year or two.

During this period, serious consideration should be given to the entering generation's ability to contribute to the business and its management, to personal compatibility and to the skill level of participants. It is also a great opportunity for the retiring generation to asses if they are truly ready and willing to give up control and management of the business. This period should give both parties the ability to assess the farm situation and withdraw, if necessary, before becoming involved in a complicated joint operating agreement.

Farming Together but Apart: Farming together but still maintaining a separate entity may be another approach. This may provide a good training ground for a young farm operator. Instead of organizing a complex business structure, farming together but separately may be an option to consider. An entering son/daughter might rent some additional land. He/she might use the parent's machinery in exchange for labor being contributed to the parent's farm business. The son/daughter may or may not pay for their fuel and repairs depending on the agreement. Perhaps they can also rent existing livestock facilities from a neighbor. In any case, they should take over the total management of their enterprises. Management includes establishing a business account and records system, developing a credit relationship with a lender, ordering and making decisions on inputs and procedures, and taking total charge of marketing decisions. As time progresses, the son/daughter can eventually take over more of the crop land or livestock enterprises.

As machinery needs replacement, they should begin to purchase the new items as they can. Eventually, the parents may purchase no new machinery as they approach retirement. This method provides a way for a son/daughter to buy the machinery gradually and for the parents to phase out of the farm business.

This method avoids the problems associated with the joint decision-making required in most complex business arrangements. It also gives the younger generation pride in ownership and the incentive for gain.

Multi-Owner/Joint Ventures: Multi-owner operations can get very complicated and can end in chaos. Many farmers begin the transfer process by bringing in a son or daughter. They purchase assets together and own some individually. Later another son or daughter may come into the business. Invariably they end up with a record keeping nightmare with many different ownership levels: some assets owned 50-50-0; some 33-33-33; others are 0-50-50 or 100-0-0 or some other percentage mix.

In most cases, where there is multiple ownership with more than two individuals involved, some other business structure may be a best.

Partnerships and Corporations:
The huge challenge for sole proprietorships is having to deal with many individual, specific assets during the transfer process. One solution to this is to form a business entity for the purposes of business transfer. In forming a partnership or corporation, you issue ownership units or shares which can be easily sold, gifted, or passed through your estate as a means of transferring the assets. This eliminates the need for transferring specific assets such as machinery or land. You effectively transfer those assets over time through the transfer of the ownership units or shares.

Forming another business entity should not be done without thorough investigation of the ramifications. These entities are complex and require legal and tax advice. For more specific information see *Transferring the Farm Series #3-Utilizing Partnerships and Corporations to Transfer Farm Assets.*

When establishing another ownership entity, the entity must establish its own checking account. The account serves as the main vehicle for operations. Organizers contribute assets or cash to the new entity in exchange for ownership units or stock shares.

The business entity then begins operation with the assets. It deposits income and pays expenses out of the entity checking account. Expenses may include wages to workers or a wage draw to partners. It may also include rent payments to all parties for rent of machinery, livestock, buildings or land. At year's end, excess profits are used to reduce debt or to pay dividends to shareholders.

Ownership units or shares provide a convenient way to transfer ownership through sale, gifting, or passing them through your estate. Younger shareholders can buy shares or sell shares to one another. This is very useful if an individual wants to enter or leave the business entity.

Many times it is desirable for owners to keep many of their assets out of the business entity. It makes it much easier to do tax planning and liquidation of the entity and may be less of a tax problem. Often land is kept out, as is machinery and breeding livestock. The new entity sometimes contains only "operating" assets. Again, seek legal and tax advice on which approach is best for you.

Farming together in one of these business entities can be a very rewarding experience if all parties remain focused and committed. However, if inequities exist or appear to exist, it can be a difficult experience. It also requires patience, good communication, tolerance, division of responsibility, delegation of authority, sacrifice, and trust. Are you ready for this kind of commitment?

Family Business Meetings:
To foster better communications, you may want to consider family business meetings where the farming partners meet often to discuss day to day operations, issues that arise, as well as short and long-term business goals. Here is an example of what a family business meeting schedule might look like:

- Each morning at 6:30 a.m. partners meet briefly to lay out plans and responsibilities for the day's work.
- On the first Monday of the month at 7:30 a.m. partners and spouses meet to discuss progress, problems, opportunities and other issues as presented.
- Quarterly meetings are sometimes held to review progress toward goals, finances and working arrangements.
- Annually, partners and spouses meet to review finances, establish goals, review operations, establish hours, payment rates, rents, vacation schedules, and other pertinent issues. This is also a time when they can celebrate a successful year of operation.

Conclusion:
Farming together requires good communications. A willingness to give and take and a lot of "biting the tongue" on everyone's part is necessary. This is probably the most stressful part of farming. It is not impossible, but proceed carefully and in a planned fashion.

Caution: This publication is offered as educational information. It does not offer legal advice. If you have questions on this information, contact an attorney.

Ag Business Management

University of Minnesota Extension

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Transferring the Farm Series #3 9/2009

Utilizing Partnerships & Corporations To Transfer Farm Assets

Prepared By:
Gary A. Hachfeld, David B. Bau, C. Robert Holcomb, & James N. Kurtz, Extension Educators

Introduction:
Transferring the farm business to the next generation can be a daunting task. However, there are strategies and methods that can help simplify the process.

When operating as a sole proprietorship, it can be challenging to establish a transition plan. There are many individual assets that need to be accounted for such as machinery, equipment, livestock, as well as land. It is difficult and time consuming to transfer separate, individual assets.

One possible solution is to establish a business entity such as one the many partnerships or a corporation to accomplish the business transition. As members and owners of the entity, the parents are issued ownership shares or shares of stock in the entity. These shares can be sold, gifted or passed through their estate to the entering generation, over time, as a method of transferring the business. This does away with the need to transfer separate, individual assets.

Partnerships: Types & Characteristics:
There are two major categories of partnerships:
1) Partnerships and 2) Limited Partnerships. There are separate entities under each category and each entity functions a bit differently. Each is outlined in this information sheet.

1) Partnerships:
Within the category of partnerships, there are two entities: 1) General Partnerships and 2) Limited Liability Partnerships.

General Partnerships (GP): Two or more people are involved in the GP and are referred to as general partners. All partners are generally liable for all debts and obligations of the GP. There is no liability protect for their personal or partnership assets. MN state law does not require a written partnership agreement. However, such an agreement outlining decision making and job responsibilities might be useful. If the name of the partnership is that of the partners (Henderson Family Partnership), the entity does not have to be registered with the State of MN. The entity is taxed as a partnership, pass-through entity with income being allocated to each partner based upon their ownership and included in their personal income tax.

Limited Liability Partnerships (LLP): The LLP is similar to the GP with a few exceptions. All partners are general partners (no limited partners) but their liability exposure is limited to the assets they have placed into the LLP. Their personal assets are protected from liability exposure. The LLP is required to register with the Secretary of State in MN. The LLP is taxed as a partnership, pass-through entity.

2) Limited Partnerships:
Within Limited Partnerships, there are three additional partnership categories: 1) Limited Partnership (LP), 2) Limited Liability Limited Partnership (LLLP), and 3) Limited Liability Company (LLC).

Limited Partnership (LP): Two or more persons are involved in the partnership. There are both general and limited partners. The general partners have no liability protection on any of their LP or personal assets. The limited partners' assets in the LP are not protected but their personal assets have liability protection under the LP. The LP is required to register with the Secretary of State in MN. The LP is classified differently and operates under a different set of statutes than the general partnership. The LP is taxed as a partnership, pass-through entity.

Limited Liability Limited Partnership (LLLP): Two or more people enter into the LLLP entity. There are both general and limited partners and they have liability protection of both their LLLP assets and their personal assets. The State of MN requires the LLLP be registered with the Secretary of State. The LLLP has its own set of statutes to comply with. The LLLP is taxed as a partnership, pass-through entity.

Limited Liability Company (LLC): This entity is the newest of the partnership entities. It requires only one person as a member of the entity. From a tax standpoint, the LLC can be taxed as a partnership, pass-through entity or as an S Corporation. The LLC provides liability protection much like a corporation.

The LLC can have both members and managers. Members elect or appoint a board of directors. The State of MN requires that the LLC register with the Secretary of State. The LLC is governed by a different set of statutes from any other of the partnerships.

The LLC can offer one additional level of liability protection by being registered in one of what are referred to as "protective states". Those protective states include: Alaska, Arizona, Delaware, Nevada, New Jersey, South Dakota, Texas, Virginia, and Wyoming. These states have written their LLC statutes to include an additional level of liability protection as long as the LLC members abide by all the statute rules. It is legal to register, for example, your MN farm business in one of these protective states and still operate in MN. This is a very complicated process so seek expert legal help if you decide to develop an LLC in one of the protective states.

As mentioned, partnerships pay no income taxes. All profit/loss, capital gains and credits are passed through to the partners on a prorated basis, depending upon the percent of ownership. However, the partnership must file a Form 1065 informational tax return, which is due each year by April 15th.

An advantage over sole proprietorship is that the owners have ownership units or shares. These units or shares can be sold, gifted or passed through their estate as a means of transferring the business to the next generation.

One disadvantage is that a partnership is not necessarily a stable business structure. Death of a shareholder or willful withdrawal by a partner can seriously disrupt partnership operations. The partnership agreement, if put into place at time of formation, should clearly describe buy-out provisions or state how the remaining partners are protected, no matter how circumstances change.

Partnership tax laws are similar to individual tax laws. A partnership can generally take over the depreciation schedule of contributed machinery or buildings. A partnership can claim the Section 179 depreciation expense which is passed on pro rata to the partners. Each partner can claim depreciation, which includes his or her portion of the partnership allocation plus any other personal Section 179 depreciation.

Partnership members are self-employed individuals and must pay self-employment tax on their share of earned partnership profits. Partnerships do not receive the favorable tax treatment on fringe benefits (medical, accident and life insurance, housing and meals) as do "C" corporations. However, it generally costs less to form a partnership than a corporation and partnerships can be less formal to operate.

Corporations: Types & Characteristics:

There are two corporation entities available to farm businesses. They are; 1) S Corporation and 2) C Corporation. Each will be outlined in this information sheet.

1) S Corporation: The S Corporation offers a higher level of asset liability protection than a sole proprietorship and some of the partnerships. It must be registered with the Secretary of State in MN. The S Corporation is taxed as a pass-through entity with profits being allocated to the stock shareholders based upon their ownership. The income then shows up on the shareholders personal income tax. There is no double taxation issue.

Business operating assets can be placed into the S Corporation or they can be left out with only the corporate checkbook as part of the corporation operating entity. Placing assets into the corporation is a non-taxable event but getting them out is not. For that reason, it is a general rule of thumb not to place land into the corporation.

2) C Corporation: The C Corporation also affords a higher level of asset protection than the sole proprietorship or some of the partnership entities. The C Corporation offers longevity to the business because it is technically an entity onto itself with a life of its' own. That is, people can enter and leave the C Corporation and it continues on without interruption. It also affords many tax advantages regarding deductable expenses.

The C Corporation however, can be subject to double taxation. The dividends paid to shareholders are taxed. If the corporation is not growing or acquiring new assets resulting in the corporation retaining earnings, those earnings can be taxed as well. Corporate tax rates are generally higher than other tax rates. Business operating assets can be placed into the C Corporation or they can be left out with only the corporate checkbook as part of

the corporation operating entity. Placing assets into the corporation is a non-taxable event but getting them out is not. For that reason, it is a general rule of thumb not to place land into the corporation.

One additional point that applies to both S and C Corporations. Shareholders have to maintain an employer-employee relationship with the corporation. If the shareholders maintain personal ownership of what they consider corporate assets, charge corporate business expense against those assets, are audited by the IRS, they may be denied those expense deductions because the assets were owned by the shareholders, not the corporation.

A corporation is established under state law. Each state permits corporations the right to do business. A corporation consists of owners who are called shareholders. The shareholders are the basic decision making group. They elect a board of directors to act for them on most operational decisions. Majority vote governs corporate decisions. Ownership of 51% or more of the stock gives you control. Minority shareholders have little if any decision making control unless permitted to do so by the majority shareholders.

Once a corporation is created, it functions much as a self-employed individual might. Corporations must establish their own name and bank accounts. The corporation can become an employer, a lessor or lessee, a buyer or seller, or engage in any other business activity.

Farms incorporate for many reasons. Here are a few of those reasons.

- It is easy to transfer shares. Shareholders can gift, sell, or pass through their estate, shares to others as they see fit. A majority shareholder can transfer up to 49% of the outstanding shares without losing control of the business.
- A corporation may simplify estate settlement in that it is easier to value shares than individual farming assets.
- Self-employment (SE) tax can sometimes be reduced with a corporate structure. Instead of paying SE tax on all the Schedule F income as a self-employed individual would, the farmer becomes an employee of the corporation and social security taxes are paid only on wages they receive.
- A portion of meals and lodging furnished to employees of a “C” corporation are generally deductible to the corporation, but not taxable income to the employee. If lodging is provided on the farm and is a condition of employment, the home’s depreciation, heat, electricity and interest become deductible to the corporation. Remember the employer-employee relationship issue.
- Fringe benefits are deductible by “C” corporations. Health, accident, and up to $50,000 of term life insurance are deductible to the corporation, but not taxable to employees.
- The corporation offers perpetual life, some economic efficiencies regarding capital acquisition, and provides income and social security tax flexibility. It can also provide continuation of a farm business through several generations.

There can be concerns related to the corporation. Some of those are listed here.

- Getting into a corporation is generally a tax-free event. Getting out is a taxable event. Don’t start a corporation unless you plan to continue it for many years.
- If the “C” corporation is profitable, but is not growing and acquiring new assets, it can be troubled with retained earnings or excess profits. This can result in a tax obligation.
- Corporations have a different set of rules. Corporate meetings, extra record keeping, corporate income tax returns, reporting requirements, and quarterly tax estimates are part of corporate life. Complying with extra legal and regulatory requirements cost time and money each year.
- Minority shareholders have no power in directing the corporate business and can be easily “frozen out”. A majority shareholder (farming heir) can direct that no dividends be paid. Minority (non-farm heirs), may own shares that generate no income, and hence have no practical value.
- Corporate ownership of a house eliminates the use of the exclusion of gain or a sale of personal residence.
- Corporate ownership sometimes reduces independence and individual pride of ownership.
- It can be very difficult for a retired shareholder to receive any retirement income from an operating corporation. This is especially true if the retiree has no rental property, discontinues working for the corporation, and the corporation pays no dividends.

The farm corporation can be a valuable tool in tax planning and in the transfer process. However, it is a major commitment and a complex task to start a farm corporation. Before starting a corporation, make sure it fits your goals, objectives, and business personality. Developing any business entity is a complicated process so seek expert legal assistance when doing so.

Self-Employment Tax on Land, Buildings, & Facility Rent Regarding Entities:

The U.S. Court of Appeals for the Eighth Circuit has ruled that if you are a member of any business entity (such as a partnership or corporation explained above); own land, buildings, or facilities that are outside that entity; and rent those items to the entity; the rental income is exempt for Self-employment tax **IF** the rent is fair and reasonable.

This applies only to those states in the Eighth Circuit which include Arkansas, Iowa, Minnesota, Missouri, Nebraska, North Dakota, and South Dakota. With any of

these laws, they are subject to change so seek legal advice on this matter.

Discounting Business Entity Assets:
An additional strategy that may be useful is the discounting of assets being placed into a business entity, such as any of the partnerships or corporations described earlier.

When you place business assets such as machinery or livestock into the business entity, you can elect to discount those assets. Generally a 25-35% discount is readily accepted by the IRS but some individuals have received larger discounts.

The main reason for discounting assets being placed into the business entity is to reduce the size of an estate in order to get below the federal and perhaps even the state estate applicable exclusion amounts. Doing so will eliminate any estate tax.

If you can afford to do some gifting of assets as a means of beginning to transfer the business, another advantage is you can gift more than the $13,000 annual gifting amount if you have discounted the assets. Assume you were granted a 25% discount on assets you placed into an LLC. You decide to gift assets in the form of ownerships shares. Because of the 25% discount, you can then gift an actual amount of approximately $17,344, not the required $13,000.

One disadvantage of discounting is that you have artificially lowered the basis of the assets in the entity. This can be a problem if the entity is discontinued and the assets are sold as a result. This could result in a tax obligation.

Assets being discounted and placed into an entity should be appraised. If, at a future date, the entity is audited by the IRS, you can document the value of the assets placed into the entity. For machinery and equipment, simply take the depreciation schedule to the local implement or equipment dealer and ask them to put a value on all machinery. Have them put the values in writing on their dealership letterhead along with a signature and date. For livestock you can take a list to a livestock auction facility or someone who deals in livestock and would have a grasp of the values. The values should be put in writing and listed on their letterhead with a signature and date. For land, seek the help of a realtor who deals with ag land. Simply have them do an estimate or appraisal of the land, put it in writing on their letterhead, with a signature and date.

With tax laws changing constantly, the discounting provision might be taken away by Congress. Seek legal assistance if you plan to use this strategy.

FSA Payments & Business Entities:
Under the current farm bill, there are some restrictions regarding Direct and Counter-Cyclical (DCP) payments made to individuals and entities. For individuals, you are limited to $40,000 maximum on DCP payments. Entities that limit member's liability exposure (all entities except the general partnership), are limited to one DCP payment limit of $40,000.

A sole proprietor can receive a DCP as a sole proprietor and a DCP payment as a member of an entity. However, the individual is limit to a maximum DCP payment of $40,000.

Example: Jeff has a farm that he operates as a sole proprietor. His DCP payment for that farm totals a maximum of $25,000.

Jeff is also a member of an LLC and a 50% owner. The LLC is large enough that it's total DCP payments are $60,000. However, the LLC is limited to a maximum of $40,000 so the LLC has to leave $20,000 of DCP payments on the table.

Of the LLC's collectable DCP payments, Jeff can collect a maximum of only $15,000 of his eligible $30,000. The reason is he personally is limited to $40,000 maximum and he has already received $25,000 from his sole proprietorship. Therefore, he can only receive $15,000 from the LLC, bringing him to his maximum limit of $40,000 ($25,000+$15,000=$40,000).

This is a complicated issue. If you have any questions or concerns related to your situation, check with your FSA Office.

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Ag Business Management

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Informing farm families and ag businesses about management issues.

Transferring the Farm Series #4 9/2009

Transferring Livestock & Machinery

Prepared By:
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Introduction:
At retirement, most farmers are faced with how to best dispose of their assets. The easiest assets to dispose of are the crops on hand and market livestock. They can simply be hauled to market and sold. The chief concern here involves self-employment and income taxes.

Income Taxes:
For the farmer using cash basis accounting, income tax is due and payable immediately on any proceeds from the sale of crops and market livestock. Selling everything in one year can push you into a higher tax bracket. Spreading the income over a couple of years may provide some tax relief. You might also use a deferred payment contract to spread income into future years.

Self-Employment (SE) Tax:
Self-employment (SE) taxes must also be paid when crops or market livestock are sold. Consider the following:

- Selling everything in one year may lessen your overall SE tax. The Social Security (SS) portion of the SE tax is adjusted for inflation each year and the income subject to this tax is capped. Bunching all SE income into one year to greatly exceed the threshold may result in less tax paid than if you spread out SE income over several years and paid SE tax on all of it. **Caution**: Take your expected Social Security benefits into consideration when doing planning. If several years of high SE contributions would greatly increase benefits, it may be worth the extra tax. Also, consider the effect of a higher income tax bracket when bunching income into one year and the potential use of income averaging.

- Watch the timing when selling crops or market livestock in your year of retirement. Farm inventory sold between your retirement date and the end of that year can count against your SS benefits for that year. If you exceed exempted amounts, your benefits for that year will be reduced. However, if you sell crops or livestock after the year you begin taking SS benefits (and the crops or livestock were produced **before** you retired), benefits will not be reduced.

If you wish to sell feed crops to the entering generation, you can do so and take payments as they fit your income and SE tax plan. If you sell and take a note as payment, the note is considered taxable income the year of sale, unless you elect to report it on the installment basis.

An easy way to sell crops or livestock is to simply turn it over to the entering generation and let them assume any debt on it equal to the property value. If the buyer of your property takes over part or all of your debt in payment for the property, you must report taxable income to the extent you were relieved of debt.

Selling Breeding Livestock and Machinery:
When selling breeding livestock, machinery and equipment the sale income is not subject to SE tax. However, you will have to pay income tax on the difference between the adjusted basis of these assets and the sale price. For example: Selling $200,000 of machinery, cows and sows having an unclaimed depreciation amount of $20,000 will result in $180,000 of taxable income.

Machinery does not qualify for installment reporting to the extent of previously claimed depreciation. Therefore, it is nearly impossible to have a bulk sale of machinery without realizing a large income tax bill the year of the sale. Raised breeding livestock can be reported to the IRS using installment sales reporting, unless the buyer is a related party.

Leasing Equipment:
Leasing allows you to receive rent payments while retaining ownership and depreciation deductions. However, you need to be cautious when doing so. If you chose to lease please note:

- A “machinery only” lease is generally subject to self-employment tax.
- Combining a machinery lease with a land lease is an effective way to avoid self-employment tax.
- Leasing fails to add assets to the entering farmer’s net worth. A piecemeal sale may add to the buyer’s net worth.

- An alternative to leasing assets is to establish a rental contract for a set number of years at a given amount per year with no buy-out provision. Mutually agree that the rental proceeds apply to the purchase price of the assets. Follow the rental contract with a simple sale agreement for the remaining value of the asset. This will also help minimize self-employment tax.

This process can work for machinery as well as breeding livestock.

Gifts:
If you can afford to do so and it does not violate your business or personal goals, it may be prudent to gift crops, livestock, or pieces of machinery to the next generation. If you gift an asset that still has an adjusted basis, that asset and the associated adjusted basis leaves your depreciation schedule and appears on the entering generation's depreciation schedule. If the asset has debt on it at the time it was gifted, in excess of the adjusted basis, the difference between the debt and the adjusted basis will be considered taxable income to you as the donor.

If you have a business entity such as a partnership or corporation, you can gift ownership units or shares to the entering generation as a means of transferring the business. See *Transferring The Farm Series #6-Gifting Farm Assets.*

Piecemeal Sales:
Selling a tractor this year, a planter next year, and a one-half interest in the combine the following year may be a good way to transfer ownership. It spreads your tax burden and lets the buyer accumulate assets gradually without paying a lot of interest. Each time a sale is made, the purchaser can add the value to their net worth statement.

If you decide to sell your machinery one piece at a time, the IRS will probably not allow you to deduct depreciation on any asset that is not used in your business or is under a lease agreement. You may wish to continue farming 80 or 160 acres after retirement so that you can claim some depreciation.

If you have a business entity such as a partnership or corporation, you can sell ownership units or shares to the entering generation as a means of transferring the business.

Hybrid Methods:
When transferring breeding livestock or machinery, it may make sense to combine the above three strategies (leasing/renting, gifting and piecemeal selling).

- You might lease/rent a few items which have a lot of depreciation remaining, while gifting and/or selling other items.
- You might gift some assets annually (usually low basis items) while selling piecemeal (high basis) other assets.
- If you operate within a business entity, you can sell or gift ownership units or shares on the entity, over time, as a means of transferring business ownership.

Charitable Remainder Trust:
A Charitable Remainder Trust allows a donor to transfer assets to a qualifying charity to avoid taxation on the disposal of the assets. The charity provides taxable income to the donor for a fixed number of years, much like an annuity, after which the remaining assets go to a designated charity. If the donor transfers appreciated property to the trust, they will also receive a charitable deduction at the time of the gift. If the donor transfers property with no basis, they will not receive a charitable deduction. However, if a donor transfers grain or market livestock, they will avoid paying self-employment tax on the transferred asset.

This can be a rewarding strategy for the donors along with providing retirement income for the future. However, it can be a complicated process so seek good legal assistance.

Conclusion:
Selling, gifting or leasing/renting machinery and breeding livestock are useful strategies for the transfer of your business assets. To facilitate this process, it is helpful to develop a plan for the use of these strategies. Outline what strategies will be used, what assets or entity ownership units or shares will be included, the parties involved, and a timeline for the process. Having this written outline will expedite the process. Keep in mind you will require legal and accounting advice as you proceed.

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Transferring the Farm Series #5 9/2009

Should You Sell Your Real Estate?

Prepared By:
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Introduction:

A major portion of assets for retiring farm families is usually real estate. Real estate assets may consist of land, buildings and a house. Disposition of real estate assets is usually a major decision.

Of all the real estate assets mentioned, land is usually the most valuable. Many farmers choose to retain ownership of most of their land into retirement. They do so for several reasons:

- Ownership can provide a fairly secure annual income throughout one's retirement years if it is rented to another operator. Most farmers prefer a simply cash rental contract rather than share renting their land. Share renting is more risky, income is unknown, and shared expenses must be paid. The landowner has to also assume responsibility for storage and marketing of their share of the crop produced. Cash rent provides a known income with less risk.

- Land ownership can be viewed as an inflation hedge and can nearly always be liquidated to willing buyers.

- Holding low basis land until death, with heirs receiving a stepped-up basis, can save many thousands of dollars of capital gains tax, especially if it is later sold by the heirs.

- Land is sometimes viewed as security and can be a valuable part of a diversified array of retirement assets which may also include stocks, bonds, savings, and retirement plans.

Some farmers choose to sell their land at retirement. Some of the reasons they give are:

- They want it to go to the farming children. They guarantee it will go to them by selling it to them.

- They don't want to be faced with the inconvenience of dealing with rental contracts including establishing and collecting rents, repair and maintenance, and the liability exposure.

- Some are fearful that land values (rents) will fall and real estate taxes will increase, leaving them with less and less income. Others fear land values will rise and increase their estate taxes.

- They feel they can get a better rate of return on their money if they invest it elsewhere.

Disposing of buildings and personal residence?

Maintaining farm buildings is expensive. There is a never-ending list of repairs, insurance, utilities, real estate taxes, and other costs. Also, tenants may request additions and improvements on a regular basis. Sometimes keeping good tenants is a problem. Consequently, many farmers dispose of their buildings. Disposal usually takes place in two ways:

- Sale: Selling low basis assets may create a large tax bill. Selling a quarter section of farmland with a farm building site and home, that has a low adjusted basis, will result in a taxable gain. The farm sold represents several different types of property that is taxed at different rates. The sale price is allocated among the various properties. Each property has its own basis. The gain on the land portion would be taxed at the maximum federal capital gain rate of 15% (through 2010). The portion of un-recaptured depreciation on depreciable buildings will be taxed at 25%, with the additional gain (if any) on the buildings taxed at the federal capital gain rate. There can be state capital gain taxes as well. In MN. capital gains are taxed as ordinary income with rates from 5.35% to 7.85%. The gain on the sale of the house can usually be tax free, providing certain tax law rules are followed.

- Gifting: Buildings can be gifted to farm heirs as well. This is assuming the donor of the gift can afford to do so and it does not violate their business transfer and personal estate planning goals.

Selling your personal residence:

If you have a personal residence you want to sell, the sale can generally be accomplished tax-free under a change made in the tax code. For sales of your personal residence after May 6, 1997, up to $250,000 of gain can be excluded from income and capital gains tax if you file a single tax return or $500,000 of gain if married, filling a joint return.

To qualify, you must have used the home as your personal residence for two of the past five years. This exclusion can be taken many times during your lifetime (but not more than once every two years), providing you meet the "personal residence" qualification.

Methods of selling land:

If you decide to sell the land and/or buildings, you have several ways to accomplish this.

- Sell it for cash in a lump sum and pay the accompanying taxes.

- Sell it on a contract-for-deed. A contract puts you in the position of a lender. As the contract payments are made, you include them in your taxable income over a number of years. By signing a contract for deed with installment sale reporting, you do obligate yourself or your heirs to paying the income tax on the gain. However, the capital gain tax, if any, is paid over the course of the contract rather than in the year of the sale. Selling on a contract can provide the buyer with a source of credit and terms he or she can afford. This method, however, obligates the buyer to pay you a lot of interest over the life of the contract. Interest you receive from the buyer is fully taxable to you. If you become a contract for deed holder, you assume the risk of default by the buyer. You may get your land back through forfeiture or you may be forced to foreclose on the party in default. The contract-for-deed does not protect the assets from lawsuits or other adverse actions.

- Sell your land piecemeal as the buyer can afford to purchase it. Using this method, the buyer can apply all purchase money to principal and none to interest. This method does not protect the asset from lawsuits and other adverse actions.

- Consider a tax-free 1031 exchange. Exchanging like-kind property with your child can postpone the taxation of gain.

  A tax-free, 1031 like-kind exchange can be used if a farming son or daughter has land they wish to exchange for the parents' home farm, which usually is the base of the operation. The parents end up with a piece of land with a low basis and the son or daughter end up with the home farm.

  Certain types of property do no qualify for 1031 exchanges. They include:
  - -inventory or stock in trade
  - -stocks, bonds, or notes
  - -other securities or debt
  - -partnership interests
  - -certificates of trust

  There are also two time limits that must be met in order to qualify for a 1031 exchange. The first limit is that you have 45 days from the date you relinquish the property and you identify a new property. The identification must be in writing, signed by you and delivered to a person involved in the exchange like the seller of the replacement property or the qualified intermediary. However, notice to your attorney, real estate agent, accountant, or similar persons acting as your agent is not sufficient. The second limit is that the replacement property must be received and the exchange completed no later than 180 days after the sale of the exchanged property or the due date (with extensions) of the income tax return for the tax year in which the relinquished property was sold, whichever is earlier. The replacement property received must be substantially the same as property identified within the 45-day limit described above.

  Caution: if property is disposed of within 2 years of the exchange, the property no longer qualifies for the like-kind exchange (see your accountant).

As always, any of these strategies can be complicated and any mistake can result in tax consequences. Therefore, make sure you check with your attorney and accountant as you proceed.

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Informing farm families and ag businesses about management issues.

Transferring the Farm Series #6 9/2009

Gifting Farm Assets

Prepared By:
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Gifting Assets:

Gifting of assets to the entering generation can be a valuable tool in the transfer process. Gifting can be used to:

- Help reduce a taxable estate,
- Transfer income tax obligations to the children,
- Help get the next generation established.

Gifts are always valued at fair market value (FMV) at the time of the gift. Each individual has an Annual Gift Exclusion of $13,000 allowing you to gift that amount per recipient per year and pay no gift taxes. Married donors who own property together can treat a gift as though each spouse has given half of it, so that together they can give $26,000 per recipient per year.

Example: A husband and wife could join together and give jointly owned land worth $208,000 to their eight children in a single year. Each child would receive a gift valued at $26,000 with no gift tax incurred by the parents. You can give unlimited gifts to your spouse (Marital Deduction) or to a qualifying charity in any year with no gift tax consequence. You can also gift unlimited amounts for tuition or medical care.

Currently every person has a Lifetime Gift Exclusion with the IRS, which will offset gifts of up to $1,000,000. Gifts given in excess of the annual exclusion ($13,000 per person, $26,000 per couple) reduce the lifetime $1,000,000 exempted amount.

Example: Sally Smith gave $53,000 to her son Paul. Minus the $13,000 annual exclusion there is a taxable gift of $40,000. This amount is subtracted from her $1,000,000 lifetime gift credit amount. This leaves $960,000 of the credit to be used by Sally for future gifting. No tax is due while Sally is alive.

No gift tax is payable until the total $1,000,000 credit amount is used up. **However,** a gift tax return (IRS Form 709) must be filed on gifts to any individual, other than your spouse, which exceed the annual $13,000 exclusion ($26,000 for couple).

If gift taxes are payable, they are generally paid by the donor (giver) not by the donee (recipient).

Summary:
- For annual gifts of $13,000 individually ($26,000 couple) – no tax, no Form 709
- For annual gifts $13,001 to $1 million individually ($26,001 - $2 million couple) – no tax due while the donor is alive, file Form 709
- For annual or lifetime gifts greater than $1 million (individual) – tax due immediately and file Form 709

Gifts of Appreciated Property:

Gifts of appreciated property held long enough to qualify for long-term capital gain treatment (longer than 12 months for land, breeding livestock, and machinery) could be gifted by high tax bracket parents to children in low tax brackets to save taxes.

Example: Parents in the 25% income tax bracket gift cull dairy cattle to their son who is in the 10% bracket. The parents would have paid 15% capital gain tax on the cattle sale. Instead, the son pays 5% capital gain tax (0% for years 2008, 2009, & 2010). Since the dairy cattle were raised and over 24 months old, they have no basis, so are taxed as 100% long-term capital gain.

Be cautious when gifting appreciated property to children under 18 years old or who are full-time students ages 19-23. Their income could be taxed at the parents' top marginal tax rate or greater ("Kiddie" tax provision). The recipient must not exceed earned income in excess of a given amount (amount changes each year – see your accountant). Unearned income above that amount will be taxed at the parent's marginal tax rate if greater than the child's rate.

Gifts of Grain or Market Livestock:

Gifts of commodities are often used in parent-child transfers. If a parent gives grain or livestock produced

in the farming operation to the children, here are the consequences:

- If FMV of the commodity is under $13,000, no gift tax or From 709 is required.
- The cash basis parent does not include the commodity on their tax return, thus reducing both income and self-employment (SE) taxes.
- The child must show the income on their tax return and pay income tax, not self-employment tax, on the income (remember "Kiddie tax provision").
- If the parent gifted the grain or livestock in the year of production, they must reduce deductible Schedule F expenses by the cost of producing the grain, but the child gets to use that carry over of basis as an expense. If the gift is made with grain produced in a year prior to the gift, the basis is in the hands of the parent donor and the child donee's basis is zero. When giving commodities, the best advice is to give crops or livestock produced in a year prior to the time of the gift.

Gifting of machinery:

Gifting machinery and equipment to the next generation provides several advantages to both parents and children. Since it is a necessity that the entering generation receive substantial financial aid to get started farming, gifting of machinery can provide equity on their balance sheet. Gifting machinery can reduce the tax burden of the parents. Gifted assets are never "sold" on the parent's tax return, thus reducing taxes. If the parents are in a weak financial position and cannot afford to give away some property, perhaps the entire transfer process should be reevaluated as to its viability.

The donor's remaining basis for depreciation on the gifted machine passes to the receiver of the gift.

If indebtedness on the gifted asset exceeds the donor's basis, the excess is considered a taxable gain to the donor at the time of the gift.

When you gift a machine, document the gift by stating it in writing. List the date of the gift, the donor and donee, the adjusted basis, the fair market value of the gift, the make and model, and you may consider listing the serial number. Sign and notarize the document effective the date of the gift.

Gifting Land:

You can gift land by deeding over actual acres. For example, you may give the west 20 acres to John and the east 20 acres to Mary. Giving actual acres requires legal work and legal descriptions of the property when each gift is given.

You can also gift land by deeding an undivided interest in property to children. You can give a 10 percent interest in the 160 acres to John and Mary together or separately. This method may require less legal work.

Some families form a business entity for the purpose of gifting land to the next generation. The parent stays in control but transfers entity ownership units or shares to the entering generation or other children over time.

Gifting contract for deed payments:

After executing a contract-for-deed with their farming heir, some parents decide they would like to occasionally forgive the annual payment.

If you wish to do so, the best procedure is to collect a check for the principal and interest payment and then issue a check to the farming heir for any gift you wish to make. Ignoring the check exchange can result in the farming heir not having complete evidence of having paid for the property. You must declare payments received on a contract on your tax return. These payments must be declared even if you forgive the payment.

Can you afford it? Does it violate your goals?

Gifting can be a very useful transfer and estate planning tool. However, don't do it unless you can afford to give up the assets. Once an asset is gifted away you have no control of it and can expect no income stream from it. If gifting jeopardizes your financial security or violates your farm transfer and estate planning goals, perhaps you should not make that gift.

CAUTION - Medicaid law change regarding gifting:

With the signing into law of the Deficit Reduction Act of 2005 on Feb. 8, 2006, there is now a 60 month disclosure on all non-compensated transfers including gifts. This includes such things as gifting farm assets but also birthday and Christmas gifts as well as donations to your church. Gifting will make an individual ineligible for Medicaid coverage for a period, beginning the date of Medicaid application. See an attorney who specializes in elder law for more details.

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Ag Business Management

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Transferring the Farm Series #7 9/2009

Tax Considerations When Transferring Assets

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Income Tax Basis:
When selling an asset, you pay tax on the difference between the selling price and your adjusted basis (cost plus improvements minus depreciation) of the asset.

Example: If you sell land for $100,000 and your adjusted basis for the land is $20,000. Your taxable gain is $80,000.

Adjusted basis is your cost to recover when you sell the asset. This adjusted basis is determined by how you acquired the asset.

If you purchased the asset:
Generally, your basis is what you paid for the asset, plus improvements, minus any depreciation you've claimed on it.

Examples:
1) If you purchase a tractor for $120,000 and depreciated it for 3 years claiming a total of $42,850 depreciation, your adjusted basis would be $77,150 (assuming no improvements).
2) If you purchased land and have claimed no depreciation on it, your basis is what you paid for it, plus any improvements.

If you inherited an asset:
Your basis is the Fair Market Value (FMV) or Special Use Value assigned the asset as it passed through the estate to you.

Example: You inherited some land from your mother. Her adjusted basis was $70,000. Upon her death, the land received a step up in basis and is valued in her estate at $160,000. Your adjusted or cost basis is $160,000.

If you received an asset as a gift:
Generally, your basis is the same as the adjusted basis of the donor.

Example: You received a gift of farmland valued at $160,000 with a basis (purchase price) to the donor of $25,000. Your basis is then $25,000.

Asset basis is extremely important to the property holder since it determines the amount of tax that will be paid upon the sale of the asset.

Assets that pass through an estate receive a "stepped up" basis. The "stepped up" basis is usually the fair market value on the date of death. This provides a strong incentive to hold low basis property until death to achieve the stepped up valuation for heirs.

Example: Sally Smith sold 160 acres of farmland for $3500/acre or $560,000. It had an adjusted basis of $100,000. Her taxable gain whether sold for cash or by installment method would be $460,000. Because of the sale, she or her heirs must pay income tax on the $460,000 gain. However, if Sally had retained the property until her death, the estate would assign a stepped up basis to FMV of $560,000. The heirs could later sell the property for that amount and pay no tax.

Personal residence:
If you sell your farm, which includes your personal residence, up to $250,000 per individual ($500,000 for married filing jointly) of the gain on the residence portion may be excluded from taxation. To qualify for the full exclusion, you must have owned and occupied the residence for at least two out of the five years before the sale. Property held under 2 years may qualify for a partial exclusion under certain conditions.

Homestead Credit:
Qualifying owners, who live on the farm, or in the house on the farm, can receive reduced real estate tax payments due to the Minnesota Homestead Tax Laws. This credit can reduce real estate taxes substantially each year. Structure your transfer plans to make the best use of this credit. Farm owners who have

relatives living on their farm may qualify for a double homestead credit. They receive one credit on their personal residence and a second credit on the farm, if a relative lives on the farm or farms the land.

If you sell your home but retain a life estate, you may be disqualified from using the personal residence exclusion. You can still maintain the Minnesota Homestead Credit. See your attorney.

Installment Sales:
Many farmers opt to report sales of property on the installment method. This allows the taxation to be spread out proportionally over the years that principal payments are made. This option may be useful to keep as many dollars in the lower tax brackets as possible. Using installment reporting late in life on low basis assets may not be wise since no stepped up basis is received on installment contracts. Heirs must continue to pay the income taxes on principal and interest payments when received. Most items can be sold using the installment method. Any gain, to the extent of depreciation on equipment and all other Sec. 1245 property as well as depreciable business property sold to related parties, will not qualify for installment tax treatment. The installment sale does not protect the asset from lawsuits and other adverse actions.

Tax Free 1031 Exchange:
If the entering generation owns tradable property, a like-kind tax-free exchange might be used to transfer farmland or buildings. This is a complicated tax issue but can move the younger generation onto the home farm. Using the tax free exchange can avoid or postpone taxation of the parents' capital gains on low basis property.

Caution: make sure your attorney and accountant communicate regarding this type of transaction so no detail is overlooked. Failure to comply with all the stipulations of the exchange can result in forfeiture of the transaction and tax consequences.

Spread Out Income:
In most cases, as a farmer retires and sells off his or her assets, a large income and self-employment tax bill emerges. It may be wise to plan ahead and spread the final sales over a two or three year period. Leveling income usually results in lower taxes paid compared to bunching income into one year.

Capital Gains:
In 2003, Federal Capital Gain tax rates were lowered to 5% for those in the 10 & 20 % federal tax brackets and 15% for those in the 25% and greater federal tax bracket. Current federal law, for years 2008-2010, allows taxpayers to pay capital gain tax at a 0% or 15% rate depending on income level on many long-term capital gain items. Those items include stocks, bonds, and land held longer than one year, as well as some raised breeding stock. Farm building sales are generally subject to different tax rates. Keep in mind that the 0% capital gain tax rate applies **only** to the amount of gain between your taxable income and the top of the 15% federal income tax bracket (is $67,900 for 2009). Gain amounts over the top of the 15% income tax bracket will be taxed at the 15% rate. State taxes must also be paid on capital gains (MN rates are 5.35-7.85%). Sales of capital assets are not subject to self-employment tax. Consult with your accountant and attorney for the best strategy for minimizing the tax consequence of any transaction.

Income Averaging:
Income averaging allows farmers to spread their income in a high income year over the past three years. This can significantly reduce taxes paid in a high-income year. Income averaging does not affect self-employment tax on either the current or previous years. Income averaging applies to ordinary (Schedule F, Form 1040) farm income as well as gain from the sale of assets used in the farming business except from the sale of land or timber. It also applies to an owner's share of net farm income from an S corporation, partnership, or limited liability company and wages received by an S corporation shareholder from the S corporation.

Self-Employment (SE) Tax:
If you have contributed to the SS system at a high level during your lifetime, you may be considering retirement before your Full Retirement Age (FRA) to begin drawing SS benefits. This would result in a reduced monthly benefit compared to retiring at your FRA. However, it might take many years of higher benefits to offset drawing reduced benefits for several additional years. In addition, farmland rental income is not subject to SS taxes. Not retiring early could cost you more per year due to not collecting monthly benefits and having to pay added tax on SE income.

However, if you have contributed to SS on a low level of earnings during your lifetime, it may be advantageous to delay retiring until your FRA. Hopefully during these last few years you can build your benefit package by making larger contributions to SS. High earnings and high contributions could have a significantly positive effect on your Social Security benefits.

This is a complicated issue but also a crucial issue to you and your farm business transfer and retirement planning. Seek advice from a qualified Social Security representative.

Caution: This publication is offered as educational information. It does not offer legal advice. If you have questions on this information, contact an attorney.

Ag Business Management

University of Minnesota Extension

Informing farm families and ag businesses about management issues.

Transferring the Farm Series #8 9/2009

Treatment of Heirs in the Transfer Process

Prepared By:
Gary A. Hachfeld, David B. Bau, C. Robert Holcomb, & James N. Kurtz, Extension Educators

Protecting the On-Farm Heirs:

The farm business can be a fragile structure. The high risk nature of farming coupled with huge start up costs and generally narrow profit margins, dictate the need for safeguards to protect the farming heirs.

In today's economy, it usually takes a great deal of parental help to get a young person started in farming. This help is usually provided through reduced charges for housing, lower machinery and land rents, lower interest rates, gifting of assets, financial supplements, and various other types of help. Unless the young person starts out with a nest egg, parental concessions are needed if the young farmer is to get started successfully.

Farming heirs can protect themselves by carrying life insurance on the parents, by carrying risk insurance on their assets and by seeking continued education to upgrade farm management skills. However, the parents also have to play a key role in protecting the financial vulnerability of the farming heirs.

It is not enough to say "You'll be taken care of when we are gone". You need to take legal written action to make the transfer happen. Farming heirs who are insecure as to their future in the business are unhappy, often indifferent and easily alienated from farming.

There are several steps that can be taken to insure a successful transfer while at the same time providing for non-farm heirs. These steps are outlined in this information piece.

How Parents Can Help Secure the Financial Future of Farming Heirs:

1. Develop and implement a transfer plan:
Formulate a detailed written transfer plan with the help and input of all farming parties involved, especially spouses and in-laws. Discuss it; work with your transfer team (attorney, accountant, etc.) to implement the plan so everyone knows what is ahead. Transfer some assets soon so the farming heirs can begin business and feel some pride of ownership. This process includes transfer of management and control of those assets as well.

2. Offer a purchase agreement:
If you haven't made any commitments as to the sale of assets, a purchase option may be useful. The purchase option gives the buyer the right, but not the obligation, to buy farm property at a later date. The agreement can involve land, buildings, livestock or machinery. It should state price, terms of payment and date of execution. It is binding on the spouse and non-farm heirs, so the agreement gives the farming heirs a definite and reasonable purchase price and terms for buying farm assets. This may prevent the farming heirs from having to buy out non-farm heirs in an unsatisfactory lump sum after your death.

3. Provide Protection in Your Will or Trust:
When writing your Will or trust, include the purchase agreement or buy-out provisions. You might wish to establish provisions as to how, when, at what price, terms, etc. the farming heirs can buy out the other heirs.

Example 1: Farm site and adjoining land and equipment to the farming heirs with cash or non-farm assets to the non-farm heirs.

Example 2: Enact a provision allowing your son/daughter to buy the land from your trust over a 15 year period at a stated interest rate with specified principal payments per year.

Example 3: Pass farm property to all children equally but establish reasonable terms, through a buy out provision, as to how the farming heir(s) might buy out the other heirs.

4. Life insurance planning:
Parents have several options regarding life insurance. Following are a few examples for your consideration.

- Parents carry enough life insurance on themselves to provide adequate dollars at death to pass to the non-farm heirs, leaving farm assets to the farming heirs.
- Parents gift some money to the farm heir during their lifetime which would be used to purchase life insurance on the parents with the farming heirs as beneficiaries. This would provide money to enable the farm heir to buy out non-farm heirs when the parents die.
- If you are in debt, a life insurance policy on yourself can provide money for debt payments and for estate tax obligations. This can relieve heirs of having to liquidate vital farm assets to pay off those expenses.

Life insurance should not be your only strategy but it can be a valuable strategy in your planning. Do not buy more than you need or can afford. Remember, if you own the insurance policy regardless of beneficiaries, the death benefit amount will be included in your estate value upon your death. This could cause a tax issue so check with your insurance agent, attorney, or accountant.

5. Passing on your farming know-how:
A key to protecting your farming successor is to spend some quality time with them during the transition years. This time should be devoted to the transfer of management and farm operation skills. Teach them to handle the management of the farm business. Share how you make decisions. Pay particular attention to successes you've had in terms of financial matters.

Pass on your wisdom. Share your "rules of thumb" and "things that went bad" and "what has always worked" philosophy. The younger generation may not always be receptive to your ideas, but this transfer of knowledge and know-how can give them a competitive edge on others. It can also help insure their success in running the farm business.

How To Be Fair With Non-Farm Heirs:

One of the most difficult questions many retiring farm families face is how to get a young son or daughter started farming while being fair to the non-farming heirs.

Non-farming heirs often leave the farm in their late teens for careers elsewhere. Most parents are concerned with being fair to all of their children at estate settlement time. Fairness, however, may not mean equal treatment of heirs.

Many farm families have reasons for unequal treatment of heirs. Some of those reasons include:

- Non-farm children received college tuition, a down payment on a house or other compensation, so they received their inheritance early.
- The farming heir helped create part of the final estate of the parents by actively contributing to the parents' business over the years, so they may be entitled to more. This is an issue of “Contribution vs Compensation” – fair does not always mean equal! See *Putting a Value on Sweat Equity by Dave Goeller, University of Nebraska, Lincoln, 9/2009.*
- Parents want the farm to "stay in the family". Consequently they are willing to give more to the farming heir whose goal it is to stay on the farm.
- Farming heirs are getting delayed compensation for work performed in years when they were underpaid.
- Farming heirs have been or will be attending to the majority of the physical and business needs of the parents in their declining years.

There are several methods farm families can use to transfer assets unequally but, in their minds, fairly to their heirs. They include but are not limited to the following:

- Parents write buy/sell agreements with farming heirs, committing to exact sale prices, terms, and timing of payments on farm properties. These agreements are binding on non-farm heirs; provide the farm heirs a guarantee of property purchase at an acceptable pace and price, and guarantee off-farm heirs a fair price.
- Use of life insurance as mentioned earlier. In addition, parents purchase life insurance on themselves and list the off-farm heirs as the beneficiaries. In this case, farm heirs get farm assets and non-farm heirs get the cash generated by the insurance.
- Parents establish a Testamentary Trust (through a Will) or Revocable Living Trust. It states that the farm heirs have the right to purchase farm assets from the trust at predetermined prices, terms and conditions over a number of years. This guarantees the non-farm heirs their percentage of the estate over time.
- The parent’s Will has been used to equalize or to make fair any previous distributions to heirs. The Will may make special provisions to fit the situation. If the farming heirs or any heir has received earlier compensation, they may now get less than other heirs. Non-farm heirs may be given an inheritance of cash, non-farm assets or remote land holdings. Farm assets are transferred to the farming heirs.

It is a good practice to involve all heirs in the transfer process and to communicate to all heirs the final plans for distribution and transfer of assets. This communication should be done prior to your death so farming heirs are not left in the embarrassing position of trying to explain your actions. Doing this can avoid catastrophic family controversy.

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Ag Business Management

University of Minnesota Extension

Informing farm families and ag businesses about management issues.

Transferring the Farm Series #9 9/2009

Developing a Written Transition Plan Outline

Prepared By:
Gary A. Hachfeld, David B. Bau, C. Robert Holcomb, & James N. Kurtz, Extension Educators

Introduction:
Developing a written transition plan outline is an important part of a successful farm transition. The process necessitates discussion between involved individuals resulting in a more focused plan. It clears up questions and potential misunderstandings. The completed plan outline provides a "road map" to follow even though you may have to make a few detours. It provides all parties with an early commitment to follow through with all phases of the transition process.

The entire process should be based upon your individual, family, business/retirement goals. *See Transferring the Farm Series #1-Preparing to Transfer the Farm Business.*

Who Should Be Involved In Plan Development?
If the transition is between two or more families, it is important that all entering and exiting parties and their spouses be involved in developing the plan. Spouses, who are informed about the plan and actively involved in plan development, are more supportive than if not involved in the process.

There are a number of steps involved as well as a whole host of questions you will need to address. The process is outlined in this information piece.

A very crucial member of your "transfer team" is an attorney well versed in business transfer, estate planning, elder law and disability planning.

A second key contributor to the development of your transfer plan will be your tax accountant. He or she will make sure your plan makes good tax sense.

There are several other individuals that need to be on your transfer team and can be instrumental in the development of your transfer plan. They might include your banker or financier, your insurance agent, your financial planner, your adult farm management instructor, etc.

When your plan is nearly developed, you may want to seek your attorney's opinion. Ask them to review your draft and make comments. The key here is to have a solid outline of your transfer plan before going to the attorney and drafting all the necessary legal documents. That will save you time and money.

It is a good idea to inform or involve the non-farm heirs as to the details of the plan. Point out to them that you are taking a business-like and systematic approach to transferring the business. Let them know why you have chosen to do certain things. Share with them your goals for the farm business and that the steps being taken are necessary to achieve those goals. This process alone can greatly reduce potential clashes within the family.

What Should Be Included in the Plan Outline?
The key is to develop a plan that fits your situation. Do not use a generic plan or template because it may not fit your farm transition situation. The attorney and accountant especially, should have the skills to design the plan unique to your situation. If they can not, find someone who can.

Include as many specific details as possible. Details make it more useful and reduce future questions. Again, base the plan on your goals. Here are some items to think about.

- How will the land be rented? What are rental rates and payment dates? How will rental rates be determined in the future?
- How will the machinery be transferred - gift, sale, lease with piecemeal buyout or exchange of labor for machine use? Who will pay the insurance, fuel, major and minor repairs? When will the machinery be transferred?
- How will livestock be transferred - lump sum sale, gradual sale, shared income for a few years, or livestock share lease?
- How will buildings and the house be handled? Use rent free? If not, what rental rate? Is it included with land rent? What arrangements are made for the

transfer, sale, gift, or tax free exchange of real estate? Who will pay for insurance, real estate taxes, repairs, and utilities? Does the plan make maximum use of the Minnesota Homestead Credit?

- Are arrangements made to improve the security of the entering farmer – life insurance on parents, a buy-out provision giving the option to buy assets later, parents' living trust or Will to bind other heirs to sale terms?
- Will land be sold? If so, when and how will price and terms be determined? Would a buy-sell agreement be in order?
- Have adequate and acceptable housing arrangements been made for the long run? Is everyone happy with those arrangements?
- If parents will be working for their children, what is the method and rate of compensation? How much will parents be expected to or want to work on the farm after retirement?
- If families will be working together through several transition years, who will be responsible for what segments of the business? Who will be responsible for and mange the livestock, crops, machinery, marketing, farm records, employees, etc.? How will work be divided? Are hours and vacation times agreeable to all?
- What are the arrangements for transition of management and who is responsible for overall decision making? In other words, who has the final word and when does that right transition to the next generation?
- How will the debt be handled? Does the entering farmer assume the existing debt, borrow elsewhere and pay off old debt? How will this impact existing farmer's tax situation?

When Should a Plan Be Established?

The sooner a plan is established and implemented, the more confident the participants will feel. Once you decide to transfer the farm, the planning process should begin. The plan should provide for the complete transition of the business, so it may have to cover a period of 10 years or more.

Put The Plan In Writing!

Putting the transfer plan in writing is a must. If not written down, details are easily forgotten and often misconstrued as time goes by.

After a first writing, all farming parties should review the plan and check it against your goals and you may want to verify it with your transfer team members. As soon as the document has agreement from everyone involved, a final transition plan can be completed.

Once agreed upon, the plan can be implemented by going to your attorney and having the necessary documents, etc. drafted and signed. All involved farming parties should read and sign the final agreement.

Once the final version is complete and signed by all farming parties, parents should make arrangements for a family meeting where they share their plan. Begin with sharing goals and then what was done in the plan to carryout those goals. The plan may not be popular with non-farm heirs but at least they are aware of what was done and why.

If the farm business changes over time or the environment in which the farm business operates changes in the future, it is crucial that all parties review the transition plan. If necessary, the plan can be modified to reflect the current situation.

Example Plan Outline:

- Parents purchase a house in town.
- Farming heir (s) purchase farmstead.
- Land will remain in parents name until death and will be rented to the farming heir(s) at 75% of high end rents in the area.
- Equipment will be gifted at $13,000 per year and farming heir(s) will buy all equipment not owned in 10 years.
- Livestock, grain and feed will be sold over three years with farming heir(s) buying what they want and can afford.
- Parents will provide labor as available but farming heir(s) should be able to complete work without parents.
- Life insurance proceeds will go to non-farm heirs along with the house in town.
- Farming heir(s) will get the farm land.
- Parents will establish a Revocable Living Trust with pour over Will for all assets moving into the trust. It will include bloodline language and protective trust provisions.
- Trustees/Co-Trustees of the trust are the parents. Upon their death specified children as successor trustees.
- Parents will establish Common Law Durable Power-of-Attorney and all associated documents.
- Parents will establish a Disability Panel: current physician, specialist, and specified children on the panel.
- Parents will complete a Health Care Directive with HIPAA authorization.
- Parents will establish a South Dakota LLC as the farm business operating entity.

Developing a transfer plan is critical to the future success of your farm business. It is very important to put together a competent transfer team with an attorney, accountant and others than understand farming, estate planning, elder law and disability planning.

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Ag Business Management

University of Minnesota Extension

Informing farm families and ag businesses about management issues.

Transferring the Farm Series#10 9/2009

Financial Help for Beginning Minnesota Farmers

Prepared By:
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Introduction:

Every farmer, when starting a farm business, has had to deal with how to finance his/her operation. Parental financing, the local bank or Farm Service Agency (FSA - formerly FmHA) financing and state government financing are all possible funding sources.

Parental Financing:

Parents often directly or indirectly help with financing. Many give direct help through gifting of assets such as feed, machinery, grain or livestock as well as possibly providing down payment money for land purchases. Others loan money to their children for various farming needs.

When lending money to children it is important to:

- Write up a promissory note which stipulates the terms of the agreement including interest rate, repayment schedule, and default remedies.
- Charge a reasonable interest rate which is similar to market place loans. You can charge less than commercial interest rates and also less than the Applicable Federal Rates (AFR). The AFR change monthly and can be determined by contacting your accountant or going to www.irs.gov and doing a search for AFR. If you charge less than the AFR, the difference will be considered a gift and may trigger gift tax consequences and Medicaid ineligibility.
- Expect and demand payments when due.
- Be prepared to write off the debt if it is not repaid. The Internal Revenue Service will not let you deduct it as a bad debt. Most bad debts to family members are considered gifts by the IRS and are not deductible to you as the lender. *See Transferring the Farm Series #6-Gifting Farm Assets.*

Direct lending of money to relatives is often the cause of broken relationships. Misunderstandings often occur. Proceed with caution when lending money to your children.

Another way parents can help is to give a loan guarantee to the local lender through the use of a co-signature. One could also assign collateral to secure the loan for a child. If the child pays off the note as agreed, loan guarantees can work well. However, if adversity strikes and the loan is not repaid by your child, you must be ready to make the payments.

If you decide to make a loan guarantee for your child, limit the dollar amount you will guarantee. Don't co-sign an unlimited loan. It's like signing a blank check. Ask the lender to notify you immediately if payments are not made on schedule.

FSA Loans:

A better approach may be to encourage the use of FSA loans. You may be better off giving some cash or equity to your child so they can qualify for a FSA loan. Doing so can limit your risk of loss to what you gave your child rather than having to pay off an entire co-signed loan.

FSA has long been a source of funding for younger, beginning, low equity farmers. Availability and terms of loans vary as programs are started and terminated. Contact your local county FSA office about your particular financing situation and current financing availability.

Local Banks:

Local banks are excellent sources of financing for young farmers. Young farmers are most successful getting loans if they start early in their career, borrowing money and repaying it in a timely fashion. Establishing a good credit history and a good bank relationship, even while in high school, can result in good financial support from that bank as financing needs develop.

In addition, your local bank can enter into loan agreements with FSA and RFA (explained in the following paragraph) to better serve your credit needs.

The Minnesota Rural Finance Authority (RFA):

The Minnesota RFA is a department within the Minnesota Department of Agriculture. RFA has several financial programs available for beginning farmers. They include programs for the purchase of real estate,

purchase of livestock equipment, livestock expansion, farm debt restructuring, farm improvements, purchase of value-added coop shares, and more.
To be eligible for any RFA programs, you must be a Minnesota resident purchasing Minnesota property. You must farm the land being purchased and have a financial need for the loan. In addition, you must have the educational background to succeed in farming, be enrolled in a farm business management program and file a soil and water conservation plan with local SWCD offices.

Interest rates, net worth requirements, and participation levels change annually in the RFA program. RFA also works with connecting retiring farmers with beginning farmers. It hopes to link up suitable retiring farmers with appropriate entering buyers, renters, leasers, or share arrangements. If you are interested in this program and others mentioned, contact:

MN Department of Agriculture
625 Roberts Street N.
St. Paul, MN 55155-2538
Phone: 800-627-3529 651-201-6556

Internet website: http://www.mda.state.mn.us. Once there, click on "Grants, Loans & Financing", then click on "Loan Program".

Procedure When Applying For a Loan:

1) Be Well Prepared: Whenever you approach a lender for money it is best to be well prepared. This is especially true if you are approaching a lender who does not know you or your business. To have the best chance of getting your loan, you should clearly and professionally show the lender where you stand financially and how the money will be used and repaid. You can greatly influence a lender psychologically if you are well prepared and present yourself and your case well.

2) Items to Prepare in Advance: Your lender would like to see several statements. They include a net worth or financial statement, a projected cash flow, the last three year's income tax returns and a complete business analysis if possible. In addition, your particular lender may have other specific requests for information such as a business plan including goals.

When applying for a loan to add a new enterprise or expand a current enterprise, be sure to have accurate cost data on assets you will be purchasing. Secure certified bids or good estimates and bring them with you.

3) Records: If you have good records, assembling all of the above information is much easier. If you have a set of good records, you may wish to briefly show them to your lender during your presentation to further convince him or her of your business skills.

What It Takes To Get A Loan Approved:

Not all loans get approved. Following are some of the most common reasons loans do not get approved.

- You are not able to **provide a substantial part of the asset value** from your own funds. Many lenders will have lending limit percentages on the market value of land, machinery, livestock and buildings. Lenders generally insist that you share a portion of the purchase and therefore share some of the risk.
- If your cash flow projections show a **poor repayment capacity**, getting the loan will be difficult.
- If you're **net worth is small** and you have nothing to lose if you default on the loan, you will have a more difficult time getting the loan.
- If you have a **history of bad credit** or **late payment** on previous loans, expect some difficulty in getting a new loan. Bankers will check out your credit reports. **Protect your credit rating** by paying off all loans (including credit cards) on time.
- If your business profit projections show a **low profit or a loss**, your lender will also hesitate to give you the loan.

Where To Get Help:

Your local adult farm management instructor may be able to help you get started in the process of applying for a loan. You can find that local person in MN. by going to www.mgt.org , selecting "farm business management" then selecting "instructors" and selecting your location in the state.

Your local MN Extension Farm Management Association field person can also provide you with some help. Contact Jim Kurtz at 507-372-3904.

Your accountant is another person who can help you prepare the above forms. You can also purchase FINPACK financial planning software through the Center for Farm Financial Management, University of Minnesota, by phoning 1-800-234-1111. The software will enable you to do cash flow planning, long-range planning, and year-end analysis.

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Bulletin 862

Transferring Your Farm Business to the Next Generation




Transferring Your Farm Business to the Next Generation

Bulletin 862 Revised

Keith L. Smith, Ph.D., Associate Vice President for Agricultural Administration and Director, Ohio State University Extension

TDD No. 800-589-8292 (Ohio only) or 614-292-1868

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Transferring Your Farm Business to the Next Generation

Five Key Questions Answered

A Note From the Authors

We each have considerable experience in working with farm families who are struggling to get farm businesses transferred to the next generation. We have noticed how often the same questions keep appearing. We decided to pool our experiences and write a bulletin just for farm families planning to or in the midst of transferring a farm business. We address five key questions around which many other more detailed questions arise:

1. Do we have an economically viable business to transfer?
2. Are there enough income and assets to provide for the older generation's retirement needs?
3. How can we happily work together to help make the transfer a success?
4. What should be transferred to the next generation and when should it be transferred?
5. How do we avoid paying unnecessary income, gift, and estate taxes?

Each of the five parts of this bulletin addresses one of these questions. Start reading anywhere in the bulletin, but recognize that all five questions are important to a successful transfer. The one of least interest at first may become the one you need the most. Failure in any one of these five areas will make it difficult, if not impossible, to transfer a successful on-going farm business to the next generation.

This bulletin is designed to be a reference that is used over and over. We do not expect anyone to read it cover to cover in one sitting to learn "all there is to know." We encourage you to share it with other family members and to discuss its content often and thoroughly.

Each of us has heard more than one family say, "I wish we had started working on this much sooner." We encourage you to start now! Addressing the five questions won't be easy. However, it is likely to be the most important challenge you will face in moving to the next stage of your farming career.

Jim Polson
Robert Fleming
Bernie Erven
Warren Lee

Updated by Donald Breece and David Miller. Supported by a grant from the North Central Risk Management Education Center, University of Nebraska.

About the Authors

Donald Breece is an Ohio State University Extension farm management specialist. He joined OSU Extension in 1985, after working with Missouri Extension as an area specialist and teaching vocational agriculture at Elida, Ohio. His Ph.D. is from Cornell University; his B.S. and M.S. are from Ohio State. He is Ohio's leader for the farm financial analysis computer program, FINPACK, and its accompanying business planning program. He is also a retired Colonel, U.S. Army Reserve.

Bernie Erven is professor emeritus and former state specialist, farm management in the Department of Agricultural, Environmental, and Development Economics. He joined Ohio State in 1969 after receiving a Ph.D. from the University of Wisconsin. He teaches courses in principles of agribusiness management and human resource management in small businesses. His Extension program focuses on human resource management in farm businesses with special attention to family relations, communication, and personnel management. He also participates in a state-wide farm management education program called ManagementExcel.

Robert D. Fleming is associate professor emeritus and former district specialist, farm management, with OSU Extension for Northwest Ohio. After joining Ohio State in 1965, his appointments have included area Extension agent, farm management; Extension agent, agriculture; Extension agent, 4-H; and county chair. He received an M.S. and a B.S. in agricultural economics from The Ohio State University and has completed post graduate course work at Ohio State.

Warren Lee is professor emeritus and former state specialist, agricultural finance with OSU Extension. He joined Ohio State in 1970 after receiving, a Ph.D. in agricultural economics from Michigan State University. His teaching and research programs included farm investment analysis, risk management, farm business information systems, and farm business analysis. He is senior author of the textbook, *Agricultural Finance,* and has written numerous journal articles and bulletins.

David Miller is a retired farm management specialist for OSU Extension. He is currently an enrolled agent income tax practitioner and works with the Paul Wright Law Company in Dublin, Ohio.

Jim Polson is retired and a former district specialist, farm management, Northeast District Extension, Wooster, Ohio. He started with Ohio State University Extension in 1971 as an area farm management agent. His book, *Handbook of Farm and Ranch Estate Planning,* was published by Prentice-Hall, Inc., in 1982. He has written many articles and conducted many workshops for farmers on Transferring Your Farm Business to the Next Generation; Estate Planning; and Farm Business Organization.

Part 1
Guidelines for Measuring Business Feasibility

The first question to answer is, "Do we have an economically viable business to transfer?"

Every farm business will be transferred someday, with or without a plan by the owner, or go out of operation. Depending on the objectives of the owner, the transfer can be during or after the life of the current owner. Decisions should be made on whether to provide for the continuation of the farm business and management responsibilities or just transfer the ownership of assets.

The most common methods of transferring property are by installment or outright sale, gift, lease, buy/sell arrangement, or inheritance. There are many variations of selling procedures with associated advantages, disadvantages, and tax implications to be discussed later.

Gifting also has potential tax implications but reduces future income sources for the donor. A true lease allows for the purchase at the end of the term at the fair market price. Inheriting property has some tax advantages, but it delays the transfer of ownership until there is a death. Consult the Ohio State University Extension Web site at http://ohioline.osu.edu/estate for information on *Estate Planning Considerations for Ohio Families.*

A business transfer plan may use a combination of all methods. The first question to answer, however, is, "Do we have an economically viable business to transfer?"

Guidelines for Measuring Financial Viability

There are few indisputable rules for predicting the financial success of a farm business. However, there are some guidelines that can be used to evaluate the chances of success. When transfers are considered, these guidelines may be useful to all persons involved in the planning. Future problems may be avoided or minimized. These measures should be used before, during, and after a transfer.

A farm business must be profitable in the long run in order to continue existence.

A farm business must be profitable in the long run in order to continue existence. The key internal factors that affect profitability in any farm business are:

1. Size
2. Rates of production
3. Labor efficiency
4. Capital efficiency
5. Cost control
6. Marketing and purchasing

To perform the management functions of planning, organizing, staffing, directing, and controlling effectively, the manager must have a mission, objectives, and goals that relate to these factors. Each manager should set his or her own goals based on past results, current conditions, and long-range objectives. Frequently, managers need a benchmark from which to begin.

America's Diverse Family Farms — Size Matters

American farms encompass a wide range of sizes, ownership structures, and business types. A farm classification system was developed by USDA's Economic Research Service (ERS).

Farm Types

The farm classification developed by ERS focuses on the family farm, or any farm organized as a sole proprietorship, partnership, or family corporation. Family farms exclude farms organized as non-family corporations and cooperatives and farms with hired managers.

Small Family Farms (sales less than $250,000)

- **Limited-resource.** Small farms with sales of less than $100,000 and low operator household income (defined as less than the poverty level for a family of four in 2003 and 2002 or less than half the county median household income in both years). Limited-resource farmers may report farming, a non-farm occupation, or retirement as their major occupation.
- **Retirement.** Small farms whose operators report they are retired (excludes limited-resource farms operated by retired farmers).

- **Residential/lifestyle.** Small farms whose operators report a major occupation other than farming (excludes limited-resource farms with operators who report non-farm work as their major occupation).
- **Farming-occupation/low-sales**. Small farms with sales of less than $100,000 whose operators report farming as their major occupation (excludes limited resource farms whose operators report farming as their major occupation).
- **Farming-occupation/medium-sales.** Small farms with sales between $100,000 and $249,999 whose operators report farming as their major occupation.

Large-Scale Family Farms (sales of $250,000 or more)

- **Large family farms.** Farms with sales between $250,000 and $499,999.
- **Very large family farms.** Farms with sales of $500,000 or more.

Non-Family Farms

- **Non-family farms.** Farms organized as non-family corporations and cooperatives, as well as farms operated by hired managers.

Large-scale family farms and non-family farms accounted for 73 percent of agricultural production in 2003.

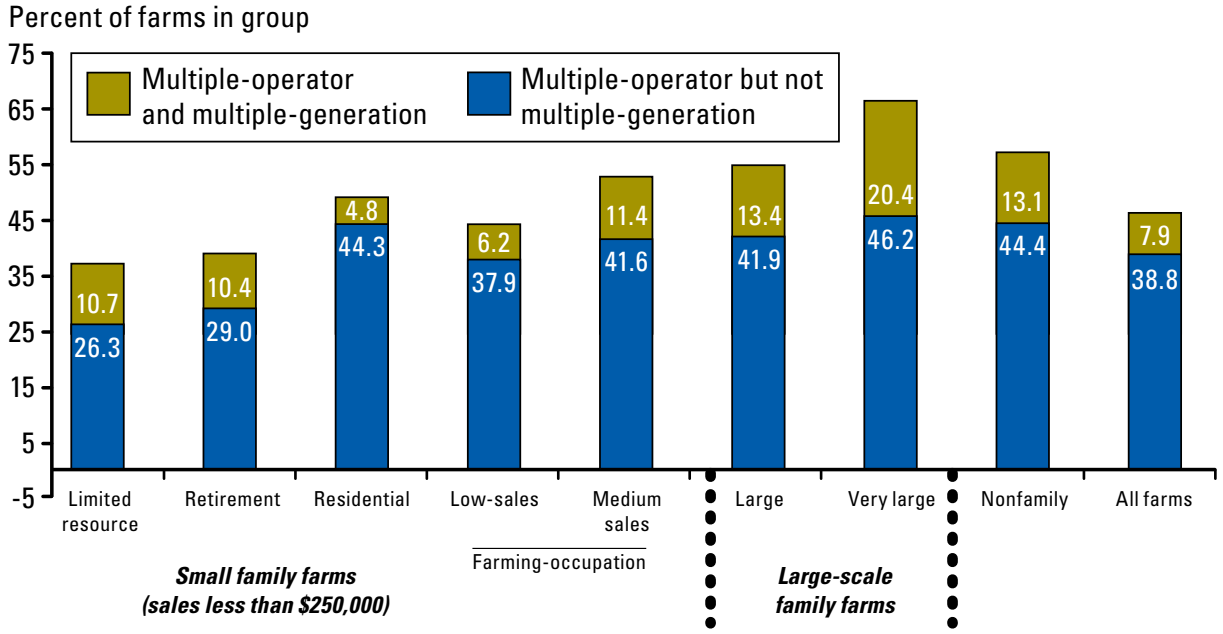
Farms and Farm Operators

Many farms have multiple operators, and many large farms have multiple generations of farm operators.

- Multiple-operator and multiple-generation enterprises are most common among very large family farms.
- Generational life-cycles, particularly the presence or absence of younger related operators, may affect farm expansion and contraction decisions.

Large-scale farms account for 73 percent of agricultural production.

Table 1.1. Multiple-Operator Farms, 2003.



Multiple-operator farms: Farms with more than one operator.
Multiple-generation farms: Multiple-operator farms with a difference of at least 20 years between the ages of the youngest and oldest operators.
Source: USDA Economic Research Service.

Farm Size and Income Requirements

The size of a farm required to make a desired living income is one of those economic questions most easily answered by "that depends." It depends upon such things as the desired family living standard, amount of debt or investment to be paid by enterprise profits, production efficiency, market prices received for the products, and per unit cost of production. The Web sites listed later in this section provide benchmark information to help establish the profit potential of given enterprises.

It should be noted that net farm income or profit will be affected greatly by assumptions made for market prices, production levels, available family labor, and input costs. However, it may be best to first step back and look at some general economic principles, as they pertain to all family farm businesses producing commodities for sale.

The 2005 and 2006 Ohio Business Summaries of farms, utilizing the FINPACK computer program for financial analysis, shows an average of $419,475 in 2005 and $414,708 in 2006 as the value of farm production per farm with 1.6 operators, $71,283 net farm income (NFI) in 2005 and $73,114 in 2006, and about $25,000 of non-farm income in 2005 and $17,662 in 2006. On a per family basis, in 2005/2006 this would be $262,172/$259,120

of farm production, $44,552/$45,697 net farm income, plus about $15,600/$11,039 of non-farm income.

Economists have generally indicated that living costs for an average farm family are about $50,000. Average family living costs and taxes from the 2005/2006 Ohio Summary were $44,104 /$41,896 per farm. So how many dollars of gross farm sales would it generally take to earn nearly $50,000 to take care of a family?

It generally will take at least $300,000 of gross revenue to generate $50,000 in family living income. Assume it takes 75 percent of revenue (operating expense ratio) to cover out-of-pocket costs. This leaves 25 percent for debt service, capital replacement, growth, and family living costs. The $300,000 gross revenue example would net $75,000. After $50,000 for family living, this would only leave $25,000 for debt payments and investment.

The Web sites listed here may be used to identify benchmarks and budget information. Also, note that farm businesses will need to grow 5 to 7 percent per year just to keep even.

- **Illinois Farm Business Farm Management Association**
  www.fbfm.org

  A report of 2005 information from 1,209 farms indicated an average of $351,457 in farm receipts, $27,810 non-farm income, $55,030 in net farm income, and non-capital family living expenses of $52,743.

- **The Center for Farm Financial Management, University of Minnesota**
  www.finbin.umn.edu

  The Center collects financial data from several states, mostly in the Midwest. In 2005, 3,236 farms reported an average of $376,778 in farm receipts, $22,944 non-farm income, $81,959 net farm income, and family living expenses of $40,753.

  "FINBIN is one of the largest and most accessible sources of farm financial and production benchmark information in the world. FINBIN places detailed reports on whole farm, crop, and livestock financials at your fingertips," Center for Farm Financial Management web site, FINBIN data location.

- **National Ag Risk Library and a Library of Budgets**
  www.agrisk.umn.edu

- **Ohio State University Extension Budgets**
  www.aede.osu.edu/programs/FarmManagement

Family Living Expenses on Family Farms

Farm families will often underestimate requirements for family living expenses. As additional operators are brought into the farm business, a realistic estimate must be considered for additional family living expenses. Some recent research in the area of family living income and expenditures is presented here.

The University of Kentucky Cooperative Extension Service completed a detailed study of 121 farm families (2002-2005). The trend is for climbing living expenses — $57,336 in 2005 for a family of 2.8 people, with 55 as the average age of the operator. The expense breakdown is as follows: contributions $4,060, medical $7,346, life insurance $1,421, and expendables of $40,936 for a non-capital total of $53,763. Capital expenses of $3,573 increased the total to $57,336.

Total farm receipts averaged $375,553, net farm income was $64,594, and non-farm income amounted to $42,068. On a per-acre basis, family living amounted to $70.64 in 2003, $72.05 in 2004, and $83.70 in 2005 (total living expenses divided by total operator acres). However, if non-farm income was considered in 2005, the 685 acres only needed to contribute $22.29 per acre toward family living.

The University of Illinois continues to study more than 1,200 farm families enrolled in the Illinois Farm Business Farm Management Association program. In 2005, non-capital living expenses averaged $52,743. The breakdown is as follows: contributions $2,058, medical $7,433, life and disability insurance $2,900, and expendables $40,352. Capital expenses added $5,542 for a total of $58,285. This was for 3.1 family members and an average age of operator of 52 years. In addition, income taxes averaged $10,351.

Total farm receipts averaged $351,457, net farm income $55,030, and non-farm income was $27,810. On a per-acre basis in 2003, family living averaged $79 for each tillable acre. However, if non-farm income of $39 per acre was considered, then $40 per tillable acre would need to have been generated from the farm business to meet family living.

Lenders, reviewing cash flow estimates from farmers, are at times perplexed at the lack of awareness about family living expense estimates. Certainly, as a minimum, farm families should plan for family living costs to exceed the U.S. Department of Health and Human Services poverty guidelines for 2007 (Table 1.2). These guidelines are used to determine qualifications for such federal programs as Food Stamps. For example, a family of four, at or below 130 percent of the poverty guidelines ($26,845), may qualify for Food Stamps. The risk of such a large investment, as in farming, deserves a more reasonable return to family labor.

A family of four, at or below 130 percent of the Federal Poverty Guidelines ($26,845), may qualify for food stamps.

Table 1.2. Health and Human Services Poverty Guidelines, 2007.

Persons in Family or Household	48 Contiguous States and D.C.
1	$10,210
2	$13,690
3	$17,170
4	$20,650
5	$24,130
6	$27,610
7	$31,090
8	$34,570
For each additional person, add:	$3,480

Source: Federal Register, Vol. 72, No. 15, January 24, 2007, pp. 3147-3148.

Family living expense requirements are driving the size requirements of commodity agriculture. Commodity production assumes smaller profit margins. To meet future family living demands, farms will continue to grow in size and scale. David Kohl, Virginia Cooperative Extension, lists some rules of thumb for family living costs: Family living costs generally account for between 10 and 15 percent of gross farm revenue. Also, a farm business exceeding a debt-to-asset ratio of 50 percent means that living expenses should generally be under 10 percent of revenue.

Family living costs generally account for between 10 and 15 percent of gross farm revenue.

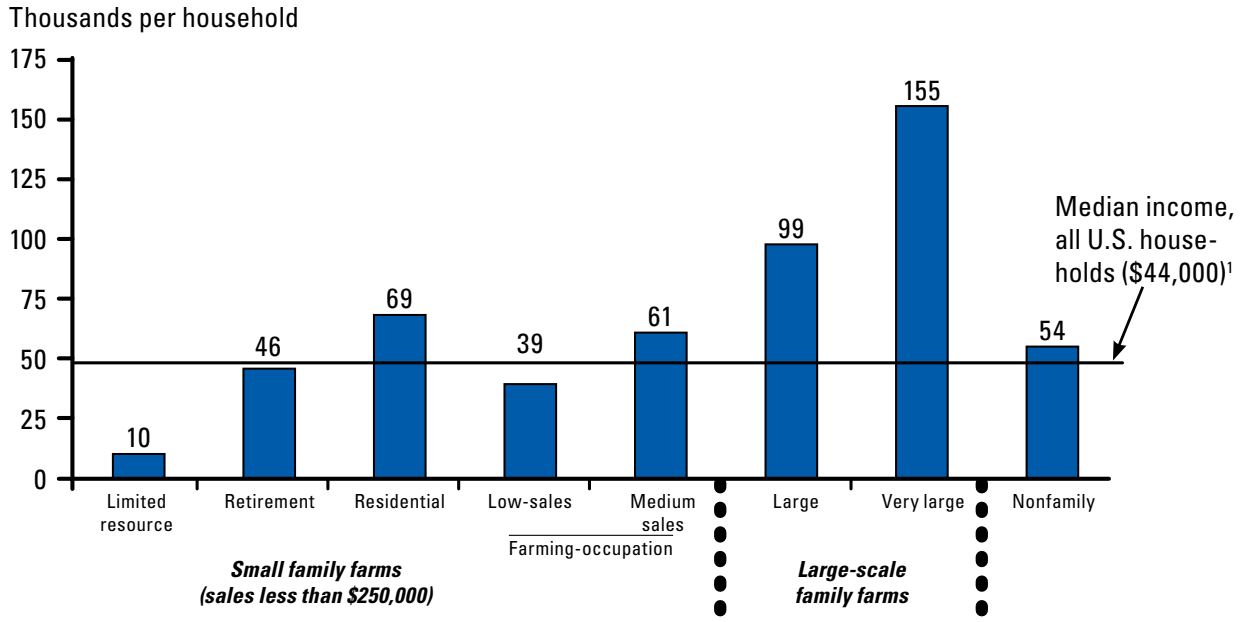
Retirement planning is essential to any transition plan.

He indicates that there may be some evidence for couples over the age of 65 requiring approximately 25 percent more to support their lifestyles than a couple who is 35. For older couples, medical costs are much higher, and travel plans add to the living expenses. What does this mean for retirement planning and its effect on the business's future? With increasing life expectancies, it will be more common to have two generations of retired farm families possibly drawing on the resources of an operating business. Retirement planning is, therefore, essential to any transition plan.

Farm Operator Income

Large and very large family farms generally realize substantial income from farming, while small family farms, especially those for whom farming is not the primary occupation, often report losses from farming. Off-farm earning provides the primary source of income for most small family farms.

Table 1.3. Median Income of Operator Households, 2004.



Note: Median income falls at the midpoint of the distribution of households by income, dividing households into two groups. Half of the households have income above the median, while the other half have income below that level. Farm household income is not estimated for nonfamily farms.

[1]Median income for all U.S. households is from the U.S. Census Bureau, 2005 Current Population Survey.

Source: USDA Economic Research Service.

Table 1.4. Average (Mean) Farm Operator Household Income by Source, 2004

Type of farm operated	Total average income	Income from farming		From off-farm sources		
		Amount	Negative	Total	Earned[1]	Unearned[1]
	Dollars per household		*Percent of households*	*Dollars per household*		
Small family farms:						
Limited-resource	7,680	-5,902	72.1	13,582	3,463	10,118
Retirement	62,468	4,128	50.8	58,339	20,252	38,087
Residential/lifestyle	96,515	-365	64.4	96,879	83,548	13,331
Farming-occupation:						
Low-sales	63,043	4,925	44.4	58,118	36,950	21,168
Medium-sales	70,365	34,354	24.6	36,011	26,241	9,769
Large-scale family farms:						
Large family farms	125,120	80,250	16.8	44,870	33,238	11,633
Very large family farms	272,527	225,094	16.3	47,434	29,320	18,114
All family farms	81,596	14,317	52.8	67,279	48,818	18,461

Note: Farm household income is not estimated for nonfamily farms.

[1]Earned income comes from off-farm self-employment or wage or salary jobs. Unearned income includes interest and dividends, benefits from Social Security and other public programs, alimony, annuities, net income of estates or trusts, private pensions, etc.

Source: USDA Economic Research Service.

Rates of Production

Production efficiency is critical due to its effect on profitability. Some enterprise guidelines that should be met or exceeded over time are presented on the following page. Additional benchmarks may be found in reports created from the FINBIN database of farms, the Center for Financial Management, www.cffm.umn.edu.

Production efficiency is critical due to its effect on profitability.

Livestock Production

Table 1.5. Ohio D.H.I.A. Averages by Dairy Breed, 2006.

	Pounds/Cow/Year		
	Milk	**Fat**	**Protein**
Ayrshire	16,134	623	511
Brown Swiss	19,262	781	642
Guernsey	16,043	743	536
Holstein	23,167	850	703
Jersey	16,336	774	588

Dairy

Feed costs for total herd of less than $7.50 per cwt of milk produced.

Beef Cow/Calf

500–600 lbs. of calf weaned per cow per year

90–95% calf crop

Less than 20% annual cow replacement rate

Less than 5% calf loss

Average daily gain >2.5 lbs

Weaning rate: 100%

Ewe/Lamb

1.50 lambs sold per ewe per year

Market lambs gain 0.4 lb. per day

Less than 4.25 lbs. of concentrate per lb. of gain

Farrow/Finish Swine

More than 18 pigs marketed per female per year

Less than 340 lbs. of feed per 100 lbs. of pork produced (whole herd)

Market hogs gain more than 1.8 lbs. per head per day

$35 or less cost per cwt of pork produced

9.7 pigs weaned per litter

85% of carcasses in premium weight and quality category

Finish Cattle

Less than 7 lbs. of feed per lb. of gain

Market animals gain more than 2.5 to 3.0 lbs. per head per day

Market weight: 1,000–1,300 lbs.

Carcass weight: 650–800 lbs.

More than 75% of carcasses ≥ low choice grade and 2–3.5 yield grade

Crop Yields

Average crop yields and prices for Ohio for a five-year period, 2001-2005, are shown in Table 1.6a and Table 1.6b for 2006 and 2007 in Tble 1.6b. Yield goals need to be related to soil productivity and fertility levels. Producers should be measuring average yields over several years as well as knowing their trend in yields.

Table 1.6a. Ohio Average Crop Yield/Acre, 2001–2005.

	Yield	Average Price/Unit
Corn[1] (bu.)	137	$2.15
Oats[1] (bu.)	65	$1.78
Soybeans[1] (bu.)	41	$5.51
Wheat[1] (bu.)	66	$3.04
Corn Silage[1] (tons)	16	$19.00[2]
Mixed Hay[1] (tons)	2.8	$108.00

[1] Ohio Agricultural Statistics Service.
[2] OSU Extension estimate.

Table 1.6b. Ohio Average Crop Yield/Acre, 2006 and 2007.

	Yield		Price/Unit	
	2006	2007	2006	2007
Corn (bu.)	159	150	$3.08	$3.95
Oats (bu.)	75	62	$1.44	$2.05
Soybeans (bu.)	47	47	$6.46	$10.10
Wheat (bu.)	68	63	$3.35	$5.50
Alfalfa Hay (tons)	3.5	3.3	$125	$161
Mixed Hay (tons)	2.83	2.55	$105	$137

Labor Efficiency

Labor is one of the major resources used in agricultural production in addition to land, capital, and management. The amount and quality of land, extent of mechanization, and management will affect labor productivity. The guidelines presented in Table 1.7 are desirable minimum levels of labor productivity for output and typical labor input (Table 1.8). Use the input measures to estimate the size of the operation needed to require 2,500 to 3,000 hours of labor per full-time worker.

The amount and quality of land, extent of mechanization, and management will affect labor productivity.

Table 1.7. Output Measures
(Production sold per full-time worker for a single enterprise.)

Corn	100,000–140,000 bu.
Milk	1 million–1.5 million lbs.
Soybeans	40,000 bu.
Beef Cows/Calf	250,000–300,000 lbs.
Wheat	65,000 bu.
Cattle Feeding	500,000–1 million lbs.
Hay	3,000–4,000 tons
Farrow/Finish	>500,000 lbs. pork
Ewes/Lambs	1,500–2,000 lambs
Gross Farm Receipts	>$300,000

Table 1.8. Annual Input Measures
(Operator Labor/Unit of Production)

	Hours/Acre		Hours/Head
Corn	2	Feeder Pig Production	20/sow
Soybeans	1.5	Farrow-Finish	33/sow
Wheat	1.5	Beef Cow-Calf	10/hd.
Hay	4	Beef Feeding	4/hd.
Canola	1.2	Dairy	60/cow
Oats	1.5	Ewe-Lamb	4/ewe
		Finish Feeder Pigs	1/hd.

The crop hours will be less with no-till production, and livestock hours will be less with high-investment facilities. Non-field labor time includes purchasing inputs, marketing, record keeping, etc.

Asset turnover measures capital efficiency in terms of output.

Capital Efficiency

Modern farms are capital-intensive; therefore, any capital invested should be used efficiently. Asset turnover measures capital efficiency in terms of output (value of farm production per year divided by average value of total farm investment). Some measurements use gross revenues rather than value of farm production and will vary the turnover ratio five to 15 percent depending on which measurement is used to calculate the ratio. The value of farm production is gross revenues minus purchased feed, plus inventory changes in market livestock and feed crops. Minimum suggested turnover ratios are shown in Table 1.9.

Table 1.9. Minimum Suggested Turnover Ratios

Type of Farm	Asset Turnover
General Crops	20–25%
Specialty Crops	25–50%
Dairy	40–50%
Farrow/Finish	50–60%
Feeder Pigs	60–100%
Beef Feeding	60–100%

Desirable turnover ratios will vary with change in tenure (percent of land owned) and capital invested in machinery and facilities.

Capital efficiency can also be measured in terms of financial investment per unit and/or debt load per unit. Conservative guidelines for these measures are presented here:

Table 1.10. Guidelines for Measuring Financial Investment per Unit and/or Debt Load per Unit.

Farm Type	Investment/Unit	Payment/Unit/ Year
Grains	$250 machinery/crop acre	$120/acre
Dairy	$7,000/cow	$400/cow
Farrow/Finish	$40/cwt. pork sold/year	$300/sow
Feeder Pigs	$60/pig sold/year	$180/sow
Beef Feeding Facilities	$300/head sold/year	$50/head

Table 1.11. Credit Providers to Ohio Farmers.

	Real Estate	Non-Real Estate
Farm Credit System	43%	36%
Commercial Banks	37%	33%
Individuals and Others	15%	29%
Life Insurance Companies	3%	0%
Farm Service Agency	2%	2%

In the long run, the average cost of production will equal the average price.

Cost Control

Economic theory states that, in the long run, the average cost of production will equal the average price. Therefore, to be profitable over time, a producer must have lower than average costs. Producers should compare their total costs of production (variable plus fixed costs) with the prices listed in Table 1.12. These figures are the average prices received by Ohio farmers in recent years.

Table 1.12. Average Prices Received by Ohio Farmers.

	2001-2005	2006*	2007*
Corn/bu.	$ 2.15	$ 3.35	$3.95
Soybeans/bu.	5.51	6.46	10.10
Wheat/bu.	3.04	3.35	5.50
Hay/ton	108.00	105.00	137.00
Hogs/cwt.	42.74	45.40	45.90
Cattle/cwt.	73.52	83.60	85.40
Calves/cwt.	96.02	118.00	105.00
Sheep/cwt.	34.64	34.80	30.70
Lambs/cwt.	89.26	91.80	97.70
Milk/cwt.	14.66	13.80	N/A

Source: Ohio Agricultural Statistics Service.
* Bio-fuel demand beginning to affect grain price.

Expenses as a percent of value of farm production should also be controlled. Since profits are a function of *(prices - total cost of production per unit) x number of units produced*, both prices and costs require management attention.

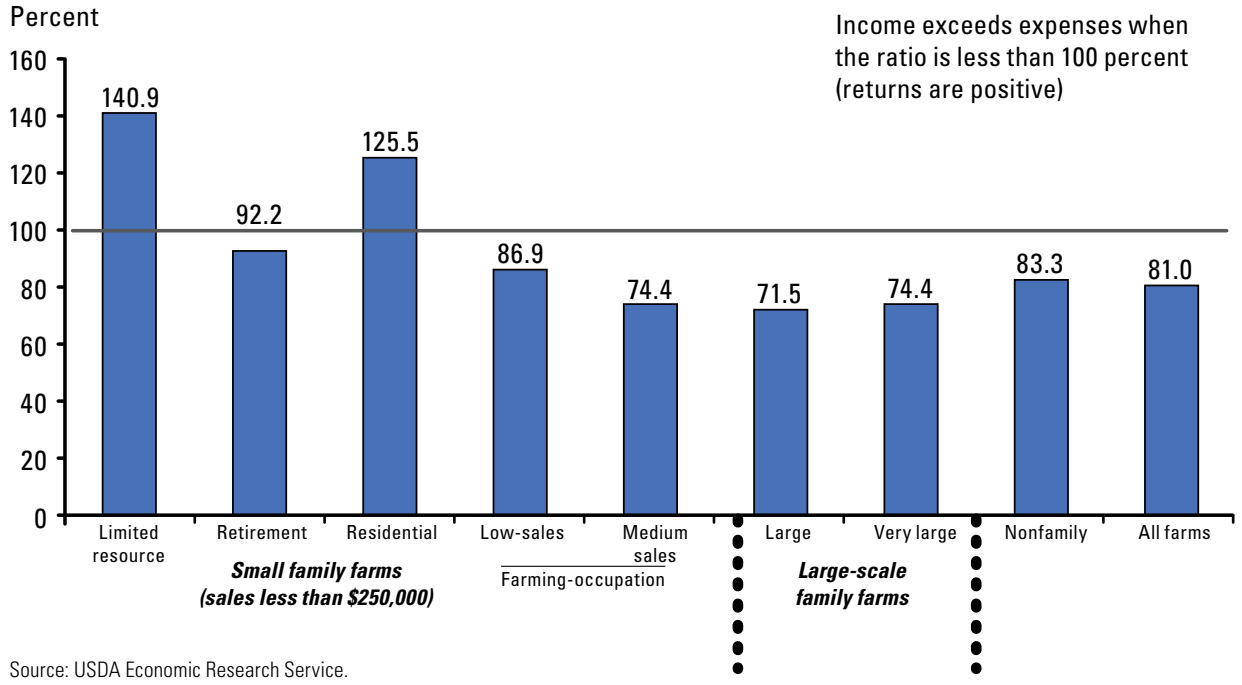
Table 1.13. Percent of Gross Farm Revenues.

	Maximum Level	Desirable Level
Total Operating Expenses (Excluding Depreciation and Interest)	80%	<65%
Depreciation	12%	<10%
Interest	20%	<10%

Farm Financial Performance

On average, medium-sales, large, and very large farms have better financial performance than other family farms as shown in Table 1.14. The operating-expense ratio measures the share of gross cash income absorbed by cash operating expenses.

Table 1.14. Operating Expense Ratio, 2003.



Source: USDA Economic Research Service.

Marketing/Purchasing

Marketing decisions are critical to profitability due to the variability of prices monthly, annually, and cyclically. Producers should strive to price their production in the upper half of the annual price variations but only produce if the expected price is greater than variable costs (in the short run). Comparing your average prices received with these can provide some measure of marketing effectiveness.

Marketing decisions are critical to profitability due to the variability of prices monthly, annually, and cyclically.

Table 1.15. Ohio Monthly Average Prices, 2001-2005.			
Season Average	**High Year**	**Low Year**	**5-Year Average**
Corn/bu.	$2.48	$1.80	$2.15
Soybeans/bu.	$7.20	$4.46	$5.51
Wheat/bu.	$3.20	$2.46	$3.04
Barrows/Gilts/cwt.	$50.00	$33.80	$43.44
Steers/Heifers/cwt.	$87.00	$66.00	$77.04
Calves/cwt.	$118.00	$78.50	$96.02
Lambs/cwt.	$109.00	$72.30	$89.26
Milk/cwt.	$16.60	$12.60	$14.67
Milk Cows/head	$1,730.00	$1,350.00	$1,536.00
Turkeys/lb.	$0.44	$0.35	$0.39
Eggs/doz.	$0.59	$0.37	$0.49

Source: Ohio Agricultural Statistics Service.

Compare your costs with prices of these selected inputs. Timely and careful purchasing also can have a significant effect on reducing costs.

Table 1.16. Average Price Paid Per Ton, 2004-2006.	
16% Dairy Feed	$221.00
14–18% Hog Feed	$224.00
Beef Cattle Concentrate	$354.00
6-24-24 Fertilizer	$172.00
Urea 44–46%	$324.00
Anhydrous ammonia	$453.00
Superphosphate	$290.00
Muriate of potash	$230.00

Source: Ohio Agricultural Statistics Service.

Farm Financial Ratios

Financial ratios can also be used to help evaluate the financial efficiency of the business. The Farm Financial Standards Task Force, a national committee charged with suggesting uniform financial records, has recommended 16 measures including the financial measures and definitions shown in Table 1.17.

Desirable ranges and guidelines vary substantially by type of farm, ownership pattern, time of year, and technology. Trends on each farm can identify management strengths and weaknesses. The 16 measures are grouped as follows:

- Liquidity
- Solvency
- Profitability
- Repayment capacity
- Financial efficiency.

Table 1.17. Farm Financial Standards Task Force Recommendations.

Measure	Definition	Desirable Range
LIQUIDITY		
1. Current Ratio	Total Current Assets ÷ Total Current Liabilities	1.5–2.0
2. Working Capital	Total Current Farm Assets – Total Current Farm Liabilities	Positive, stable
SOLVENCY		
3. Debt/Asset	Total Farm Liabilities ÷ Total Farm Assets	Less than 0.4
4. Equity/Asset	Total Farm Equity ÷ Total Farm Assets	Greater than 0.6
5. Debt/Equity Ratio	Total Farm Liabilities ÷ Total Farm Equity	Less than 0.66
PROFITABILITY		
6. Rate of Return on Total Farm Assets (ROA)	Net Farm Income + Interest Expense – Unpaid Operator Labor and Management ÷ Average Total Farm Assets	Greater than interest rates
7. Rate of Return on Farm Equity (ROE)	Net Farm Income – Unpaid Operator Labor and Management ÷ Average Total Farm Equity on Total Farm Assets	Greater than ROA
8. Operating Profit Margin	Net Farm Income + Interest Expense – Unpaid Operator Labor and Management ÷ Gross Farm Revenue	20–30%
9. Net Farm Income	Cash Income +/–Change in Inventories +/–Change in Accounts Receivable – Operating Expenses +/–Changes in Accounts Payable – Interest Paid +/–Change in Interest Payable = Net Farm Income From Operations +/–Gain/Loss on Sale of Farm Capital Assets = Net Farm Income	No Standard
REPAYMENT CAPACITY		
10. Term Debt and Capital Lease Coverage Ratio (TD and CLC Ratio)	Net Farm Income From Operations + Non-Farm Income + Depreciation + Interest Paid – Income Tax Expense – Family Living Withdrawals ÷ Scheduled Principal and Interest Payments on Term Debt + Capital Lease Payments = TD and CLC Ratio	Greater than 1.25

Table 1.17 (continued). Farm Financial Standards Task Force Recommendations.

Measure	Definition	Desirable Range
REPAYMENT CAPACITY (continued)		
11. Capital Replacement and Term Debt Repayment Margin (CR and TDR Margin)	Net Farm Income + Non-Farm Income + Depreciation – Income Tax Expense – Family Living Withdrawals = CR and TDR Capacity – Payment on Unpaid Operating Debt – Principal Payment of Term Debt – Capital Lease Payments – Payments on Personal Liabilities = CR and TDR Margin	At least 25% more dollars than scheduled payments on debts and leases
FINANCIAL EFFICIENCY		
12. Asset Turnover Ratio (See Table 1.9.)	Gross Revenues ÷ Average Total Farm Assets	Greater than 25–30%
13. Operational Expenses Ratio	Total Operating Expenses – Depreciation ÷ Gross Revenues	Less than 65%
14. Depreciation Expense Ratio	Depreciation/Amortization ÷ Gross Revenues	Less than 15%
15. Interest Expense Ratio	Total Farm Interest Expense ÷ Gross Revenues	Less than 15%
16. Net Farm Income From Operations Ratio	Net Farm Income From Operations ÷ Gross Revenues	Greater than 15%

Forbes, Stan, Recommendations of Farm Financial Standards Task Force, 1992.

The standards of comparison can be the business against itself, benchmarks, or industry averages.

All 16 of these factors have an impact on farm profitability. An accurate business analysis, emphasizing profitability, should be conducted annually to aide in making the transfer decision. The analysis can also point out other financial issues such as liquidity and risk. The recommended annual financial statements include:

- Balance Sheet
- Income Statement
- Statement of Cash Flows
- Statement of Owner Equity
- Cash Flow Budget
- Pro Forma Income Statement

An annual, consistent completion and analysis of these statements will indicate the economic viability of the business and the potential for transfer.

FINPACK 2005

"The most comprehensive farm financial planning and analysis software available," according to the Center for Farm Financial Management.

FINPACK is a computer program to organize and analyze the current financial situation of an agricultural business, answering the question "Where am I?" Next, FINPACK will help to explore alternatives within the ag business, helping to answer the question "Where do I want to be?"

After projections are analyzed, FINPACK provides the information to make better decisions about the ag business, "How do I get there?" All of this helps to better manage the operation.

Developed by the University of Minnesota's Center for Farm Financial Management, FINPACK is available through local Farm Business and Analysis (FBPA) Programs and county Extension offices. It may also be purchased at www.cffm.umn.edu.

Computer Records Manual

The Quicken self-study manual was developed to meet the demand of Ohio producers seeking assistance with using an inexpensive, easy-to-use program for farm record keeping. The objective of the authors is for Quicken users to begin keeping farm records on their home computer by following the step-by-step procedures outlined in each chapter of the manual.

What about the use of Quicken Basic for farm record keeping? If the farm business requires customer invoices and statements and accounts for payables and receivables, consider the Home and Business version of Quicken. The Home and Business version can also generate accrual-based profit-and-loss statements if the program is set up and used properly throughout the year.

However, for the majority of cash-basis farm record keepers, Quicken Basic will provide more than enough information for management decisions and income tax planning. Find this manual under accounting/record keeping at **http://aede.osu.edu/Programs/FarmManagement/MgtPublications. htm**.

Part 2
Retirement and Financial Issues

Life Cycle of a Farm Business

Farm businesses typically go through a four-stage life cycle that is closely related to the ages of the owners. In the **entry** stage, the owners plan the type and size of business and how to get enough capital resources for a viable economic unit. The next phase is the **growth** stage, which emphasizes increasing the size of the business. Capital requirements increase, and the owners get resources by borrowing and leasing.

In the **consolidation** stage, the family tries to maintain and stabilize the resource base and income stream. Repaying loans is more important than getting more resources. In the **exit** stage, the owners withdraw their labor, management, and capital from the business. The exit can be voluntary through planned retirement or forced by advancing age, ill health, accident, or death.

This bulletin focuses primarily on business transfer issues that occur during the consolidation stage. Typically, the parents want to provide an opportunity for children to come into the business, but they aren't quite ready to exit and withdraw their labor, management, and capital. This stage is difficult because the experience gained from a lifetime of active farming helps little in dealing with the complex personal, financial, tax, and legal issues.

Here are some typical goals of parents who want to transfer an on-going business to the next generation:

1. Give members of the next generation an opportunity to come into the business.
2. Help the next generation develop the management skills necessary to run the operation.
3. Be fair to children who don't want to come into the business.
4. Minimize transfer costs and thereby maintain and increase the financial resources of the extended family.
5. Reduce debt to the point where it will not be a burden to the next generation.

Farm businesses typically go through a four-stage life cycle that is closely related to the ages of the owners.

6. Have the operation operating efficiently and profitably so it can meet the financial demands on it.

7. Keep the farm in the family and have it farmed by family.

8. Accommodate the parents' retirement and estate planning goals, which primarily address the time when the parents are no longer an active part of the business.

Families frequently are trying to simultaneously juggle another set of estate planning goals related to their exit from the business. Typical goals, as described in Bulletin 595, *Estate Planning Considerations for Ohio Families* (see **http://ohioline.osu.edu/**) are to:

1. Provide for the financial needs of a widow/widower, children, and other dependents.

2. Provide adequately for the parents during retirement.

3. Treat all children fairly, not necessarily equally.

4. Maintain the business as an efficient and functioning unit.

5. Provide liquidity to settle the estate.

6. Maximize the amount remaining after settlement costs.

7. Maximize total family satisfaction.

Some of these goals are the same as those on the previous list. Others are different. Clearly, though, the business transfer and estate planning goals cannot be addressed independently. For example, business transfer decisions affect retirement and liquidity to settle the parents' estate.

Fulfilling these goals also requires a realistic assessment of resources, abilities, and circumstances. Some families have large businesses that can easily bring in one or more members of the next generation. In other cases, the business is barely large enough to provide adequately for the parents. Some parents want their business to grow and prosper, while others want to slow down and enjoy the fruits of their labor. The abilities and aspirations of prospective new entrants also affect the intergeneration transfer decision.

Timing and the number of other children are also important. An intergeneration transfer may be simple if the parents are five years from retirement and there is one capable child who is willing and old enough to start farming. At the other extreme

are 45-year-old parents with a modest one-family business, substantial debt, two married children who want to farm with them, and three other children. Transferring the business to the next generation is certainly easier if the entry stage for the children coincides with the exit stage for the parents.

Families frequently face trade-offs among goals. It is important that all family members, including in-laws, understand why parents made certain trade-offs. Clear recognition of the important goals in the consolidation stage is important.

Life Expectancies

Plans for retirement and transfer must include a realistic estimate of the life expectancies of the parents. Figure 2.1 was prepared from Joint Life and Last Survivor Expectancy, IRS Publication 590.

In Figure 2.1, follow the line for a participant's age (example 65 years) to a spouse's age of 60 years. The table indicates a planning period of 28.8 years for the joint lives.

Joint life expectancy probabilities show when one can expect the last (surviving) spouse to die. Actuarial data suggest that one of the two lifetimes should exceed the longest individual life expectancy by about three years.

Prospective heirs should use a similar planning horizon to project when they are likely to inherit their parents' estate. For Retirement Estimates for Farm Families, see: **http://www.ces.purdue.edu/farmretirement/**.

Actuarial data suggest that one of the two lifetimes should exceed the longest individual life expectancy by about three years.

Figure 2.1. Ordinary Joint Life and Last Survivor Annuities

- Two Lives -

To determine your remaining joint life expectancy, find the age of the oldest spouse in the column on the left and go across until you find your beneficiary's age from the top row.

Beneficiary's Age

Participant's Age / Ages	35	36	37	38	39	40	41	42	43	44	45	46	47	48	49	50	51	52	53	54	55	56	57	58	59	60	61	62
35	55.2	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----
36	54.7	54.2	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----
37	54.3	53.7	53.2	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----
38	53.8	53.3	52.7	52.2	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----
39	53.4	52.8	52.3	51.7	51.2	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----
40	53.0	52.4	51.8	51.3	50.8	50.2	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----
41	52.7	52.0	51.4	50.9	50.3	49.8	49.3	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----
42	52.3	51.7	51.1	50.4	49.9	49.3	48.8	48.3	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----
43	52.0	51.3	50.7	50.1	49.5	48.9	48.3	47.8	47.3	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----
44	51.7	51.0	50.4	49.7	49.1	48.5	47.9	47.3	46.8	46.3	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----
45	51.5	50.7	50.0	49.4	48.7	48.1	47.5	46.9	46.3	45.8	45.3	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----
46	51.2	50.5	49.8	49.1	48.4	47.7	47.1	46.5	45.9	45.4	44.8	44.3	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----
47	51.0	50.2	49.5	48.8	48.1	47.4	46.7	46.1	45.5	44.9	44.4	43.9	43.4	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----
48	50.8	50.0	49.2	48.5	47.8	47.1	46.4	45.8	45.1	44.5	44.0	43.4	42.9	42.4	----	----	----	----	----	----	----	----	----	----	----	----	----	----
49	50.6	49.8	49.0	48.2	47.5	46.8	46.1	45.4	44.8	44.2	43.6	43.0	42.4	41.9	41.4	----	----	----	----	----	----	----	----	----	----	----	----	----
50	50.4	49.6	48.8	48.0	47.3	46.5	45.8	45.1	44.4	43.8	43.2	42.6	42.0	41.5	40.9	40.4	----	----	----	----	----	----	----	----	----	----	----	----
51	50.2	49.4	48.6	47.8	47.0	46.3	45.5	44.8	44.1	43.5	42.8	42.2	41.6	41.0	40.5	40.0	39.5	----	----	----	----	----	----	----	----	----	----	----
52	50.0	49.2	48.4	47.6	46.8	46.0	45.3	44.6	43.8	43.2	42.5	41.8	41.2	40.6	40.1	39.5	39.0	38.5	----	----	----	----	----	----	----	----	----	----
53	49.9	49.1	48.2	47.4	46.6	45.8	45.1	44.3	43.6	42.9	42.2	41.5	40.9	40.3	39.7	39.1	38.5	38.0	37.5	----	----	----	----	----	----	----	----	----
54	49.8	48.9	48.1	47.2	46.4	45.6	44.8	44.1	43.3	42.6	41.9	41.2	40.5	39.9	39.3	38.7	38.1	37.6	37.1	36.6	----	----	----	----	----	----	----	----
55	49.7	48.8	47.9	47.1	46.3	45.5	44.7	43.9	43.1	42.4	41.6	40.9	40.2	39.6	38.9	38.3	37.7	37.2	36.6	36.1	35.6	----	----	----	----	----	----	----
56	49.5	48.7	47.8	47.0	46.1	45.3	44.5	43.7	42.9	42.1	41.4	40.7	40.0	39.3	38.6	38.0	37.4	36.8	36.2	35.7	35.1	34.7	----	----	----	----	----	----
57	49.4	48.6	47.7	46.8	46.0	45.1	44.3	43.5	42.7	41.9	41.2	40.4	39.7	39.0	38.3	37.6	37.0	36.4	35.8	35.2	34.7	34.2	33.7	----	----	----	----	----
58	49.4	48.5	47.6	46.7	45.8	45.0	44.2	43.3	42.5	41.7	40.9	40.2	39.4	38.7	38.0	37.3	36.7	36.0	35.4	34.8	34.3	33.7	33.2	32.8	----	----	----	----
59	49.3	48.4	47.5	46.6	45.7	44.9	44.0	43.2	42.4	41.5	40.7	40.0	39.2	38.5	37.8	37.1	36.4	35.7	35.1	34.5	33.9	33.3	32.8	32.3	31.8	----	----	----
60	49.2	48.3	47.4	46.5	45.6	44.7	43.9	43.0	42.2	41.4	40.6	39.8	39.0	38.2	37.5	36.8	36.1	35.4	34.8	34.1	33.5	32.9	32.4	31.9	31.3	30.9	----	----
61	49.1	48.2	47.3	46.4	45.5	44.6	43.8	42.9	42.1	41.2	40.4	39.6	38.8	38.0	37.3	36.6	35.8	35.1	34.5	33.8	33.2	32.6	32.0	31.4	30.9	30.4	29.9	----
62	49.1	48.1	47.2	46.3	45.4	44.5	43.7	42.8	41.9	41.1	40.3	39.4	38.6	37.8	37.1	36.3	35.6	34.9	34.2	33.5	32.9	32.2	31.6	31.1	30.5	30.0	29.5	29.0
63	49.0	48.1	47.2	46.3	45.3	44.5	43.6	42.7	41.8	41.0	40.1	39.3	38.5	37.7	36.9	36.1	35.4	34.6	33.9	33.2	32.6	31.9	31.3	30.7	30.1	29.6	29.0	28.5
64	48.9	48.0	47.1	46.2	45.3	44.4	43.5	42.6	41.7	40.8	40.0	39.2	38.3	37.5	36.7	35.9	35.2	34.4	33.7	33.0	32.3	31.6	31.0	30.4	29.8	29.2	28.6	28.1
65	48.9	48.0	47.0	46.1	45.2	44.3	43.4	42.5	41.6	40.7	39.9	39.0	38.2	37.4	36.6	35.8	35.0	34.2	33.5	32.7	32.0	31.4	30.7	30.0	29.4	28.8	28.3	27.7
66	48.9	47.9	47.0	46.1	45.1	44.2	43.3	42.4	41.5	40.6	39.8	38.9	38.1	37.2	36.4	35.6	34.8	34.0	33.3	32.5	31.8	31.1	30.4	29.8	29.1	28.5	27.9	27.3
67	48.8	47.9	46.9	46.0	45.1	44.2	43.3	42.3	41.4	40.6	39.7	38.8	38.0	37.1	36.3	35.5	34.7	33.9	33.1	32.3	31.6	30.9	30.2	29.5	28.8	28.2	27.6	27.0
68	48.8	47.8	46.9	46.0	45.0	44.1	43.2	42.3	41.4	40.5	39.6	38.7	37.9	37.0	36.2	35.3	34.5	33.7	32.9	32.1	31.4	30.7	29.9	29.2	28.6	27.9	27.3	26.7
69	48.7	47.8	46.9	45.9	45.0	44.1	43.1	42.2	41.3	40.4	39.5	38.6	37.8	36.9	36.0	35.2	34.4	33.6	32.8	32.0	31.2	30.5	29.7	29.0	28.3	27.6	27.0	26.4
70	48.7	47.8	46.8	45.9	44.9	44.0	43.1	42.2	41.3	40.3	39.4	38.6	37.7	36.8	35.9	35.1	34.3	33.4	32.6	31.8	31.1	30.3	29.5	28.8	28.1	27.4	26.7	26.1
71	48.7	47.7	46.8	45.9	44.9	44.0	43.0	42.1	41.2	40.3	39.4	38.5	37.6	36.7	35.9	35.0	34.2	33.3	32.5	31.7	30.9	30.1	29.4	28.6	27.9	27.2	26.5	25.8
72	48.7	47.7	46.8	45.8	44.9	43.9	43.0	42.1	41.1	40.2	39.3	38.4	37.5	36.6	35.8	34.9	34.1	33.2	32.4	31.6	30.8	30.0	29.2	28.4	27.7	27.0	26.3	25.6
73	48.6	47.7	46.7	45.8	44.8	43.9	43.0	42.0	41.1	40.2	39.3	38.4	37.5	36.6	35.7	34.8	34.0	33.1	32.3	31.5	30.6	29.8	29.1	28.3	27.5	26.8	26.1	25.4
74	48.6	47.7	46.7	45.8	44.8	43.9	42.9	42.0	41.1	40.1	39.2	38.3	37.4	36.5	35.6	34.8	33.9	33.0	32.2	31.4	30.5	29.7	28.9	28.1	27.4	26.6	25.9	25.2
75	48.6	47.7	46.7	45.7	44.8	43.8	42.9	42.0	41.0	40.1	39.2	38.3	37.4	36.5	35.6	34.7	33.8	33.0	32.1	31.3	30.4	29.6	28.8	28.0	27.2	26.5	25.7	25.0
76	48.6	47.6	46.7	45.7	44.8	43.8	42.9	41.9	41.0	40.1	39.1	38.2	37.3	36.4	35.5	34.6	33.8	32.9	32.0	31.2	30.3	29.5	28.7	27.9	27.1	26.3	25.6	24.8
77	48.6	47.6	46.7	45.7	44.8	43.8	42.9	41.9	41.0	40.0	39.1	38.2	37.3	36.4	35.5	34.6	33.7	32.8	32.0	31.1	30.3	29.4	28.6	27.8	27.0	26.2	25.4	24.7
78	48.6	47.6	46.6	45.7	44.7	43.8	42.8	41.9	40.9	40.0	39.1	38.2	37.2	36.3	35.4	34.5	33.6	32.8	31.9	31.0	30.2	29.3	28.5	27.7	26.9	26.1	25.3	24.6
79	48.6	47.6	46.6	45.7	44.7	43.8	42.8	41.9	40.9	40.0	39.1	38.1	37.2	36.3	35.4	34.5	33.6	32.7	31.8	31.0	30.1	29.3	28.4	27.6	26.8	26.0	25.2	24.4
80	48.5	47.6	46.6	45.7	44.7	43.7	42.8	41.8	40.9	40.0	39.0	38.1	37.2	36.3	35.4	34.5	33.6	32.7	31.8	30.9	30.1	29.2	28.4	27.5	26.7	25.9	25.1	24.3
81	48.5	47.6	46.6	45.7	44.7	43.7	42.8	41.8	40.9	39.9	39.0	38.1	37.2	36.2	35.3	34.4	33.5	32.6	31.8	30.9	30.0	29.2	28.3	27.5	26.6	25.8	25.0	24.2
82	48.5	47.6	46.6	45.6	44.7	43.7	42.8	41.8	40.9	39.9	39.0	38.1	37.1	36.2	35.3	34.4	33.5	32.6	31.7	30.8	30.0	29.1	28.3	27.4	26.6	25.8	24.9	24.1
83	48.5	47.6	46.6	45.6	44.7	43.7	42.8	41.8	40.9	39.9	39.0	38.0	37.1	36.2	35.3	34.4	33.5	32.6	31.7	30.8	29.9	29.1	28.2	27.4	26.5	25.7	24.9	24.1
84	48.5	47.6	46.6	45.6	44.7	43.7	42.7	41.8	40.8	39.9	39.0	38.0	37.1	36.2	35.3	34.3	33.4	32.5	31.7	30.8	29.9	29.0	28.2	27.3	26.5	25.6	24.8	24.0
85	48.5	47.6	46.6	45.6	44.7	43.7	42.7	41.8	40.8	39.9	38.9	38.0	37.1	36.2	35.2	34.3	33.4	32.5	31.6	30.7	29.9	29.0	28.1	27.3	26.4	25.6	24.8	23.9
86	48.5	47.5	46.6	45.6	44.6	43.7	42.7	41.7	40.8	39.8	38.9	38.0	37.1	36.1	35.2	34.3	33.4	32.5	31.6	30.7	29.8	29.0	28.1	27.2	26.4	25.5	24.7	23.9
87	48.5	47.5	46.6	45.6	44.6	43.7	42.7	41.7	40.8	39.8	38.9	38.0	37.0	36.1	35.2	34.3	33.4	32.5	31.6	30.7	29.8	28.9	28.1	27.2	26.4	25.5	24.7	23.8
88	48.5	47.5	46.6	45.6	44.6	43.7	42.7	41.7	40.8	39.8	38.9	38.0	37.0	36.1	35.2	34.3	33.4	32.5	31.6	30.7	29.8	28.9	28.0	27.2	26.3	25.5	24.6	23.8
89	48.5	47.5	46.6	45.6	44.6	43.7	42.7	41.7	40.8	39.8	38.9	38.0	37.0	36.1	35.2	34.3	33.3	32.4	31.5	30.7	29.8	28.9	28.0	27.2	26.3	25.4	24.6	23.8
90	48.5	47.5	46.6	45.6	44.6	43.7	42.7	41.7	40.8	39.8	38.9	38.0	37.0	36.1	35.2	34.2	33.3	32.4	31.5	30.6	29.8	28.9	28.0	27.1	26.3	25.4	24.6	23.7

Figure 2.1 (Continued). Ordinary Joint Life and Last Survivor Annuities
- Two Lives -

Beneficiary's Age

Participant's Age / Ages	63	64	65	66	67	68	69	70	71	72	73	74	75	76	77	78	79	80	81	82	83	84	85	86	87	88	89	90
35	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----
36	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----
37	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----
38	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----
39	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----
40	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----
41	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----
42	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----
43	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----
44	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----
45	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----
46	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----
47	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----
48	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----
49	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----
50	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----
51	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----
52	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----
53	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----
54	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----
55	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----
56	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----
57	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----
58	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----
59	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----
60	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----
61	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----
62	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----
63	28.1	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----
64	27.6	27.1	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----
65	27.2	26.7	26.2	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----
66	26.8	26.3	25.8	25.3	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----
67	26.4	25.9	25.4	24.9	24.4	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----
68	26.1	25.5	25.0	24.5	24.0	23.5	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----
69	25.7	25.2	24.6	24.1	23.6	23.1	22.6	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----
70	25.4	24.8	24.3	23.7	23.2	22.7	22.2	21.8	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----
71	25.2	24.5	23.9	23.4	22.8	22.3	21.8	21.3	20.9	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----
72	24.9	24.3	23.7	23.1	22.5	22.0	21.4	20.9	20.5	20.0	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----
73	24.7	24.0	23.4	22.8	22.2	21.6	21.1	20.6	20.1	19.6	19.2	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----
74	24.5	23.8	23.1	22.5	21.9	21.3	20.8	20.2	19.7	19.3	18.8	18.4	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----
75	24.3	23.6	22.9	22.3	21.6	21.0	20.5	19.9	19.4	18.9	18.4	18.0	17.6	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----
76	24.1	23.4	22.7	22.0	21.4	20.8	20.2	19.6	19.1	18.6	18.1	17.6	17.2	16.8	----	----	----	----	----	----	----	----	----	----	----	----	----	----
77	23.9	23.2	22.5	21.8	21.2	20.6	19.9	19.4	18.8	18.3	17.8	17.3	16.8	16.4	16.0	----	----	----	----	----	----	----	----	----	----	----	----	----
78	23.8	23.1	22.4	21.7	21.0	20.3	19.7	19.1	18.5	18.0	17.5	17.0	16.5	16.0	15.6	15.2	----	----	----	----	----	----	----	----	----	----	----	----
79	23.7	22.9	22.2	21.5	20.8	20.1	19.5	18.9	18.3	17.7	17.2	16.7	16.2	15.7	15.3	14.9	14.5	----	----	----	----	----	----	----	----	----	----	----
80	23.6	22.8	22.1	21.3	20.6	20.0	19.3	18.7	18.1	17.5	16.9	16.4	15.9	15.4	15.0	14.5	14.1	13.8	----	----	----	----	----	----	----	----	----	----
81	23.4	22.7	21.9	21.2	20.5	19.8	19.1	18.5	17.9	17.3	16.7	16.2	15.6	15.1	14.7	14.2	13.8	13.4	13.1	----	----	----	----	----	----	----	----	----
82	23.4	22.6	21.8	21.1	20.4	19.7	19.0	18.3	17.7	17.1	16.5	15.9	15.4	14.9	14.4	13.9	13.5	13.1	12.7	12.4	----	----	----	----	----	----	----	----
83	23.3	22.5	21.7	21.0	20.2	19.5	18.8	18.2	17.5	16.9	16.3	15.7	15.2	14.7	14.2	13.7	13.2	12.8	12.4	12.1	11.7	----	----	----	----	----	----	----
84	23.2	22.4	21.6	20.9	20.1	19.4	18.7	18.0	17.4	16.7	16.1	15.5	15.0	14.4	13.9	13.4	13.0	12.6	12.2	11.8	11.4	11.1	----	----	----	----	----	----
85	23.1	22.3	21.6	20.8	20.1	19.3	18.6	17.9	17.3	16.6	16.0	15.4	14.8	14.3	13.7	13.2	12.8	12.3	11.9	11.5	11.1	10.8	10.5	----	----	----	----	----
86	23.1	22.3	21.5	20.7	20.0	19.2	18.5	17.8	17.1	16.5	15.8	15.2	14.6	14.1	13.5	13.0	12.5	12.1	11.7	11.3	10.9	10.5	10.2	9.9	----	----	----	----
87	23.0	22.2	21.4	20.7	19.9	19.2	18.4	17.7	17.0	16.4	15.7	15.1	14.5	13.9	13.4	12.9	12.4	11.9	11.4	11.0	10.6	10.3	9.9	9.6	9.4	----	----	----
88	23.0	22.2	21.4	20.6	19.8	19.1	18.3	17.6	16.9	16.3	15.6	15.0	14.4	13.8	13.2	12.7	12.2	11.7	11.3	10.8	10.4	10.1	9.7	9.4	9.1	8.8	----	----
89	22.9	22.1	21.3	20.5	19.8	19.0	18.3	17.6	16.9	16.2	15.5	14.9	14.3	13.7	13.1	12.6	12.0	11.5	11.1	10.6	10.2	9.9	9.5	9.2	8.9	8.6	8.3	----
90	22.9	22.1	21.3	20.5	19.7	19.0	18.2	17.5	16.8	16.1	15.4	14.8	14.2	13.6	13.0	12.4	11.9	11.4	10.9	10.5	10.1	9.7	9.3	9.0	8.6	8.3	8.1	7.8

Effects of Inflation on Retirement Income

The life expectancy graph in the preceding section illustrates that even senior citizens frequently live 30 or more years, especially when considering their joint life expectancies. Thus, the effects of inflation on asset values and living costs can be dramatic.

We can use Table 2.2 to estimate future asset values and income needs for inflation rates from 3 to 12 percent per year. Simply locate the intersection of the estimated future inflation rate across the top of the table and the number of years in the left column to determine how inflation will affect asset values, income, and living costs. For example, if the expected inflation rate is 5 percent, Table 2.2 tells us that it will take $1.63 in 10 years to buy what $1.00 will buy today.

Divide the interest (inflation) rate into 72 to estimate the number of years it will take for asset values or living expenses to double.

The Rule of 72 is a rule of thumb that can help estimate how fast asset values and living expenses will double at compound interest. The Rule of 72 is as follows: Divide the interest (inflation) rate into 72 to estimate the number of years it will take for asset values or living expenses to double. For example, if the inflation rate is 4 percent, living costs will double every 18 years (72 divided by 4). We can use the Rule of 115 in the same way to estimate how long it will take for net worth or living costs to triple.

An adequate income for the parents should take priority over transfer of the business to the next generation. NCR Publication No. 610F, *Planning the Late-Career, Retirement-Mode Years*, provides many useful guidelines for estimating retirement living expenses and projecting retirement income. Here is a step-by-step procedure:

1. Project what your desired life style will cost in today's dollars.
2. Adjust these costs to the beginning of retirement and beyond.
3. Monitor, refine, and adjust these projections regularly.
4. Project income from Social Security, pensions and benefits, savings and investments, earnings and assets that could be sold.

Completing the worksheets in Publication No. 610F will help you decide whether the transfer of assets to the next generation should begin before retirement, during retirement, or at death. An example of a worksheet is included here (Figure 2.1) to illustrate the procedure. For example, the Joneses have projected

Table 2.2. Annual Rate of Inflation.

Years to Retirement	3%	4%	5%	6%	7%	8%	9%	10%	11%	12%
1	1.03	1.04	1.05	1.06	1.07	1.08	1.09	1.10	1.11	1.12
2	1.06	1.08	1.10	1.12	1.15	1.17	1.19	1.21	1.23	1.25
3	1.09	1.13	1.16	1.19	1.23	1.26	1.30	1.33	1.37	1.41
4	1.13	1.17	1.22	1.26	1.31	1.36	1.41	1.46	1.52	1.57
5	1.16	1.22	1.28	1.34	1.40	1.47	1.54	1.61	1.69	1.76
6	1.19	1.27	1.34	1.42	1.50	1.59	1.68	1.77	1.87	1.97
7	1.23	1.32	1.41	1.50	1.61	1.71	1.83	1.95	2.08	2.21
8	1.27	1.37	1.48	1.59	1.72	1.85	1.99	2.14	2.30	2.48
9	1.31	1.42	1.55	1.69	1.84	2/00	2.17	2.36	2.56	2.77
10	1.34	1.48	1.63	1.79	1.97	2.16	2.37	2.59	2.84	3.11
11	1.38	1.54	1.71	1.90	2.11	2.33	2.58	2.85	3.15	3.48
12	1.43	1.60	1.80	2.01	2.25	2.52	2.81	3.14	3.50	3.90
13	1.47	1.67	1.89	2.13	2.41	2.72	3.07	3.45	3.88	4.36
14	1.51	1.73	1.98	2.26	2.58	2.94	3.34	3.80	4.31	4.89
15	1.56	1.80	2.08	2.40	2.76	3.17	3.64	4.18	4.78	5.47
16	1.61	1.87	2.18	2.54	2.95	3.43	3.97	4.60	5.31	6.13
17	1.65	1.95	2.29	2.69	3.16	3.70	4.33	5.05	5.90	6.87
18	1.70	2.03	2.41	2.85	3.38	4.00	4.72	5.56	6.54	7.69
19	1.75	2.11	2.53	3.03	3.62	4.32	5.14	6.12	7.26	8.61
20	1.81	2.19	2.65	3.21	3.87	4.66	5.60	6.73	8.06	9.65

that their living costs in the first year of retirement will be $46,745. If the inflation rate is expected to be 5 percent per annum, their living costs 10 years into retirement will be 1.63 times higher, or $76,194 for the same lifestyle. One could use different inflation rates for different items. Past experience has shown, for example, that the rate of increase in medical expenses has been much higher than in food.

Planning the Late-Career, Retirement-Mode Years, NCR 610F, discusses everything to be considered when planning for retirement from farming. Worksheets, illustrations, and step-by-step instructions are featured in this publication. Go to the Midwest Plan Service web site at: **http://www.mwps.org/**

Figure 2.1. Example: Joneses' Estimated Annual Cost of Living After Retirement

	Joneses' Future Budget at Time of Retirement	Inflation Factor	Joneses' Future Budget, 10 Years After Time of Retirement
Shelter	$ 6,598	1.63	$
Household Operation and Maintenance	$ 3,666	"	$
Home Improvement	$ 1,146	"	$
Automobile and Transportation	$ 5,729	"	$
Food	$ 7,562	"	$
Clothing	$ 1,833	"	$
Personal	$ 1,146	"	$
Medical and Health	$ 6,874	"	$
Recreation, Education	$ 5,729	"	$
Contributions	$ 2,750	"	$
Taxes and Insurance	$ 1,490	"	$
Savings, Investments	$ 0	"	$
Any Future Irregular Expense (ex: new roof, new car, new furnace, etc.)	$ 2,222	"	$
TOTAL	$ 46,745	1.63	$ 76,194

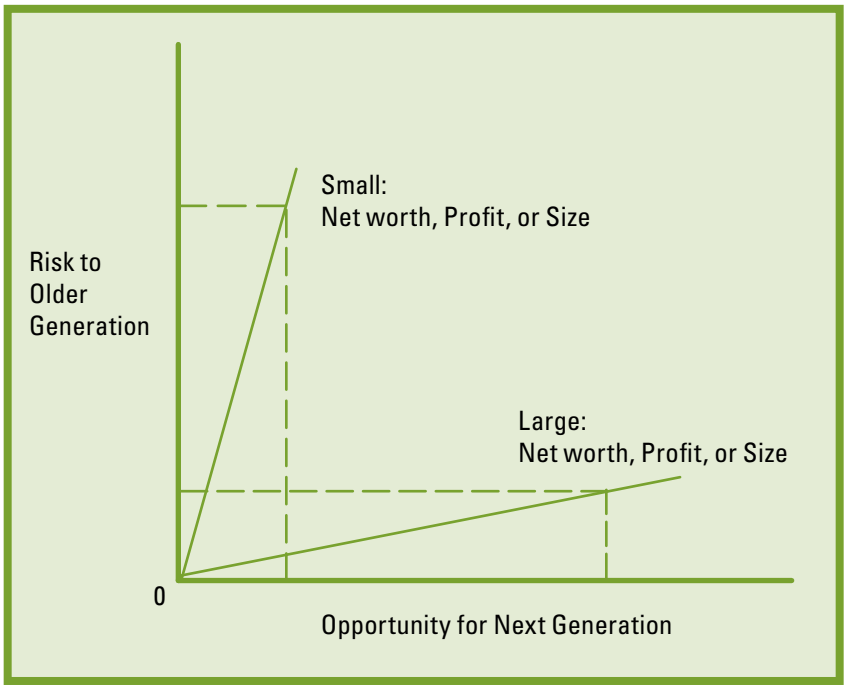
The parent's assets and liabilities influence their retirement income, the potential estate tax liability, and the viability of the farming operation for the next generation.

Some Financial Rules of Thumb

Decisions about the feasibility of transferring assets before death also should include consideration of the parents' financial situation. The parents' assets and liabilities influence their retirement income, the potential estate tax liability, and the viability of the farming operation for the next generation. Our guidelines are based on the net worth of the parents. Net worth is defined as the fair market value of all assets minus selling costs and income taxes that would have to be paid if these assets were sold.

This tradeoff between financial security for the parents and opportunities for the next generation is illustrated in Figure 2.2. The parents whose situation is depicted in the upper left of Figure 2.2 have a low net worth in a less profitable, small business. Therefore, they would assume considerable risk to their financial security even if they provide relatively little opportunity for their children to take over the business. The parents in the lower right corner of Figure 2.2 have a high net worth in a profitable, large business. They are in a position to provide a significant

Figure 2.2. Risk Versus Opportunity



opportunity for the children to become established in farming with very little risk to their financial security in retirement.

Net Worth Under $600,000

As a guideline, retirement-age parents with less than $600,000 of assets and Social Security as their primary retirement income are probably in a marginally adequate to inadequate situation, even if they have no debt. They need to maintain their net worth for retirement income and security.

The basis for this guideline is that a reasonable real (inflation adjusted) rate of return on farm net worth is about 3 percent per year. Therefore, a $600,000 net worth would yield an income of $18,000 per year. This $18,000 would be needed to supplement Social Security benefits so that the parents would have enough retirement income to support a modest lifestyle. A net worth below $600,000 or so in a farming operation can barely support one family, much less two.

Things can really become tight when the parents are no longer able to do the physical work but need retirement income from the farm, and the children have to hire someone to do the work previously done by the parents. The farm that was large enough to support the parents has trouble supporting the parents in retirement, children on the farm, debt payments, and the employee(s) hired to do the work formerly done by the parents.

A net worth below $600,000 or so in a farming operation can barely support one family, much less two.

Federal estate taxes are not a major concern for this size estate. However, there will likely be probate costs and state estate taxes. The parents usually can safely transfer assets to the children only after the children purchase them. Frequently, the children do not have money to buy the parents' assets because they are trying to raise a family on the limited income available to them. The parents really are not in a financial position to make substantial gifts to the children.

This may cause great distress to children wanting to farm. A net worth below $600,000 or so frequently is evidence of a marginally profitable farming operation for children wanting to farm full-time. It is even more difficult when the parents need $20,000 per year or more from their investment to live on.

Net Worth $600,000 to $1 Million

Parents with between $600,000 and $1 million of net worth may have adequate resources for their own retirement income and security needs. However, they should still be cautious about transferring large amounts of property without getting paid for it — especially in pre-retirement years.

If they have substantial savings and investments or retirement income in addition to Social Security, they may feel more comfortable making gift-type transfers. However, if their primary sources of income are Social Security and the farm business, gift-type transfers become more questionable.

If the parents' net worth approaches $1 million, they also have a potential federal and state estate tax problem. Couples with a net worth in that range usually should have wills that do not leave everything to the surviving spouse. That type of will causes the surviving spouse's net worth to approach or exceed $1 million or more. Estate settlement costs will take nearly 45 percent of every dollar above the Federal Exclusion amount of net worth in a single person's estate. A simple change of wills while both parents are alive can solve much of the estate tax problem.

For more details see Ohio State University Extension Bulletin 595, *Estate Planning Considerations for Ohio Families,* at **http://ohioline.osu.edu/**

Net Worth More Than $1 Million

Parents with more than $1 million in assets and little or no debt usually may begin the transfer process whenever they desire. A widow or widower with a net worth above the Federal Exclusion amount should consider gifts to try to protect the estate from potentially large federal estate tax liabilities.

However, even in this adequate to very adequate situation, parents must carefully plan transfers. Substantial amounts of debt, particularly non-mortgage debt, may also limit the advisability of transfers. Prospective farming heirs should prove their management ability and aspirations before large amounts of property are transferred to them. Parents also should try to treat non-farm heirs fairly.

Prospective farming heirs should prove their management ability and aspirations before large amounts of property are transferred to them.

Detaching Yourself From Financial Responsibility

During the farm financial crisis of the 1980s, an estimated 200,000 to 300,000 U.S. commercial farmers went out of business. Most of these were young, highly leveraged operators who lacked the equity reserves to withstand the combination of low commodity prices, high interest rates, and falling land values. Often their parents and sometimes their grandparents also lost everything because they had loaned their children or grandchildren money, co-signed notes, and/or sold them property with existing debt. One lesson from these experiences is that parents should structure transfers in ways that will avoid continuing financial responsibility for their children's debts.

Providing Financing

Be wary of providing financing for the buyer of property, even if the buyer is your child. If the buyer defaults, a major source of retirement income could be interrupted or lost. Also, mortgages, land contracts, and other personal loans are illiquid, and they typically have fixed interest rates that offer no protection against inflation. Whenever possible, the children should get financing from a financial institution or other third party.

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Cosigning Notes

Children whose credit rating is questionable usually must have a cosigner on their loans. Borrowers usually ask their parents, other relatives, or close friends to cosign their notes. Cosigners do not always assume the same liability as the primary borrower, but they always assume some liability.

If a person cosigns with the borrower in the lower right corner of the note, the law regards that person as a comaker. If a parent is a comaker on a note with a child and property solely owned by the child is pledged as security, the parent is fully liable for repayment of the loan.

This includes any deficiency outstanding after foreclosure and disposition of the security. The lender can collect from the parent if the child defaults on the loan. However, the parent can legally collect reimbursement from the child for only half the amount paid. In cases of foreclosure, lenders must notify comakers before selling property securing the loan. Failure to notify ends the comaker's liability for any deficiency remaining after selling the collateral.

Accommodation Party

A person who signs an instrument to lend their name to another party is an accommodation party. By definition, then, a cosigner is an accommodation party. An accommodation party is a surety. A surety agrees that the lender will not have a loss if the borrower defaults. Unlike a comaker, a surety who pays the lender is legally entitled to full reimbursement from the borrower. Moreover, a surety may choose not to pay the lender but may choose to bring action against the delinquent borrower. Any change in the original loan agreement, such as an increase in the amount of the loan or the maturity date, without the consent of the surety, releases the surety from all liability.

An area of conflict between cosigners and lenders is whether a cosigner is an accommodation party or a comaker. Information used to resolve these conflicts includes:

- The location of the signature on the note.
- The language of the note itself.
- Whether the cosigner received any proceeds of the loan.
- The intent of the parties when they signed the note.

Guarantor

A guarantor is a person who promises to answer for the debt or default of a third party. In Ohio a guarantor is a surety and has the statutory and common law rights and obligations discussed earlier under *Accommodation Party.*

The contract between the creditor and the guarantor is separate and distinct from the contract between the creditor and the borrower. A general or absolute guarantor guarantees

payment to the creditor on the same terms as the principal debtor.

A conditional or limited guarantor does not necessarily become liable when the principal borrower defaults. The creditor must meet all conditions specified in the contract between the creditor and the guarantor before the guarantor becomes liable.

If parents must cosign loans to ease the transfer of property to their children, they should do so as accommodation parties, or limited guarantors, not as comakers. They should carefully explain their status of surety in the note. In addition, the parent should sign the note as *John Doe, Surety* to clarify their status of accommodation party.

The parents' attorney should carefully word conditional or limited guarantor contracts to limit their liability as far as duration and/or amounts of money. Even so, parents should recognize that their legal rights to reimbursement from children who default on their loans may not mean much. There is little point in taking costly legal action against children who do not have funds to repay their own debts.

If parents must cosign loans, they should do so as accommodation parties, or limited guarantors, not as comakers.

Selling Property With Debt on It

If parents transfer property to children and that property has outstanding debt against it, the parents may continue to be legally responsible for that debt. If they sell indebted real estate to children, the lender retains the security interest in the property and the obligation of the original borrower. The parents' obligation can be released only by a voluntary agreement between them and the lender.

The purchaser's liability depends upon whether they purchase the property *subject to* the mortgage or the buyer *assumes* the mortgage. If the property is acquired *subject to* the mortgage, the buyer pays the seller the difference between the purchase price and the loan balance but does not assume a personal obligation to pay the debt. A buyer who *assumes* the mortgage pays the difference between the sale price and the loan balance and becomes personally liable for the debt. To detach themselves from further responsibility, the parents should require the buyer to *assume* the mortgage rather than selling it *subject to* the mortgage.

Parents should require the buyer to assume the mortgage rather than selling it subject to the mortgage.

Getting Advice

The development of a comprehensive transition plan takes expertise from many different sources. Some of the sources that should be consulted as a plan is developed are listed here. Many will require a fee for services, but it is money well spent. A well-thought-out plan considering the family's objectives, farm organization, financing, taxes, and business structure requires professional advice and legal documentation.

Outside Advisors:

- Attorney
- Accountant
- Financial Planner
- Extension Educator/Specialist
- Business Consultant
- Mediator
- Lender
- Other respected business persons.

An advisory board may help to formalize the process and assist in establishing milestones for writing of the transition plan. This group may also meet periodically to serve as a reminder to review the plan from time to time as situations dictate.

Advisory Board Functions Include Providing:

- Fresh ideas
- A sounding board
- Technical information
- Evaluation of plans
- Suggestions for improvements
- Motivation of managers to address problems
- Mediation of differences.

Part 3
People Issues in Transferring the Farm Business

Family farm businesses mix business and family.

Some Reasons Why Transfers Fail

What explains the often observed difficulty of keeping family farm businesses going beyond two generations? There are the obvious answers —lack of profits, inadequate financial and legal planning, bad luck, farm is too small or too large, and failure to stay current with technology and modern farming practices. However, there are additional reasons that center on people and the family. These reasons include:

1. Family farm businesses **mix business and family.** For example, family Thanksgiving dinners often involve more farm talk than family talk. Family problems are mixed with business problems. Solutions are rarely pure business or pure family in nature.

2. It is **difficult** for any one farm business **to provide opportunities that fit all family members' strengths.** The strengths may be in skills not applicable to a farm. For example, a dairy farmer's three children may have limited mechanical, financial management, and animal husbandry skills. Their outstanding artistic, musical, and finish carpentry skills do not provide a strong pool of talent for a dairy farm's next generation of managers.

3. Farm businesses typically provide **limited career growth opportunities for family and employees.** The vast majority of family farms have fewer than 25 key, year-round people. They usually have one or two levels of management and only one or two top-level managers. So, even a highly motivated and talented 35 year old may have a 20-year wait for an opening higher in the business.

4. Health, marriage, weather, and economic **calamities can bring ruin** to even the strongest of family farm businesses. Planning and insurance can only provide some of the needed protection.

5. Business **continuity requires generation to generation transition.** Correct timing is essential. However, the parents may be unwilling to give up control and authority at the time the next generation wants it and should have it. On the other hand, the next generation may not be ready for their responsibilities when they should take them.

6. **No two farms and no two families are alike.** Each family must discover its own strengths and weaknesses, its own opportunities, and its own niche. What has worked beautifully for one farm family business may be a recipe for failure in another.

7. The farm family **must continuously deal with change.** The changes are diverse and pervasive — technology, public policies and regulations, growth and aging of people, and economic opportunities. Farm families must manage change, not avoid it.

8. **Lack of parents' acceptance and affirmation of their children.** Parents may not take their children's emotional needs into consideration. Parents, who assert that their promises of a future on the farm should be enough, may leave children feeling like no more than another worker.

Taken together, these eight reasons demand the best in management creativity and planning to bring about successful transfer of a farm business to the next generation of family members.

There are no simple, or even complex, recipes on how to transfer a business that guarantee business continuity, all parties' happiness, and acceptance of the outcome.

There are no simple, or even complex, recipes on how to transfer a business that guarantee business continuity, all parties' happiness, and acceptance of the outcome. Some principles or guidelines can help, but each successful transfer is a unique challenge.

Personal and business goals of the current and future owners may be unclear or in conflict. For example, security for retirement may be in conflict with providing opportunity for all children to join the business. The families may never even discuss why the business is transferring and what would be success in the transfer. Even if there is discussion of these delicate questions, it may lead to more conflict rather than agreement.

There are almost always winners and losers in the transfer of a business. The transfer may treat people unequally even though they are treated fairly. The self-perception of being a loser can cloud the facts of the case and interfere with family relations for years.

Parents are dealing in their own lives with more than transfer of a business. Retirement plans may be tentative or even non-existent. Boredom with the challenges presented by the business can cause the parents to want quick relief from daily responsibilities. Little experience in delegating authority and responsibility may raise doubts about being able to unhook from the business. Chronic illness, age, and calamities such as divorce and fire can complicate the transfer.

In many cases, highly personal matters prevent the transfer from being a strictly business matter. Complicating factors include:

- Disinterest of some owners in the business.
- Differences in knowledge, skills, and abilities among the next generation of owners.
- Treatment of special cases such as in-laws and step-children.
- Long-standing and loyal non-family employees.

Human Relations Guidelines in Business Transfers

Successful transfer of a business involves both parents (current owners) and children (next generation of owners). Each has critical decisions to make and implement. Neither group can assure success in the transfer by working alone. The parents create the environment for success in the transfer; the two generations work together to make the transfer; and the next generation determines the success of the business after the transfer. The guidelines presented here are aimed at parents. However, the next generation should find these guidelines helpful in understanding the steps being taken and parents' decisions.

Have a Plan

A plan for transfer of the business starts with the parents accepting the fact that someday the business will either have new owners or will not exist. Base a plan on realistic assessments of the past and present, and reasonable expectations for the future. A plan for transfer must be more than a dream to work a little less and have fewer responsibilities for day-to-day decisions while maintaining control of the business. A need for more leisure time, help with the work, or even delegation of some management is far from a commitment to transfer the business.

The parents create the environment for success in the transfer, the two generations work together to make the transfer, and the next generation determines the success of the business after the transfer.

One can postpone retirement or even planning for retirement while aggressively planning to transfer the business. The transfer plan may provide explicitly for the new owners to employ the parents in important positions. A second career within the same business can be much more attractive than retirement. Having the parents involved can be tremendously valuable to the children.

The plan for business transfer needs to stay flexible. Annual updates should reflect changes in goals, the business, and the people involved. Ignoring the plan is the same as having no plan.

The plan should start with financial and legal intentions. The major elements of a transfer plan that addresses people issues are:

- Timing of the transfer.
- Responsibilities of family members during and after the transfer (including managers for the next generation of the business).
- Arrangements for a testing stage.

The plan should include provisions for changing as needed and a commitment to communication, including at least annual meetings of the parties to the agreement.

Start the Business Transfer 'In Time'

Under the pressure of time to get the legal and financial matters resolved, the human relations concerns often fail to get the necessary attention.

The best transfer plans have often evolved over many years.

Planning for transfer and then carrying out the plan is a time-consuming and tedious task. Even with the full cooperation of all family members, working out the necessary legal and financial plans can be difficult. Under the pressure of time to get the legal and financial matters resolved, the human relations concerns often fail to get the necessary attention.

Preliminary thinking may be secretive and change often. As plans begin to firm up, people are assumed to understand what is being done and why. Communication tends toward the informal and second-hand. The parents may not take time to talk to the affected parties before the key meetings with an attorney or planner. Therefore, people go to meetings confused and suspicious that they are intentionally being kept in the dark. The excuse "I just didn't have time to talk to you" rarely satisfies the person who wants more information and who feels left out. The best transfer plans have often evolved over many years.

Prepare Family Members for Their Responsibilities in the Business

One approach to preparing family members to assume responsibilities in the business is to use on-the-job-training; that is, have them work. Work may have greater emphasis than the training. Work is important, but it is not all that is needed to prepare for ownership of the business.

Another approach is to protect future owners from business problems. Letting them believe all is rosy in the business almost certainly leads to their having unrealistic expectations.

Parenting is an important part of getting the next generation ready for ownership. Experiences children have in the family business affect attitudes toward the business, desire to be part of it as adults, and capability to handle ownership responsibilities. Parents influence their children's attitudes toward self-employment, continuation of a business, riskiness of investments, the importance of education, and the benefits of experience in other businesses before joining the family business.

As discussed elsewhere in this bulletin, acceptance and affirmation of children are important in this parenting.

Treat People Fairly, Not Necessarily Equally

How can we help one or two children take over the business while being fair to other children? This is a perplexing question. Equal treatment is easy when transferring only assets to the next generation. Equal treatment may be virtually impossible when transferring a business. In spite of the difficulty, judgment of what is fair rests with the current owners of the business. Careful explanation to each person of what is being done and why is crucial. It does not guarantee that all parties will be happy with the decisions.

The inability to treat people fairly often becomes a reason to do nothing. Death of one or more of the current owners passes unsolved problems to someone else. The person on whom difficult decisions have been dumped may be less qualified to make them than the deceased was. The heirs may resort to the easier solution of breaking up the business and distributing assets.

Equal treatment may be virtually impossible when transferring a business.

Develop and Select Managers for the Next Generation of the Business

Transferring ownership to the next generation is easier than transferring management to the next generation. The transfer process should anticipate management voids created by people moving up, retiring, or leaving the business for other reasons. Development of managers is a long-term investment in people.

When businesses fail to develop people, success in the next generation absolutely requires hiring managers from outside. Being one of the children does not guarantee readiness for a management position by having worked in the business for years, being the son or daughter of the owner and founder, having a degree in management, or simply wanting it badly.

Selecting the new management team should be part of the transfer plan or a collective decision of the owners.

Select a manager or managers for the next generation of the business. A person can rarely be successful in declaring himself or herself the new manager. Selecting the new management team should be part of the transfer plan or a collective decision of the owners.

Strive to Understand the Culture of the Business

What is valued? What are the core beliefs? Keeping the business in the family may or may not be valued. On the other hand, sale of land may be out of the question because it has been in the family for many generations. Reputation in the community may be more important than size or profitability of the business.

Each business has a culture. The culture of the Smith business matters to the Smiths and the Jones' culture matters to the Joneses. Differences in culture among businesses and families are as important as differences in enterprises, acres, and breeds of livestock. Agreements and disagreements within the business may be over values and beliefs as much as or more than over business opportunities, size, promotions, and profits.

Determining values and core beliefs challenges all managers. Values and beliefs evolve through passed-down wisdom, discussion within the business and with others, answers to many value-laden questions, and the ways in which ethical problems are handled. With patience, managers can gradually change the culture of a business though they cannot escape its influence on their actions.

Through Regular and Detailed Communication, Make the Family Part of What Is Happening

Spouses have a key role. They need to be involved and informed. They need information to develop an understanding of how the business transfer affects their futures. The amount and kinds of information needed depend on the potential impact of the transfer on their future and the extent of their involvement in the current and future business.

Spouses have a key role. They need to be involved and informed.

Put the Transfer Plans and Agreements in Writing

Oral agreements may be easier in the short-run, but they often lead to confusion and disagreement. Putting plans and agreements in writing forces discussion of potential disputes and misunderstandings. Family members cannot overlook the details of a lease, partnership agreement, job description, or plan for transfer when all parties must read and sign a written document.

A written record provides parties to the agreement basis for resolving future differences about the business transfer. However, written records do not prevent or resolve all future disagreements and problems. However, a written agreement clearly beats argument, recall, and guesses about the intent of an oral agreement made months or years ago.

Take Advantage of a Testing Stage

Transferring part ownership of a business immediately can be a costly and risky test of the relationship among current and prospective future owners. Typically, a future owner should first come into the business as an employee. An employee learns the inner workings of the business while earning greater responsibility. Time spent in a business does not necessarily earn greater responsibility. The testing period is two-way. The future owner is testing and being tested. The goal is to prepare the prospective future owner for an ownership and management role. However, the testing stage can cause the employee (son or daughter) to leave rather than become an owner of the business. The possibility of leaving, rather than joining the business, is an important argument in favor of a testing period.

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The testing period challenges a future owner's patience while waiting for more responsibility in the business. Agreement to an employee relationship during the testing period makes the expectations of the future owner more realistic. Unfortunately, the current owners may call someone a partner or even co-owner when in fact their intent is to treat the person as a laborer from now on.

Making testing periods successful is difficult. The employee, even if a son or a daughter of the owners, should have a written job description. The employee's performance should be reviewed regularly. Performance reviews should address an employee's weaknesses and make plans for training, more supervision, or whatever is necessary to address the weaknesses.

However, identifying and highlighting strengths is more important than harping on weaknesses. Encouragement, pats on the back, sharing of successes with others in the business, reassurance, and increased responsibility are more important to most employees than money. Major accomplishments should be cause for celebration.

Pay Careful Attention to the Daughters-in-Law and Sons-in-Law

Daughters-in-law and sons-in-law may bring valuable experience, management capability, humor, perspective, mediation, money, and dedication to the business. They also may bring pointed questions, confusion, and conflict. Regardless, they are important to the transfer of a business. Their futures, their children's futures, their families, their roles and image in the community are all affected by the business. In short, the business matters to them, and they matter to the business.

In-laws need to recognize that they differ from their spouses and from the in-laws of the previous generation. New in-laws should accept that they have not built the business, are unlikely to understand the subtleties of the business and family culture, and may be considered threatening to current owners. The most important decisions are going to be made by someone other than new in-laws.

In some cases, in-laws come to be treated as equals to daughters and sons. In other cases, they remain outsiders to the business and to decisions about business transfer. Communication and clarification of their roles is more important than the extent of their involvement.

Deal With Differences of Opinion and Conflict

Differences must be aired and discussed openly. The accumulation of unresolved small differences can be as devastating as a single large issue. No two people in a business are alike. From their individuality come differences in opinion and different views about what is the right solution to a problem or conflict. Often, there is more than one good answer to a problem. One person insisting that his or her way is the only way is more likely to magnify than solve a problem. Outside parties serving as mediators may be the only feasible alternative if differences cannot be resolved within the business.

Face the Tough Trade-Offs

Transferring a business changes the business and affects the lives and welfare of people involved. It is better to make choices than to ignore them. It is the current owners' responsibility to make clear the goals to be accomplished through transfer and the preferred means for transfer.

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Maximizing the chances of the business being successful in the next generation may conflict with providing a son or daughter the opportunity to own and manage a business. Complete separation of the current owners from the business may conflict with the business surviving during the first five years after the transfer, while the new managers learn the business. So, business transfer often begins with transfer of the chattels. The current owners can gradually transfer chattels to correspond with increasing management responsibility going to the next generation.

Transferring the business to the next generation means the current manager must give up control to the new manager. This doesn't happen all at once, but to get a new manager ready for his or her responsibilities, the current manager must give up decision-making power. The current owner cannot delegate management responsibility to the most qualified son or daughter and still treat the less interested and less competent siblings equally.

Involve Outsiders

An outside committee of advisers can bring in fresh ideas and technical information. For example, they can serve as a sounding board, evaluate progress and plans, suggest parts of the business needing improvement, and motivate managers to address problems rather than procrastinate about them. They also may mediate differences and conflicts within the management team and among the owners.

An outside committee of advisers can bring in fresh ideas and technical information.

The committee needs to meet at least once a year and be compensated for its services. The committee is advisory to the business rather than a decision-making body. Call it a board of advisors, advisory committee, review team, consulting board, or anything else that describes the role of the select group of outsiders.

Carefully choose the committee for its expertise and willingness to be useful. Intentionally choosing people with varying experiences, interests, and expertise is preferable. Regular rotation of committee members assures a continuous source of new ideas and perspectives.

Accompany the Transfer Plan With a Business Plan

The current owners may not be up-to-date on technology, competition, changes in legal and government institutions, and influences of the local, national, and international economy.

If the next generation of owners cannot develop a viable business plan, the current owners need to address this deficiency in management immediately instead of leaving it for later consideration. Talking about vague ideas for the future is not enough. Typical components of a business plan are:

- Purpose and objectives of the business
- Enterprises
- Facilities
- Machinery
- Land
- Technology
- Marketing strategies
- Human resources
- Insurance
- Financial statements
- Cash flow
- Break-even projections
- The management team.

The plan needs to be in writing. A variety of business planning tools, e.g., FINPACK and the FINPACK Business Plan, has made business planning possible even for those inexperienced with computers and budgeting. Contact a local Extension office for details or go to the Center for Farm Financial Management Web site at www.cffm.umu.edu.

A written business plan may include:

- Mission, purpose, objectives, and goals
- Enterprises, facilities, machinery
- Marketing strategies, risk management
- Human resources, management team
- Financing
- Business structure
- Cash flow plan.

Have a Staffing Plan With Written Job Descriptions and an Organization Chart

Who is the boss? Who makes the critical decisions? Who hires? Who trains? Who evaluates? Who steps forward in crises? Requiring a written job description for each position in the business, with at least annual updates, clarifies the organizational structure and improves communication. Written job descriptions also clarify people's roles during the transition period to new ownership. An organization chart helps everyone involved with the business understand who is responsible for what.

As a business grows in size and complexity, more people, more jobs, and more decisions follow. An informal relationship between two brothers and their two employees may work well. Addition of the brothers' two daughters and an additional employee may force a more formal structure and written job descriptions. The alternative to having an organization chart often is to stumble along with confused and disgruntled people.

Look for Opportunities in the Business That Fit the Strengths of the New Owners

Strengths of management people in a business vary from generation to generation. New strengths can lead to new enterprises. A son or a daughter with strong interest and ability in working with people may lead to adding a retail farm market to a fruit farm. Strong mechanical ability may lead to adding a

This section relies heavily on materials from the book The Blessing, by Gary Smalley and John Trent, 1986, Thomas Nelson, Inc. Used with permission. Also see the book The 7 Habits of Hightly Effective People, by Stephen R. Covey, 1989, Simon & Schuster, Inc.

repair business. A gifted farm business analyst may want to start an accounting service for neighboring farmers. New enterprises have the potential of increased enthusiasm among new owners, fuller use of resources, and higher profits.

Transfer Acceptance and Affirmation to Children

Dealing with emotions is one of the most difficult and sensitive areas in transferring a farm business to one's own children. Parents have an inescapable and permanent impact on their children.

Parents with adult children can easily overlook some basic emotional issues that can make the difference between success and failure in transferring a successful ongoing business to the next generation.

Child-Rearing Then and Now

Most parents tend to raise their children in much the same way they were raised. When in doubt, they do it like their parents did, or would have done. Many of today's farmers were raised when the common philosophy was "Children are to be seen, not heard." Most people worked hard, long hours; life was serious business. Motivation was often the threat of punishment if you didn't perform.

Children worked with dad on the farm, but when he spoke to them, it may have been only to correct them or give them a command. If dad touched a child, it was often for disciplinary purposes. Discipline was frequently quick and often physically painful. Many children never observed expressions of tenderness between their parents.

In recent years, countless studies have shown some major problems associated with many of these child-rearing ways. Children need acceptance as well as discipline.

Desirable Behavior for Parents

Every family and every child is different. Studies have identified some basic parental behaviors that help children feel affirmed and accepted and, therefore, to achieve their full potential.

Among many other things, it is desirable for parents:

- To speak words of love and encouragement to their children.
- To regularly touch their children affectionately.

- To help each child identify his or her unique abilities and encourage their use.
- To picture a special future for each child, based on who they are and what they are interested in.
- To keep doing these things over and over even when the children are grown.

Importance of Parental Affirmation

Some adult children are emotionally unable to take over their parents' operations because of the relationship they have with their parents. People who do not receive their parents' affirmation suffer more from anger, fear, loneliness, addictions, and an inability to be intimate with others. The lack of one or both parents' affirmation leaves some children emotionally crippled and may limit children's ability to succeed their parents in the farm business.

This isn't necessarily the parent's fault! Usually the parents were simply modeling their parents, who didn't affirm them either. There is growing evidence that adult children who didn't benefit from acceptance and affirmation from their parents when they were young children, may still benefit from it as adults. Adult children who have never received parental affirmation may appreciate it more and benefit more from it than receiving physical possessions, wealth, or a farm business.

Parents' acceptance and affirmation may dramatically improve adult children's self-esteem and ability to take over the farm. There should be plenty of opportunities when working together on the farm. But sometimes it isn't possible for one or both parents to give their affirmation. We discuss *Living Without Parental Affirmation* at the end of this section.

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How Some Homes Withhold Affirmation and Acceptance

Here are five common ways parents fail to affirm their children:

Favoritism

Favoring one child over others hurts all the children, even the one receiving favored treatment. It fosters insecurities among the unfavored and unrealistic expectations and dependencies in the favored. It is extremely difficult for two children from the same family to farm together when their parents show or have shown open partiality to one child or one child's family.

Affirmation Just Out of Reach

Some parents keep the carrot-on-the-stick so far in front of the children that the children never get the carrot. No matter how well the children perform, they never quite measure up. Frequently they simply quit trying.

Acceptance Exchanged for a Burden

Some parents coax their children by fear or guilt to sacrifice their own goals for those of the parents. Variations on the theme "We are depending on you to keep the farm going" can be a blessing or a burden.

In some families, the child gets acceptance that lasts only until the parent's next selfish desire beckons. These parents may abuse their children verbally, emotionally, or physically while they provide some elements of acceptance.

Unyielding Traditions Live Here

Some parents withhold acceptance in an attempt to control their children's lives. For example, if the farm has been in the family for many generations, how do the parents react to an only son wanting to become a mechanic? What if the father always finished corn planting first, had the straightest rows, and the highest yields? What if the parents are from a leading farm family and a daughter wants to marry someone considered to be a commoner?

Many parents leave deep emotional scars in their children by denying them acceptance while trying to make them live up to some family tradition.

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Single Parent Households

Children need the acceptance of both parents. When there has been death, divorce, or desertion, there is an emotional void that needs filling. Children in these homes may struggle with the question, "Why did my parent leave me?" The remaining parent or guardian needs to find a substitute for the missing parent's blessing. Sometimes a grandparent, other relative, close friend, or church can meet much of the need.

One study of prisoners found that most inmates had received their mother's affirmation, but not their father's. The father plays a key role in helping children develop into mature, emotionally secure adults. The strong, silent father plays well on television, but he can deny children an important part of their upbringing.

Elements of Parental Affirmation

Meaningful Touch

A meaningful touch, hug, or kiss communicates warmth, personal acceptance, and affirmation; and it improves the recipient's physical health. It is extremely hard for many men and women to affectionately touch others, but the effort is more than worth it. If it's hard for you to hug someone or give an affectionate pat on the back, it's probably because you didn't receive many hugs or affectionate pats as a child. Children will not die for lack of a hug, but they may be happier if they receive meaningful touches from their parents.

Spoken Words of Love and Acceptance

It is important to bless with spoken words of love and acceptance. A parent's silent presence, or an absence of negative words, isn't enough. You may feel like you don't know what to say, or you may be afraid your children will take advantage of you if you praise them. You may think it's too difficult. But the real reason most people don't speak words of love and acceptance to their children or others is that their parents never gave them words of love and acceptance.

Attach High Value to Each Child

It is important to recognize each child's special qualities. Children need to know they are important because of who they are, not just because of their performance or hard work. They need unconditional acceptance to feel truly loved and secure about themselves.

Picture a Special Future for Each Child

Use words like, "You are really good with machinery and are an important part of our success." When transferring assets to a child to help them get started, interject the idea that it is because you know they can handle them. Use words like, "You'll do a great job on your own someday." What a contrast to "You're lazy," or "You're so slow, you'll never be able to run this farm!"

Regularly Spend Time Affirming Your Children

It takes an active, consistent commitment to do everything possible to help children be successful. Many parents pray for their children. Parents need to spend time with their children to learn their real desires, needs, goals, hopes, and fears. They should participate in activities the children are interested in. Simply "being around" is not enough.

It takes an active, consistent commitment to do everything possible to help children be successful.

Living Without Parental Affirmation

It is difficult for an adult to admit their parents' lack of affirmation. We are not talking about individual incidents where parents punished or tried to modify children's behavior they objected to. Parents have a right, if not a responsibility, to discourage such behavior. Here we are talking about long-term repeated denial of one or more elements of affirmation.

It is easy to explain away not receiving parental affirmation or to put off admitting the obvious in our lives. Denial of having missed out on parents' affirmation postpones dealing with the pain of the past, but it can never be avoided. The legitimate pain of honestly dealing with this situation leads to healing and a new, freer life. Thus, the first step in learning to live without parents' affirmation is self-honesty.

Be Honest With Yourself

It is critically important to be honest with your feelings about missing the missing parental affirmation. It is an important first step toward healing.

In the vast majority of cases, parents who do not give affirmation never received it themselves.

Try to Understand Your Parents' Background

In the vast majority of cases, parents who do not give affirmation never received it themselves. Try to understand as much as you can about your parents' background. This one bit of advice frees many people from wondering about the void in the relationship with their parents.

Some will never hear words of love and acceptance from their parents. Some will try to break down the door to their parents' hearts to receive this missing acceptance, but all too often their attempt fails. Sometimes one or both parents have died. For whatever reason, you must face the fact that their affirmation will have to come from another source.

Give Acceptance and Affirmation to Others

Many people are willing to provide elements of acceptance and affirmation to friends and relatives. This acceptance may make others feel better about themselves and result in better and deeper relationships.

Some will need help from a trained counselor, pastor, priest, or rabbi to deal with feelings of anger and fear and to facilitate forgiveness and healing. The book, *The Blessing,* by Gary Smalley and John Tent, 1986, Thomas Nelson, Inc., may also be helpful.

Part 4
Planning an Orderly Transfer

Intangible Transfers

Farm property transfer and estate planning usually deal with the transfer of tangible assets like cash, real estate, and machinery. Here we look first at some intangible transfers that are crucial to the future success of farm businesses. These include leases, agreements, goodwill, authority, and records. Then we look at a suggested order for transferring tangible assets such as livestock, machinery, inventories, and land.

Leases, Agreements, and Goodwill

Almost every successful farming operation has formal and informal arrangements with landlords, suppliers, markets, veterinarians, accountants, attorneys, consultants, Extension educators, and others. The next generation needs to understand the history and background of these key relationships.

For example, current landlords and prospective next generation farmers need to meet and discuss the possibility of the younger generation beginning to farm the landlord's land. It is important to try to pass the goodwill from those currently farming to those taking over.

The older generation and the landlord may have verbally agreed to many things that are now part of an oral lease. The landlord may have asked you not to raise any soybeans and not to work the land in the fall. What would happen if you forgot to mention this to your next generation farmer who plowed in the fall, expecting to plant soybeans in the spring?

There may be similar unwritten agreements with suppliers of feed, seed, fertilizer, veterinary services, accounting, etc., to do certain things at certain times or in certain ways. The parents should invest the time necessary to transfer their knowledge and goodwill to the next generation of farmers. The older generation should initiate discussion with all involved parties about what is expected now and in the future.

The next generation needs to understand the history and background of key relationships.

A frequent point of confusion is whether someone from the next generation has the authority to do something.

Authority

A frequent point of confusion is whether someone from the next generation has the authority to do something. Having responsibility may be meaningless if there is not corresponding authority. It is usually wise to have a testing period for the next generation lasting several years, before entering into business together. The next generation's authority should grow during this time.

Frequently, people outside the business are uncertain about the business arrangements between the two generations during the testing period and perhaps beyond. Does the next generation have the authority to order a load of feed for the farm? May they purchase a more expensive feed? Buy feed from another supplier? May they authorize a tractor repair? A major overhaul? Are they authorized to obligate the farm to buy something costing $100? $1,000? A $25,000 used tractor? A $250,000 combine? A farm? Does the authority vary depending on whether the parents are in Ohio or Florida, or whether they are feeling well or a bit under the weather?

One difficulty is that the answers to these questions change over time. The next generation usually gains more responsibility and authority over time. This is frequently confusing to suppliers and people providing services to the farm. They want to assume that if someone from the farm asks to do business with them, they have the authority to do so.

It is important for the two generations on the farm to regularly communicate how the next generation is or is not authorized to obligate the farm.

It is important for the two generations on the farm to regularly communicate how the next generation is or is not authorized to obligate the farm. There is some natural tension, with the younger generation wanting more authority and responsibility than the parents are willing to give. The older generation naturally holds back, perhaps feeling a loss of control and a reluctance to give up control too soon. The younger generation may make some decisions and obligate the business in ways objectionable to the parents. Almost inevitably the younger generation makes some mistakes — this is expected! It is part of how the next generation learns to operate the business just as the parents have made and continue to make mistakes.

Control of the Checkbook

During the transfer process, the parents usually maintain control of the farm checkbook until the younger generation is fully integrated into the operation or takes it over completely. Because the older generation has more at stake financially, this arrangement is logical. Having control of the checkbook, however, should not relieve the parents of their responsibility to share financial information with the children regularly.

Records and Compliance

Some of the most difficult and most dreaded jobs on a farm are keeping records, complying with all the different rules and regulations involved in farming, filling out required forms, and doing other required paper work. These jobs take much time, energy, and patience. Sometimes different people are responsible for different parts of these jobs. At some point the next generation must become involved if its members are going to run the operation in the future.

Frequently, someone from the next generation starts helping with the books before the younger generation takes possession of the farm. The new record-keeper usually learns from the person who was doing the books for the older generation.

These responsibilities often fall to women, especially daughters-in-law in the next generation. However, record-keeping is not a responsibility determined by virtue of sex or relationship to the farm. Traditionally, farm wives did most of the farm book work, and on many farms they still do. However, in the past, most farm wives did not have careers of their own or full-time work off the farm.

Under today's smaller profit margins, it is more important for someone in the operation to organize the records to make them useful for management decisions. It is becoming more important for someone on the farm to have the ability to use records for financial statement preparation and for cost accounting.

A computer may or may not make the job easier. It should improve information quality, but initially, at least, it increases the complexity and time required. A computer is not the ultimate solution to the problem. Record keeping, bill paying, complying with government regulations, etc., are tough jobs requiring patience, persistence, much time, and perhaps some outside training. Nevertheless, modern farm management is evolving to the point where computerization of records, payroll, inventories, depreciation, and business analysis is essential.

Record keeping is not a responsibility determined by virtue of sex or relationship to the farm.

Under today's smaller profit margins it is more important for someone in the operation to organize the records to make them useful for management decisions.

More and more farms are paying family members or others to perform record keeping and compliance services for them. These are not small tasks that one should expect a busy wife to do for free in her "spare time."

It makes sense for the next generation to gradually assume ownership as their experience and commitment to the farm increases.

With the increased complexity and demands for records on today's farms, it is important to carefully consider how best to keep records, comply with government agencies, pay the bills, etc. More and more farms are paying family members or others to perform record keeping and compliance services for them. These are not small tasks that one should expect a busy wife to do for free in her spare time.

Structure of the Farm Business

Ohio farmers have many choices when selecting a business structure or entity. The choice affects liability, taxation, management, and succession planning. A fact sheet, *Comparison of Business Entities Available to Ohio Farmers,* is among several fact sheets about farm transition planning. The fact sheet may be found at: http://ohioline.osu.edu/anr-fact/pdf/3613.pdf.

In What Order Do You Transfer Tangible Property?

Tangible assets include things you can touch and feel like livestock, machinery, inventories, and land. Rarely does the next generation take over ownership of all the tangible farm business assets at once. Even when a parent or grandparent dies, the surviving spouse, if any, usually becomes owner of the deceased's assets.

The next generation usually does not have the money required to purchase, or cannot finance the purchase of, all the farm assets at once. They also usually lack the management experience and ability to take over everything at once. It makes sense for them to gradually assume ownership as their experience and commitment to the farm increase.

This raises the question, "What do you transfer first?" Here we look at possible transfers prior to either farming together in a partnership or corporation, or turning the farm completely over to the next generation.

Breeding Livestock First

Farm families with livestock usually start the next generation into an operation with breeding livestock. Farmers without breeding livestock may want to skip to the discussion of inventories of grain, hay, and feed.

Here are some reasons farm families frequently transfer livestock first:

- Transferring livestock is easy. Frequently, the transfer begins with the parents giving young children a heifer calf, gilt, or foal.
- No money changes hands, and the animals are still in the herd, so it does not seem to cost much at this point.
- It usually increases the child's interest in caring for the livestock. These animals are often raised at family expense, as part of the herd. The next generation can own several animals fairly quickly. In fact, the next generation's investment may become substantial. Frequently, the next generation receives additional breeding animals instead of income from their animals.

  The older generation may use the same process with adults. However, often the older generation isn't financially able to give away large numbers of young animals and raise them for the benefit of the next generation. The next generation may need to purchase them or at least provide labor to help compensate parents for transferring animals.
- Livestock can be good investments for the next generation. During their productive lives, livestock usually hold their value well. They don't rust and depreciate. The next generation can usually get most of its money out of them, if necessary.
- Livestock are mobile. The next generation can take livestock with them or sell them if they decide to leave.
- If the next generation leaves and takes its livestock with them, their livestock may be identifiable and can be sorted out.
- The parents can replace the livestock if the next generation leaves, although there is a cost.
- It may be reasonable to start an equal partnership, with each partner owning the same number of animals and the partnership leasing all other assets from one or more of the partners. A complete discussion is beyond the scope of this publication, but there are two major advantages of a livestock-only partnership. First, it makes it possible for a next

Livestock can be good investments for the next generation.

generation with limited capital to become an equal partner. Second, with limited assets involved, it makes it much easier to break up the partnership if it does not work out.

Inventories of Grain, Hay, and Feed Second

The next generation frequently does not buy the older generation's inventories if it is a family deal. Children usually don't have the money, and the parents don't want to pay the income tax; therefore, nobody bothers with these inventories. If the parents don't need the income, they may simply ignore the inventories and let the children or new partnership use them up, without compensation.

Sometimes the inventories are simply too large and valuable to ignore. One way to reduce the problem is to start the next generation in the business when inventories are low and before planting next year's crops (March-April). Another way is for the next generation or a partnership that takes over the operation to buy them, perhaps in installments.

Machinery and Equipment Third

The next generation usually starts buying machinery and equipment after receiving a desired percentage of the breeding herd, if any, and before buying the parents' land. Machinery and equipment are necessary on the farm; but they wear out, rust, break down, become out of date, and take a lot of money to keep going. Equipment usually isn't a highly profitable investment. The next generation usually should not start buying machinery until its members have a means of paying for it and are fully committed to staying in the operation.

The next generation usually does not buy much, if any, of the older generation's machinery and equipment.

Income taxes are a major consideration when thinking about selling machinery and equipment to the next generation. In the next section, we discuss some critical income and gift tax considerations when selling to the next generation. Due primarily to income tax considerations, the next generation usually does not buy much, if any, of the older generation's machinery and equipment.

Commonly, the older generation leases its existing machinery to the next generation or the two-generation partnership. We discuss *Machinery and Equipment Leases* in the next section. The parents usually don't buy additional machinery once they start leasing machinery to the next generation. When the operation purchases new machinery, the people doing the farming (perhaps including parents) buy it. Sometimes parents give their children the old piece of machinery they are replacing to use as a trade-in.

Land and Buildings Fourth

Under current tax laws, extensive farm land often isn't transferred to the next generation until the death of both parents. For most families, an earlier transfer requires a voluntary contribution to IRS that many feel is simply too expensive. A transfer also may reduce the older generation's retirement security.

The section, *Selling Farm Real Estate to the Next Generation* in Part 5 of this publication, discusses income, gift, and estate tax laws that, when considered together, may make other alternatives look better than a transfer. That section also includes discussions of some alternatives and some arguments that could be made for transferring at least part of the real estate while one or both parents are still living. We addressed some income security and retirement concerns in the earlier section, *Some Financial Rules of Thumb.*

Some families will decide to make major real estate transfers to the next generation during the parents' lives. Some circumstances that suggest making a real estate transfer are:

- The older generation family has a net worth approaching $1.2 million or more and wants to reduce potential federal estate taxes.
- A child or children live in a home owned by their parents.
- The families want the next generation to own and control the main base of operation that includes crucial farm buildings and other improvements. However, even in these cases, the families should carefully consider the costs and other options.

The tax problem stems from farm owners having an income tax basis well below what the farm is worth.

Part 5
Tax Considerations

Selling Farm Real Estate to Children

Paying income taxes discourages farm families from selling the family farm. There is nothing in the law that specifically prohibits a sale. It is just that several key income tax, gift tax, and estate tax provisions, when considered together, may make other alternatives look better than a sale.

The largest and most immediate problem faced by most farm families considering a sale is income taxes. Many farm owners must pay $20,000 to $50,000 or more in income taxes if they sell the farm. However, if they leave it to their children after both parents' deaths, there frequently is no federal estate tax and little or no income tax. We'll explain that in more detail later. First, let's look at the income tax on a sale.

Gains Are Fully Taxed Now

As a rule, when you sell a farm, the difference between the selling price and the property's *income tax basis* is fully taxable. The tax problem stems from farm owners having an income tax basis well below what the farm is worth.

For example, if the owners paid $20,000 for an unimproved farm when they bought it, their initial income tax basis was $20,000. If they've never made any improvements or taken any depreciation on improvements, their income tax basis is still $20,000. If they sell the land for its $100,000 fair market value, they have an $80,000 taxable gain (sales price minus basis equals gain). It is capital gain, but it is taxable.

Tax Basis Rules Are Crucial

Income tax basis is a crucial tax concept. It is important when considering income, gift, or estate taxes. Usually, your income tax basis in an asset is what you paid for it. In the previous example, it was the $20,000 originally paid for the unimproved farm.

Income tax basis increases when you make capital improvements and decreases when you depreciate. If our hypothetical farm family made capital improvements on the farm costing $10,000, their income tax basis would increase from $20,000 to $30,000. Their income tax basis would decrease each year, by the amount of any depreciation on the capital improvements.

If someone gives you property, you get their basis, too. For example, assume that due to inflation, the farm with the $20,000 basis has a current fair market value of $100,000. If someone gives it to you, their gift is valued at $100,000, but you receive their $20,000 income tax basis. Thus, if you later sold it for $100,000, you would have an $80,000 gain, the same gain the person who gave it to you would have had if they sold it for $100,000.

Stepped-Up Basis at Death

Property going through an estate gets a *stepped-up income tax basis* equal to its appraised value in the estate. In our example, if the farm owner(s) let the farm go through their estates and it is appraised in the estates at $100,000, the $100,000 appraised value becomes the heir's income tax basis.

Therefore, if the parents in our example leave the farm to their children, they avoid the income tax on a sale, the children receive a *stepped-up basis* equal to the property's appraised value in the estate, and the parents get the benefits of ownership until death. This provides a significant disincentive to selling the farm.

Parents can avoid the income tax on a sale by giving it to the children. But they must forfeit the benefits of ownership, and the children receive the parent's $20,000 income tax basis. The low basis means the children must pay tax on $80,000 of gain if they sell it for $100,000.

When It Pays Not to Sell

From a tax standpoint, under current law, it is frequently preferable for children to receive property through the parents' estates rather than by gift or sale from the parents. This is primarily so when one or more of the following is true — the property has a low income tax basis, the property is likely to be sold later by the person(s) who receive it, the property may appreciate significantly in value before the death of the current owners, and the parents have a short life expectancy.

Property going through an estate gets a stepped-up income tax basis.

We arrive at the point of trying to decide whether the advantages of getting ownership into the hands of the next generation now are worth the estimated cost. If not, you should consider some alternatives to selling rather than sitting idly and doing nothing.

Alternative Strategies

If you decide to postpone a sale, it may still be important to develop a strategy that will protect the parents and those children wanting to farm. Gifts, leases, and purchase options are possible means of meeting family goals.

Conservation Easements

If properly structured, a conservation easement can create several benefits. First, if you donate an easement to a qualified charitable organization or governmental agency, you may obtain a current income tax deduction for a charitable contribution of the fair market value of the easement. Second, the value of the real estate will be reduced because it is subject to the conservation easement, and the property can no longer be developed or sold for development purposes. This reduced value of the real estate may be an advantage if you are considering gifting or selling real estate to the children. A qualified conservation easement can also be of benefit for estate planning if the real estate is not transferred during the owner's lifetime but instead passes through the owner's estate.

Since a conservation easement limits the future use of the property and therefore the property's value, the decision to donate a conservation easement is one that needs to be made very carefully. You should consult with your attorney and other professional counselors to make sure that the use of a conservation easement fits into your over-all business transfer and estate plans.

Giving Away Farm Assets

When parents find it too expensive or otherwise impractical to sell to their children, they often ask about the possibility of giving property to their children. Sometimes families use gifts with a sale, or in place of a sale, to help meet a family's goals.

There are many types of gifts. Most of us think of outright gifts of cash, chattels, or real estate. However, the sale of the farm to the children at below fair market value or financing it under favorable terms is also a gift under federal law. There is nothing right or wrong with making gifts. However, there are some

important rules, regulations, and guidelines that one should consider.

Some Gifting Considerations

There are two primary reasons for considering gifts. First, from a tax standpoint, the primary motivation is the expectation that assets may appreciate significantly in value before death — causing them to be taxed at a higher rate. Secondly, from a personal standpoint, it may seem important to get certain property transferred now so that the new owners can benefit from it.

On the other hand, it isn't always necessary, desirable, or fair to make gifts to children. In some cases, parents have already provided their on-farm children with significantly more advantages than their off-farm counterparts. Secondly, a significant gift will almost always reduce the financial security of the parents. Third, it isn't always in the children's own best interest to give them property.

Fourth, the children could sell the gifted assets or do other things with the assets that parents would not approve of. That could be good or bad. It may be good, if the parents have only made limited gifts, and the parents can adjust future transfers accordingly. It may be bad, if the parents have transferred control of the business, and the children change it in ways that distress the parents.

The sale of the farm to the children at below fair market value or financing it under favorable terms is also a gift under federal law.

Gifts Valued at Fair Market Value

There are no specific laws limiting how much you can give away. However, there are some provisions that may limit how much one will want to give up. Ohio has no gift tax and few restrictions on making gifts. Most of the rules and regulations are federal.

It is important to note that, for most purposes, gifts are valued for taxes at fair market value. In simple terms, *fair market value* is the price at which a willing buyer and a willing seller would agree to transfer the asset, with neither under the compulsion to buy or sell. Usually fair market value is significantly different from the basis.

Ohio has no gift tax and few restrictions on making gifts. Most of the rules and regulations are federal.

Annual Gift Tax Exclusion

Under federal law, an individual can give away any amount up to the *annual gift tax exclusion* to any other individual in that year without having to file a federal gift tax return. The annual

gift tax exclusion is $12,000 for 2006 and 2007. The gift tax exclusion is indexed for inflation, and the amount is determined during the preceding year.

Someone giving away assets with an uncertain value, which may be equal to the annual gift tax exclusion amount or more, may wish to have them appraised. Appraisals aren't required, but it may be necessary to prove that values are fair market value, if audited by the IRS.

Usually a person can make gifts in total much larger than the annual exclusion without paying any gift tax or other tax on the transfers. A person must file an IRS Form 709 anytime he or she makes gifts greater than the annual exclusion amount to one person in one year.

For example, in 2007 each parent can give up to $12,000 to each child without filing a gift tax return. Similarly, a parent can make separate gifts up to $12,000 to the child's spouse, each grandchild, and anyone else, without filing a gift tax return. They can do the same thing each year.

We each may transfer $1 million by gift during our life or through our estate.

$1-Million Tax-Free Transfers During Lifetime

The *applicable exclusion amount* (AEA) is another important part of federal law that applies to gift taxes and estate taxes.

Under the applicable exclusion amount, every individual can transfer property during his or her lifetime with a fair market value of up to $1 million to persons other than their spouse (spouse transfers are discussed later), free of federal gift tax. Thus, a husband and wife can transfer up to $2 million by gift during their lifetimes tax free.

For gifts, the $1 million is in addition to the annual gift tax exclusion. Since the annual exclusion is available each year, it is used first. For example, assume that a widow who had never used any of her *lifetime exclusion amount* gave one granddaughter $100,000 during 2007. The first $12,000 would transfer tax free under the *annual gift tax exclusion.* She would have to file an IRS Form 709 to inform the IRS that she made a gift over $12,000, but the remaining $88,000 is not taxed because of the *lifetime exclusion amount.* She could make additional gifts, exceeding the annual gift tax exclusion, of up to $912,000, utilizing the remainder of her lifetime gift tax exclusion.

For a more detailed explanation of the applicable exclusion amount for gifts, the applicable exclusion amount for federal estate taxes, and how they interact, see OSU Extension Bulletin 595, *Estate Planning Considerations for Ohio Families,* at **http://ohioline.osu.edu/**.

Gifts and Other Transfers Between Husband and Wife

Federal law places few restrictions on transfers between spouses. In general, a married couple can make unlimited tax-free transfers from one spouse to the other, both by gift and through their estates. They don't use any of their annual exclusions or applicable exclusion amounts to do so. Sometimes it is appropriate to make gifts between spouses to balance estates and make maximum use of the applicable exclusion amount.

You Must Give Up Control

The concept that probably keeps more people from making gifts than any other is the necessity of giving up control. In order for a gift to be completed (removed from an estate), the person making the gift must totally give up control and ownership rights to the property given away. Most of us simply don't want to give up control of our assets.

Retaining control can cause tax problems for the heirs of persons with large estates. If the person retains control or ownership rights, the total value of that property may be included in their federal estate.

In order for a gift to be completed (removed from an estate), the person making the gift must totally give up control and ownership rights to the property given away.

Income Tax Basis Considerations

We discussed income tax basis in some detail earlier in the section on selling the farm. One important point that bears repeating is that the person receiving a gift gets the previous owner's income tax basis, too. Therefore, when you give children farm products, such as grain or livestock, they also receive your income tax basis (usually zero). Upon sale, they have the same taxable income you would have had if you had sold the products yourself.

Under current law a family will usually pay less tax if children receive property through the parents' estates rather than by gift.

Gifts Aren't Easy Answers

Under current law a family will usually pay less tax if children receive property through the parents' estates rather than by gift. The savings come from the stepped-up basis rules discussed earlier. This is particularly true for parents with estates that will not pay federal estate tax.

Here we highlighted some basic tax laws relating to gifts between family members. Persons considering large gifts or sales of property should discuss the actual and potential tax implications with professional tax counsel before making the transfers.

Some Additional Considerations When Considering a Sale or Gift

Here are some additional considerations when the situation seems to favor the transfer of at least part of the land and buildings by sale or gift while the older generation is living.

Responsibility for and concern about maintenance and replacement of buildings and facilities can be transferred to the younger generation.

The younger generation gains an opportunity to build equity and take income tax deductions for interest and depreciation. They get a new basis for depreciation (if they buy). They can make needed improvements and gain the benefit from their use.

The operating generation may be bringing a third generation into the business, and they may need the security of a base of operations that is not subject to the whim of parents or other heirs.

Where several parcels of land are involved, and especially where they are separate or separable, one or more could be transferred, while other(s) are retained for the older generation's security. Long-term leases, options, etc. (discussed later) could be used with the retained parcel(s).

Low basis is better than no basis. In the case of land, the advantage of a higher basis is upon sale, which may never occur, or not until some distant time.

Sales and gifts could be used together. The parents could sell on installments, then choose each year how much principal (and/or interest) they can afford to (and want to) give back. Other uses for the funds could include paying income taxes on the sale, supplementing retirement income, or making gifts to other children.A combination of below-market sale price and/or interest rate, along with an extended-term loan, could be used to bring principal and interest payments close to cash rental rates.

Parents could sell a bare parcel with a higher basis to children, then make a tax-free trade of the parcel with the buildings in exchange for it.

A balance should be maintained among concerns for the parents' financial security, the children's economic opportunity, and minimizing income taxes.

A balance should be maintained among concerns for the parents' financial security, the children's economic opportunity, and minimizing income taxes.

Sale of the Personal Residence

Sale of a personal residence, alone or as part of a farm sale, offers some unique opportunities for not paying income taxes. Residences may receive special income tax treatment even when they are sold as part of a farm or other business.

People selling farms usually are selling many different assets. Some assets qualify for special tax treatments by the seller or the buyer. It is desirable for the buyer and the seller to agree on the value of assets such as fence, tile, buildings, wells, rental homes, personal residence, land, machinery, etc. If values aren't in the sales contract, then the parties must estimate their own.

The seller usually wants to place as much of the value as possible on the personal residence in an attempt to get the most tax benefit. Buyers usually want to set a high value on the farm buildings and other depreciable assets so they can take more depreciation.

Buyers and sellers trying to set values after the sale usually use property tax appraisals to help estimate values. For example, if the property tax appraisal attributed 20 percent of a property's value to the personal residence, the seller might attribute 20 percent of the sales price to the personal residence.

One frequent question is, "How much land can we include with the residence?" There isn't a specific number of acres. Usually it's the area surrounding the house that is fenced in or mowed for personal use.

Gain on Sale Eligible for Exclusion

An individual taxpayer can exclude from income up to $250,000 of gain, and married taxpayers filing jointly can exclude up to $500,000 of gain on the sale of their principal residence. Generally, the exclusion applies if the taxpayer(s) owned the home and used it as a principal residence for at least two of the five years ending on the date of the sale.

Other Provisions

If a home is involuntarily converted (stolen, destroyed by accident, or seized in condemnation proceedings), the insurance proceeds or condemnation award isn't taxable when all the proceeds are invested in another residence within prescribed time limits. It is also possible to trade your home for another of equal or higher value — tax free.

Residences receive special income tax treatment.

Sale of Machinery and Equipment

A sale of farm machinery and equipment may cause unexpected tax consequences. The general rule is the same as for other assets: *The difference between the selling price and the property's income tax basis is fully taxable.* However, there are some additional rules that are probably best illustrated with a simple example:

	Machinery Cost	$40,000
–	Depreciation	(30,000)
=	Adjusted Basis	$ 10,000

This farmer bought a machine for $40,000. He has taken $30,000 in depreciation, leaving an adjusted basis of $10,000. Further assume that the current fair market value of this machinery is $25,000.

A sale of farm machinery and equipment may cause unexpected tax consequences.

Unexpected Gift

If this farmer sells this machine for $10,000, there is no taxable gain, because the sales price and adjusted cost basis are equal. However, there is a gift of $15,000 because the fair market value of the tractor is $25,000.

If the farmer sold the tractor to one person, the result is a $15,000 gift to that person, and the farmer must file an IRS gift tax return reporting the gift if the $15,000 exceeds the annual gift tax exclusion. If the gift exceeds the annual exclusion, there is no gift tax to be paid unless the farmer has already used up the $1-million lifetime gift tax exclusion (discussed earlier), but the farmer must file Form 709. If the farmer gave it to two people, such as a daughter and son-in-law, each received $7,500, and no gift tax return is required.

Gain Taxed in Year of Sale

Gain, due to depreciation previously taken, is fully taxable in the year of sale.

If the farmer sells the machine for $25,000, there is a $15,000 gain (sales price of $25,000 minus $10,000 basis). The $15,000 gain is fully taxable. The income has some additional characteristics that apply to machinery, equipment, and similar property.

First, the $15,000 gain is all taxable in the year of sale, regardless of the down-payment and payment schedule. Gain, due to depreciation previously taken, is fully taxable in the year of sale for most machinery, equipment, and other personal property. The $15,000 is added to the other income on the seller's income tax return that year.

That may not cause problems when you're selling one tractor, but it can come as a real surprise when you are selling a whole line of machinery at much more than its book value. All the gain is taxable in the year of sale. Additional rules apply if you sell it for more than you paid for it.

Gain Is Not Farm Income

Gain from the sale of farm machinery is not farm income for determining whether you must file estimated income tax. You are not required to file estimates if two-thirds of your total gross income is from farming in the current or prior year. If less than two-thirds of your income is from farming, you fail the two-thirds income test in the year of sale. If you didn't meet the two-thirds test in the previous year, you may incur penalties and interest for not filing estimates. The rules and tests are not simple, so talk with a professional to check about these and other implications before entering into a sale.

Gain Does Not Affect Social Security

Gain from the sale of farm machinery is not self-employment income for Social Security purposes. The gain is not subject to self-employment (Social Security) tax. It is not earned income and therefore does not reduce the amount of Social Security received by the seller.

Selling Livestock to Children

Livestock, particularly breeding livestock, are among the first things usually transferred from parents to children. If you hold breeding livestock more than one year (more than two years for horses, cattle, or poultry) and use it in your trade or business, the gain or loss from its sale qualifies for capital gains treatment.

Raised Animals

The same rule applies to livestock sales that applies to most other assets. The difference between the selling price and the property's income tax basis is taxable income. The difference here is that with raised livestock, the basis is zero. Thus, the total sales price is taxable income. The basis is zero because all the costs associated with raising the livestock were tax-deductible expenses in the year incurred.

With raised livestock the basis is zero. Thus, the total sales price is taxable income.

The zero basis is also important for livestock transferred by gift. As discussed in the section on gifts, the fair market value of the livestock determines the value of the gift for gift tax purposes. However, the person receiving the gift gets the donor's

basis (zero). Thus, when the person who received the livestock sells them, the sales value is taxable income.

Purchased Breeding Livestock

Purchased breeding stock are eligible for depreciation.

The tax treatments of purchased market livestock and purchased breeding livestock are slightly different. Purchased breeding stock are eligible for depreciation. Market livestock are not depreciable and do not qualify for capital gains.

Let's look at purchased breeding stock first, using a simplified example. Assume that a farmer bought a two-year-old heifer for $1,000. Two and one-half years later the farmer sells it to a daughter for $750. Does the farmer have a gain or loss? How much? First, even if a loss occurs, a person cannot deduct a loss on a sale to a related party.

Does the farmer have a gain? That depends on the amount of depreciation. Under current law, the farmer could have taken from $214 up to $1,000 in depreciation on the cow. If the farmer took $214 depreciation, there is a small loss that cannot be claimed because of related party rules. If the farmer took more than $250 in depreciation (basis less than $750), the gain would equal the difference between the cow's basis and the sales price.

What if the farmer had never depreciated the cow? Depreciation is allowed or allowable, meaning that the IRS assumes depreciation is taken even if it isn't. The farmer may not deduct the unclaimed depreciation in the current year or any later tax year. The farmer could file amended returns, claim the depreciation, and possibly benefit from depreciation not taken. An amended return must be filed within three years of the date of filing the original return, or within two years of the time the tax was paid, whichever is later. That would not eliminate the gain, but it would reduce taxable income in previous years and possibly generate a refund.

Purchased Market Livestock

Purchased market livestock have a basis equal to their cost.

Purchased market livestock have a basis equal to their cost. Deduct this *cost basis* on the tax return in the year the animals are sold. The costs associated with raising the market livestock are deductible in the year incurred and do not increase or decrease the livestock's basis. Figure gain by subtracting basis from sales price. The difference is taxable income or loss. Losses are not allowed on sales between related parties.

Selling Raised Grain, Hay, and Inventories

The income tax treatment of a sale of raised inventories is fairly straightforward in most cases. Raised inventories usually have a zero income tax basis, which means that their total value is taxable when they're sold. Treat sales to family members the same as sales to others.

However, there is one important provision of interest to farmers who retired the previous year and don't want to reduce their Social Security benefits in the year of sale.

Sales After Retirement

The month a person is entitled to begin receiving Social Security benefits (retirement, disability, Medicare, etc.) is his or her *month of entitlement.* Once a taxpayer is entitled to Social Security benefits, those benefits may be reduced by earned income. The sale of raised farm products is earned income in most cases.

However, farmers are permitted to exclude the sale of stored crops from earned income, regardless of when they are sold after entitlement. More precisely, this is earned income received in a taxable year after the year of entitlement, from services performed during the year prior to the month of entitlement.

Since most crops in Ohio are harvested in the fall, it suggests that farmers should probably delay retirement until their last crops are harvested and stored. Then, if December becomes the month of entitlement, grain income from this last crop sold in the next (or later) year(s) can be excluded from earned income in those years and not reduce benefits. (However, when the crop is sold, it will still be subject to both income and self-employment taxes.)

This rule does not apply to income received by an individual from a trade or business of buying and selling products produced or made by others. There are a number of other rules about self-employment income that also impact this type of transaction.

Required Minimum Interest Rates

The Internal Revenue Service (IRS) has specified minimum rates of interest for several common farm transactions. There are minimum interest rates for seller financing and for loans of cash.

Farmers should probably delay retirement until their last crops are harvested and stored.

Seller-Financed Sales

The minimum rate for most seller-financed transactions is 9 percent, or the *applicable federal rate*, whichever is lower. However, there is a special 6 percent rate available for certain farm real estate transactions (discussed later). In general, the interest rules operate by requiring the parties to report interest *as if* the required rate had been paid from the borrower to the lender. Frequently, this causes an unexpected tax burden on the buyer, seller, or both.

The applicable federal rate fluctuates each month, based on the interest rate paid on outstanding marketable obligations of the U.S. government. The rates are published each month in the *Internal Revenue Service Bulletin* and many financial periodicals. There are actually 12 different rates, depending on the length of loan and the compounding method chosen.

The applicable federal rate (AFR) is the lesser of the rate for the month of the seller-financed sale or the previous two months. For seller-financed sales for $4.483 million or less, the required rate cannot exceed 9 percent compounded semi-annually.

6 Percent Farm Real Estate Loans

The required minimum interest rate for land sales of $500,000 or less (per year) between family members is the lesser of the AFR or 6 percent compounded semi-annually. However, the 6 percent safe harbor for bare land sales to family members has had no effect since 2000 because the AFR has been below 6 percent since that time. Buildings, tile lines, fences, personal residences, etc., are not land and do not qualify for the 6 percent rate. They are subject to the applicable federal rate compounded semiannually.

Gift Loans

Occasionally parents loan children money for little or no interest. The general rule requires them to charge the applicable federal rate. However, there are two exceptions that eliminate the minimum interest requirement for many loans.

The interest rules do not apply to a loan between individuals for any day that the total outstanding loans between the individuals is $10,000 or less.

First, the interest rules do not apply to a loan between individuals for any day that the total outstanding loans between the individuals is $10,000 or less. This exception does not apply if the loan is directly attributable to the purchase or carrying of income-producing assets.

Second, if parents loan large amounts of cash to children at no interest, the investment income earned by the children is taxable to the parents. However, the amount of interest is limited

to the borrower's net investment income on any day the total outstanding loans between the borrower and lender are $100,000 or less. For the purposes of this rule, if the borrower's net investment income is $1,000 or less, it is treated as if it were zero. Thus, if the total outstanding loans are $100,000 or less and the borrower's net investment income is $1,000 or less, the interest rules do not apply to the loans.

Leasing Your Farm Assets to Your Children

In earlier sections, we looked at some of the pros and cons associated with parents selling or giving farm assets to their children. Here we'll look at some of the pros and cons of leasing farm machinery and equipment and farm real estate to children. Let's look first at machinery and equipment leases.

Machinery and Equipment Leases

In an earlier section, we discussed several potential problems with selling or giving away machinery and equipment. Perhaps the most troublesome is the fact that upon sale, the total gain is taxed in the year of sale.

Some families might prefer to lease their machinery and equipment to their children. This eliminates income and gift taxes on a sale or a gift. It allows the parents to maintain the financial security of ownership. However, the lease payments are taxable income to the parents. A lease allows the children to control the machinery without tying up a lot of money in machinery.

However, machinery leases are not without problems of their own. Frequently, the children don't feel they can pay what the equipment is really worth. Sometimes parents can help out and make it work, but other times this is a sign that the children really don't have a financially viable operation. (See Part 1.)

Machinery repair, replacement, and insurance are major considerations in machinery and equipment leases. Who pays when the engine blows or when the machine wears out and must be replaced? Who pays the insurance? Maintaining a line of equipment is very costly, but not optional, if the business is to continue.

Parents frequently find that after several years of leasing, their machinery and equipment have little value. Sometimes the children face the prospects of replacing a whole line of machinery but again find they cannot afford it. Both families

lived on depreciation, and the children still don't have the financial resources to replace the worn-out equipment line.

Usually, the children leasing the machinery assume all of the costs associated with maintaining and replacing it. When an item breaks, the children fix it or have it fixed. When it is time to replace an item, the children purchase the new item. Over time the parents own less and less machinery so the lease payment goes down. The children own more and more machinery.

Sometimes parents are financially able to assist the children at trade-in time by giving them or selling them the old machinery at a low price, prior to trade-in.

A machinery or equipment lease can solve some of the tax problems associated with sales.

A machinery or equipment lease can solve some of the tax problems associated with sales. However, it cannot solve the basic financial problems of an operation that isn't financially viable to start with.

It takes time to establish a reasonable lease value. Usually the annual lease payment will range from 10 to 25 percent of the fair market value of the leased property. An equipment dealer or an appraiser may help you determine fair market value. Many factors can come to bear on the lease payment used in a particular situation.

Farm Real Estate Leases

In the past, parents frequently sold their farms to their children. However, we are dealing with higher valuations, higher interest rates, and more complex tax issues than in the past. Nevertheless, families are still looking for ways to transfer the farm from parents to children.

For many families, there comes a time when control of the farm should be turned over to the children. A simple year-to-year lease meets part of the need but provides little security to the children on the farm or their lender. A multi-year lease gives children more security than a one-year lease.

Long-Term Leases

Here we consider how a long-term lease might work as an alternative to selling or giving away farm land, or as a temporary method of operating until the time is right for a sale or a gift. When we say long-term lease, we are thinking of a farm lease that spans three to eight years, although the actual length is somewhat arbitrary.

For our purposes, it makes little difference whether it is a cash lease or a share lease. However, the type of lease used may impact self-employment tax payments, Social Security benefits, and federal estate tax options, so consider the type of lease carefully.

A long-term lease usually fits best after the children are on the farm long enough for the parents and children to be reasonably satisfied that the children are going to farm.

Parents and children generally should not enter into a three- to eight-year lease immediately after the children finish school and start farming full-time. Leases work best when the children have been on the farm for several years, the relationships have stabilized, and the children have acquired substantial chattels.

Normally, the children's financial position has reached the point where there is serious consideration of selling or giving one or more farms to the children. The parents are ready to make a long-term financial commitment to the children, but for whatever reason(s), a transfer isn't appropriate now.

Long-term leases work best when the children have been on the farm for a while.

Why a Three- to Eight-Year Lease?

A three- to eight-year lease encourages stability and encourages children to plan for an ongoing operation. The children leasing the farm can purchase equipment, plan rotations, borrow money, maintain fertility, maintain the farm, and so on, with the expectation of farming it for several years.

You can set up the lease to provide some continuity through the death of one or both parents. For example, if the lease is binding on the parents' (owners') heirs and the child has a lease with three more years remaining when the child's widowed mother dies, the child has at least three more years on that farm. That gives time for planning and possible negotiation with brothers and sisters.

An intermediate-term lease can provide the children several years of continuity beyond the parents' deaths. If that seems desirable, consider providing that the lease is binding on the landlord's heirs, executors, administrators, legal representatives, successors, or assigns.

The lease might also provide, for example, that at the time of the last parent's death, the lease would automatically extend for a period of time. You could write it so it always extends three to eight years into the future until it is terminated. For example, each year when it is renewed, the renewal could extend it for another three to eight years. However, if there are problems or disagreements, both parties would be stuck with one another for several years.

Some Added Leasing Advantages

There are some other possible advantages besides providing continuity and stability to the children's operation. Leasing avoids some of the income tax which, as we discussed earlier, may be substantial if the property is sold. It provides a mechanism for children to progress until a sale becomes more appropriate or the parents die.

Leasing has two particularly important advantages for parents planning to retire. Both advantages hinge on farm lease payments not being considered earned income unless the landlord is *materially participating* in the farm operation. Material participation is discussed in some detail in the self-employment chapter of the *Farmer's Tax Guide.*

First, lease payments received by a landlord not materially participating are not subject to self-employment tax. Secondly, receiving farm lease payments will not reduce a farm landlord's Social Security benefits, unless the landlord is less than full retirement age, is materially participating in the farm operation, and has earned income in excess of certain limits.

If non-farming children inherit part of a farm subject to a multi-year lease, they will have some time to get used to the idea of being a landlord. This may help them look more favorably on the possibility of continuing as landlords beyond the term of the existing lease.

Leasing farm property from parents generally requires substantially smaller annual payments than a purchase. This is generally true even when the children pay the customary rates for their area. The smaller payment helps the children's cash flow, which may be important as they start a family and begin building equity in things such as machinery, equipment, livestock, inventories, and real estate.

A lease also will generally provide the parents with more financial security than a sale of the farm. They would still own the real estate. They would not have to pay taxes on a sale or be subject to the risks of choosing and managing other investments. The children don't own it, so they cannot borrow against it or lose it in a bankruptcy or divorce settlement.

Multi-Year Leases Must Be In Writing

A final advantage that can be very important in some situations is that a multi-year lease must be in writing. This should encourage the persons involved to carefully consider their relationship and to put their wishes in writing. The members

of many family businesses would get along much better if they had a written lease. When the inevitable disagreements and irritations arise, a written lease may provide an answer or at least provide a method of seeking a solution.

A lease with a term of more than one year cannot be legally enforced unless it is in writing. A lease of three years or more can be enforced against persons other than the original parties (such as a new owner) only if it is both written and recorded. An abbreviated memo of lease can be recorded to avoid public disclosure of lease details.

County Extension offices have sample lease forms that may be valuable as a guide. To minimize potential problems, all families should consider what should be in the lease and then work with an attorney to prepare the final written document.

Some Disadvantages of Leases

Leases aren't the perfect solution for helping children take over the farm. (There isn't any one perfect solution!) Leases are simply another option.

One of the biggest potential disadvantages of a multi-year lease is that all parties are stuck with the others for what may be a considerable period of time. It can be quite a problem if one party wants out, others will not let him or her out, and the lease has another five years or so to run.

Try to include all contingencies when drafting a multi-year lease. Unfortunately, to consider everything that might come up is impossible. Ensure that the lease is fair. Some leases unduly favor one party over the other.

For those reasons, it may be best to begin with a one-year or other relatively short lease for the first few years and to gradually lengthen it as it seems appropriate to provide additional security to the parties involved.

At some point, the farming children will probably want or need to make a substantial capital improvement on the property owned by the parents. Substantial capital improvements should not be made on the parents' real estate by the children until there is a written agreement clearly spelling out the business arrangement. The lease may specify the terms for making such improvements, or an attorney should prepare a separate legal document.

A lease with a term of more than one year cannot be legally enforced unless it is in writing.

Try to include all contingencies when drafting a multi-year lease.

Consider a Farm Purchase Option for Family Members

Earlier we looked at sales, gifts, and leases of farm property from parents to children. We saw that when a sale or gift from the parents to the children does not seem appropriate, it may make sense for the parents to consider leasing the property to the children on a multi-year lease. This provides some additional security for the children.

Buy/sell agreements are a type of purchase option frequently included in a farm partnership or farm corporation to provide for purchasing a partner's share or shareholder's stock when he or she leaves the business. Books have been written about buy/sell agreements for partnerships and corporations, but we are not discussing them here.

Unlike some purchase options, the children do not have the right to purchase at any time.

This discussion focuses on using purchase options with intermediate term farm leases from parents to children. There are several types of purchase options. The one discussed here gives the children the right to buy the property covered, *if* the parents decide to sell. Unlike some purchase options, the children do not have the right to purchase at any time. The parents initiate the process, not the children. The children should pay the parents, at least a nominal sum, for a purchase option. The payment of consideration strengthens the legality of the option.

Creating a legal purchase option does not mean that the parents have to sell or that the children have to buy the option property. It simply means that if the parents offer it for sale, the children with the purchase option will have the first opportunity to purchase it. The parents cannot sell it to someone else without first offering to sell it to the children with the option. Such an option can represent important security to on-farm children.

A purchase option is a legal document that should be drafted by an attorney.

Why Consider an Option?

An option provides different assurance than a will that states that certain children will receive certain property. A person can change his or her will without the benefactors knowing about it. A purchase option is a legal document that limits the seller's sales options. It may be useful to provide certain persons with purchase options in a will. They are legal and binding.

Sometimes a will provides an opportunity for certain children to purchase particular assets. Sometimes the purchase provisions are favorable to the children purchasing the property. There is nothing wrong with that. One problem with children relying on a parent's will is that wills are easily changed without the children knowing until after the parent's death.

Possible Problems

One frustrating thing about this option is that there is no assurance that the property will be offered for sale. It may never be offered for sale during the current operator's lifetime. The option simply provides that *if* the owner(s) want to sell the property, the person(s) with the option can buy it.

Sometimes a worse frustration occurs when the property is offered for sale, but the children with the option are unable to buy it. The children may have become financially unable or have simply reached an age when they no longer want to take the financial risk associated with purchasing it.

Sometimes conditions change so the parents no longer want to sell to the children holding the option. There may have been a disagreement or a change in circumstance such as a death, a disability, or a divorce that makes a sale less desirable. Sometimes the parents can buy back the option. Other times they may simply refuse to sell, or they may have to sell to children other than those to whom they would prefer to sell.

Valuation Concerns

There are many ways to set the selling price to the person holding an option. Sometimes the price is determined by the price offered by some bona fide third-party purchaser.

The option itself could specify a set purchase price. If the price is near fair market value when set, and the buyer pays reasonable consideration for the option, it probably will be acceptable to the IRS. However, any attempt to set the price artificially low, freeze prices, or avoid estate or gift taxes is likely to come under the scrutiny of the IRS.

You could put a method for determining price in the agreement. The method could require an appraisal, valuation by formula, capitalization of earnings, or another reasonable method.

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Planning Your General Farm Partnership Arrangement, NCR 224.

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THE OHIO STATE UNIVERSITY
EXTENSION

Strategic Management:

Module 9: Succession Planning

Preparation

Review the exercises associated with the presentation.

Readings include the following:

Weness, Erlin, Transferring the Farm Series, University of Minnesota. 1994. Available at

www.extension.umn.edu/distribution/businessmanagement/DF6317.html

Managing the Multi-Generational Family Farm, Canadian Farm Business Management Council, 1997, Ottawa, Ontario. ISBN 0-9682142-2-3. Available at www.farmcentre.com/.

Presentation
How Do I Train the Next General Manager? (ppt)

Exercises (pdf)
Family First or Business First? (pdf)
Evaluation of Management Strengths and Weaknesses (pdf)
Choosing the Successors (pdf)

Purpose of Lecture

No one likes thinking about their mortality and some business founders so closely identify with their ventures that they can't imagine their business continuing without them. A well-thought out succession plan is essential to the continuation of a business, no matter what its size and structure. This presentation presents key things to consider as a plan is built.

Structure of Presentation

The presentation reviews the seven steps associated with building a plan of succession. Three exercises are provided.

Other References

Succession Planning – Passing the Mantle. Small Business Administration, Washington DC. Available at www.sba.gov/gopher/Business-Development/Success-Series/Vol7/success.txt

The Beginning Farmer Center from Iowa Extension has many online publications available at www.extension.iastate.edu/bfc/.

Donald Jonovic has several books available at www.familyenterprise.com/

Farm Estate and Business Planning, Neil Harl, Iowa State University Press, 12th edition.

CHAPTER 9

TRANSFERRING THE FAMILY FARM

Transfer of the family farm to succeeding generations is one of the most complicated areas of estate planning. All of the traditional planning considerations come into effect, such as how to transfer the property in the most cost-effective manner, consideration of federal and state estate taxes, and a determination of who the transferors desire to eventually own their property. In addition, family farm estate planning is complicated by the fact that there are generally children who are working on and off the farm. Most farm operations have been operating at a certain size, and it's difficult to reduce the size of the farming operation in order to make equal distributions to farming and non-farming children. The manner in which the parents treat the transfers between their children who are farming and those who are not will generally make a difference in whether the family farm will be continued by the next generation.

In most family farm situations, both spouses are involved in the farming operation in some way. It's important for spouses to discuss what should occur in the event of the death of the spouse who has been primarily responsible for the farming operation. A detailed plan should be discussed so that the surviving spouse knows what would be the best way to manage the farm in the event of a death. Among things to be considered would be the sale of livestock, liquidation of a cow herd, and the leasing of the farm to third persons, if there are no children to take over the farming operation, or if the children are not old enough to do so.

TRANSFER OF FARM ASSETS

There are many decisions that parents or grandparents need to make when considering the transfer of the family farm to succeeding generations. This chapter will discuss arranging for the transfer of the family farm to children or grandchildren who are operating the farm and will continue to do so in the future.

Transfer of Livestock and Machinery

There are several ways to transfer livestock and machinery to children involved in the farm operation. One of the better ways is to

establish a Limited Liability Company, farm corporation, or farm partnership and transfer those assets into that entity. Gifts of interest in those entities can be made on an annual basis, which allows for a percentage transfer to the next generation without having to transfer an interest in the combine or so many head of cattle per year. If not all of the entity has been transferred at the time of death of the parents or grandparents, the operation of the farm through the entity allows it to continue, under most circumstances, without interrupting the farming operation.

If an entity has not been established, a good way to effectuate transfers over a period of time is for the parents to gift machinery being traded for new equipment and allow the child to buy new equipment with the trade-in. In the transfer of livestock, if the parents lease the cow herd to a child and receive lease payments and proceeds as cows and bulls are culled from the herd, the offspring belong to the child. Eventually, the cow herd can be moved over to the next generation without making gifts.

Transfer of Farmland

The next generation needs to be sure that the land will be available for them to farm. There are a variety of ways to do so, but the most preferred is for the next generation to own the farmland.

There is usually an area of the farm designated as the headquarters which will include cattle and livestock handling facilities, barns, machine sheds and grain storage. It's important that this portion of the farm be transferred to the child that is continuing to farm, as they will need to use these assets in future farm management. There are also portions of the farm that are more integral to the farming operation, usually closer to the headquarters, which would be helpful for the child who is farming to own. If the parents or grandparents desire to divide the estate between the farming and non-farming children, it's usually preferable to allow the non-farming children to own the land that is not so directly integral to the farming operation and lease that back to the child who is farming. That child would then have the option to purchase the property in the future. This can be done by direct transfer to the non-farming children with requirements that they lease the property to the farming child with option to purchase.

Another alternative is to allow the property to remain in trust for a period of years, and the trustee directed to make these types of lease

arrangements with the farming children and the non-farming children receiving the income from the trust.

Gifts of the farm can be made on an annual basis to the children by using the annual gift tax exclusion previously discussed or by using up a portion of the lifetime exemption. Undivided interests in the land can be transferred. If the property is not gifted during the lifetime of the parents or grandparents, then they should provide in their Wills or Trusts which portions of property are to be distributed to the farming and non-farming children. The Wills or Trusts can also provide that the farming children have the option to purchase the property should they desire to do so from their brothers or sisters. The Wills or Trusts can provide for a method by which the value of the property will be determined. This can be done by appraisal at the time of death or a set "per acre value" can be placed in the Will or Trust. If that is done, it assures the farming children of being able to purchase the property without having to worry about the value of the property being highly inflated.

It's usually preferable for the farming and non-farming children to have their own individual tracts of land, if possible, rather than undivided interests owned by everyone. The interests of the farming and non-farming children are usually different. The farming children will want to put income from the farm back into the farm in improvements to the farm property. The non-farming children may wish to receive the income from the farm, rather than placing the income back into the farming operation. If both own their own land, they may do this more easily. Also, if the non-farming children desire to sell their land, they may do so without affecting the land owned by the children who are farming. Allowing the farming children the right to purchase the land is important if that property is something the farming children need to keep as part of their farm unit.

Financing Alternatives

If the farming children are going to be required to purchase a portion of the farm assets from the non-farming children, some thought as to how this would be done is important. There are a variety of alternatives that could be considered.

The Will or Trust may allow the farming children to acquire farm assets from the estate, trust, or non-farming children on an installment basis. The interest rate could be established so that the farming children will know exactly what is required in terms of their payout. The non-

farming children would then receive payments over a period of years. Generally, the property will receive a stepped-up basis for income tax purposes at the death of the parents or grandparents. The principal payments should be without significant tax consequences to the non-farming children, and only the interest would be taxable income. Parents or grandparents may also sell property on installment basis during their lifetime to the farming children. This approach is not recommended since it creates taxable income for the parents or grandparents selling the property. If there are installments left at the time of death of the sellers, then the estate heirs have to pay tax on the remaining income that was not taxed during the lifetime of the sellers. If property is sold on installments following death, generally a stepped-up basis will avoid most of that income taxation.

Life Insurance

A common way that many people use for financing of the farm purchase for the farming children is the use of life insurance. There are two ways that this can be done. The farming child can take out a life insurance policy on their parents, and the parents or the farming child can pay the premium. Upon the death of the insured, the farming child will have insurance proceeds to be used to buy out the farm personal and real property. The Will or Trust can give the farming child this option, and since they would have the funds, it would flow fairly smoothly. The second option would be for the non-farming children to be beneficiaries of life insurance on the lives of their parents. That could then constitute their inheritance. The Will or Trust would then provide that the farm and related assets would go directly to the farming child, and they would not be required to buy out their siblings' interests. This allows the parents to set the amount that they desire the non-farming children to receive in the form of the insurance proceeds, and for the farming child to know that they should receive the farm without having a large payment obligation.

Transfers to Surviving Spouse

An important consideration in transferring the family farm is coordinating this transfer with the surviving spouse. This is particularly important if the spouse who dies first has been the one that's been primarily involved in the farming operation. Some of the considerations for the surviving spouse are as follows.

A plan should be established during the lifetime between spouses as to what would be intended insofar as the farm is concerned if something happened to the spouse who has been instrumental in the farming operation. If there are farming children, that decision is somewhat easier. The surviving spouse may continue to own and operate the farming operation with the assistance of the children who are farming. A determination needs to be made as to how that would be handled most effectively. The two alternatives would be: 1) the surviving spouse leasing the farm to the farming child, or 2) the surviving spouse continuing to operate the farm with the child performing labor and management. The surviving spouse and the farming child could then make a determination how they wish to go forward insofar as the operation of the farm is concerned.

If the surviving spouse is not familiar with farming and there are no children to take over the operation of the farm, then a plan needs to be in place to liquidate portions of the family farm to preserve its value. This is particularly important with livestock and machinery. The surviving spouse should proceed to liquidate the livestock as soon as possible to preserve its value. Consideration should also be given to liquidate the machinery as well. To the extent the livestock and machinery receive a stepped-up basis for income tax purposes, they can sell these assets without a great amount of income tax. The surviving spouse would then be in a position to lease the land to someone else to farm or to pasture cattle. The spouses should discuss this prior to the death of either. Potential good tenants for the farm and a list of individuals the surviving spouse could count on for advice and support should be considered.

The surviving spouse would need to coordinate with a group of advisors. Important advisors would be an attorney, an accountant, someone that would assist with investment decisions, and possibly a friend or neighbor familiar with farming. By networking with all of these advisors, the surviving spouse should be able to work through the transition of the family farm.

The family attorney will help determine if any legal or tax work is necessary from an estate tax standpoint. He will assist in preparing an inventory of the farm and valuing farm assets. He can help with leases of the family farm to third parties, and if there is a child who will be

taking over farming, work on arrangements with that child. If there are assets that need to be transferred legally, the attorney can help with that.

An accountant will assist with income tax matters which could be important insofar as transition of the farm is concerned. He will provide advice concerning income tax on the sale of farm assets and what would be preferable there. He will also help with preparation of income tax returns for the surviving spouse and for the estate or trust, if indicated.

A financial advisor will be important to help with investment of proceeds from the sale of livestock or machinery in a manner that will be most beneficial for the surviving spouse.

A person should be designated as a trusted advisor to the surviving spouse to deal with transition issues. This would include advising as to how best to sell livestock and equipment, who would be appropriate for the leasing of the farm property, and whether any of the land should be sold.

If all of these advisors are in place, the surviving spouse will have the best chance of success insofar as the continuation of the farming operation is concerned.

For More Information:

Transferring Estate Property - Selected sites for transferring the family farm can found online at:

- Nebraska Cooperative Extension – Relationship and Working Together With Extended Family
  http://ianrpubs.unl.edu/family/nf555.htm
- Ohio State University – Transferring Your Farm Business to the Next Generation
  http://ohioline.osu.edu/b862/
- University of Minnesota Extension Service – Transferring the Farm
  http://www.extension.umn.edu/distribution/businessmanagement/DF6317.html
- University of Minnesota Extension Service -Preparing to Transfer the Farm Business
  http://www.extension.umn.edu/distribution/businessmanagement/components/6317-1.pdf

- Purdue University - A Retirement Estimator for Farm Families
  http://www.ces.purdue.edu/farmretirement/
- Purdue University – Frequently Asked Questions
  http://www.ces.purdue.edu/farmtransfer/faq.htm
- Plan Farm Transitions Between Generations
  http://www.findarticles.com/p/articles/mi_m0HEE/
  is_8_61/ai_113714174
- Manitoba Agriculture, Food and Rural Initiatives – Home Economics
  http://www.gov.mb.ca/agriculture/homeec/index.html
- Maryland Cooperative Extension
  www.agnr.umd.edu/MCE/Publications/Publication.cfm?ID=138

CONCLUSION

We hope the information found in **Securing a Solid Future: Farm Financial and Transitional Planning Guidebook** will be helpful to you in planning for the future of your farming operation. This publication is designed to provide you with practical and useful information, and to suggest possible solutions to problems encountered in operating a farm.

The Kansas Farm Bureau Legal Foundation intends to update this publication on our Kansas Farm Bureau Legal Foundation web site: http://www.kfb.org/legalfoundation.htm so that up-to-date information is readily available. As other web sites become available for references, they will be included on our web site as well.

This guide is not a substitute for legal and accounting advice. You should contact qualified professionals to assist you with your estate planning. The time to begin the planning is now. Even though the laws may change in the future, having a good estate plan in place will allow transfer of your family farm in the manner you decide. You will maintain control rather than relying on the law to distribute your estate. This will be beneficial to your surviving spouse and your children, who will appreciate the thought and effort you put into your estate plan. In the final analysis, it may allow the family farm to continue, rather than being consumed by estate administration expense and taxes. It will also assist the children remaining on the farm to have the opportunity to carry on the farm in the best possible way.

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Cooperative Extension

Estate Planning Research

- 2/3 of Iowa Farmers plan to never **"Fully Retire"**

- Over 1/2 of all Nebraska farmers do not have a **Will**

Why don't we Plan?

Why don't we Plan?

- Too Complicated

Why don't we Plan?

- Too Complicated
- Don't like to Plan

Why don't we Plan?

- Too Complicated
- Don't like to Plan
- Facing our own Mortality

Is there a Successor for your farm/ranch?

Is there a Successor?

- Farm/Ranch Income may leave the area

Is there a Successor?

- Farm/Ranch Income may leave the area

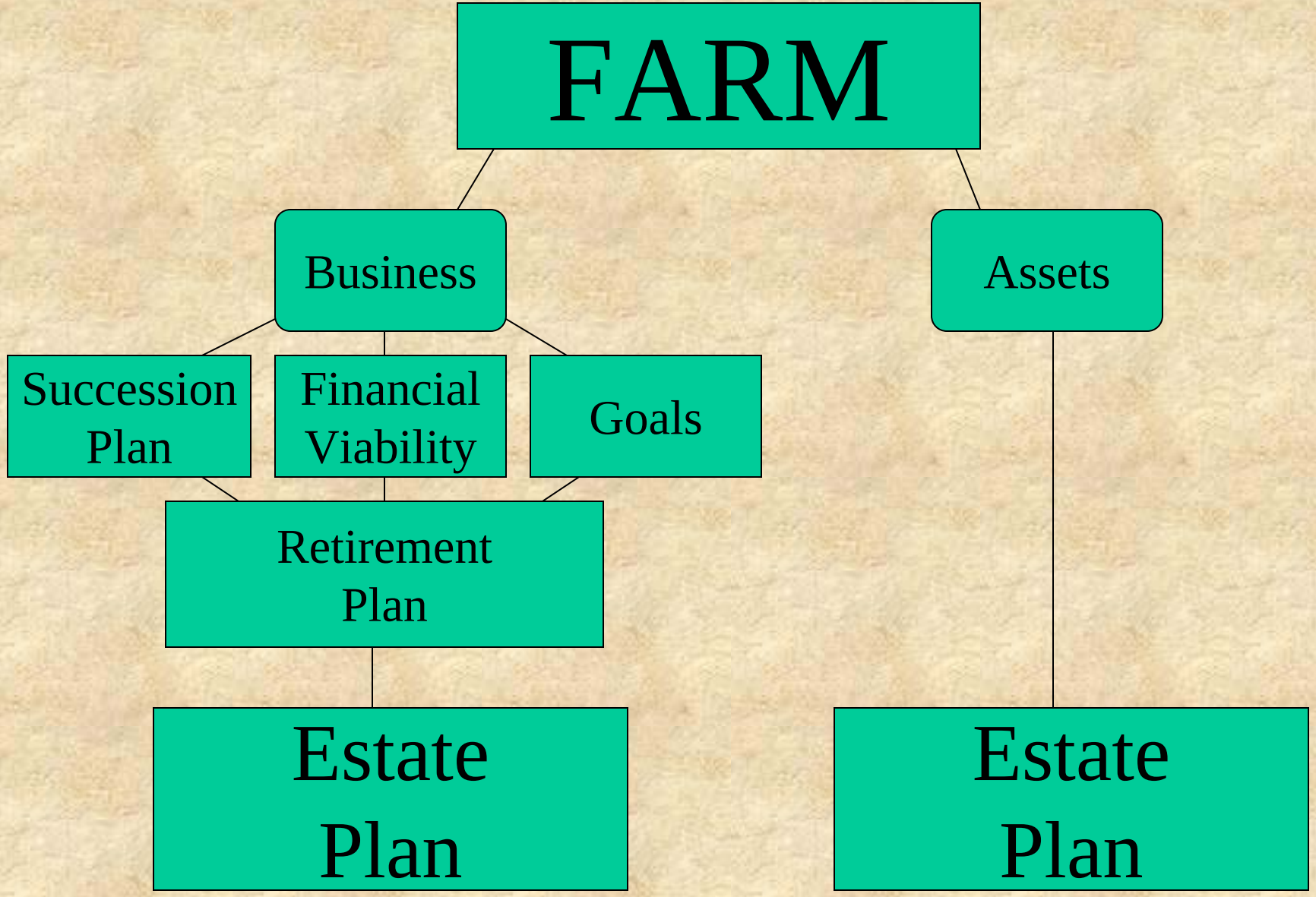
- Unintended Consequences:
  - ✓ Community
  - ✓ Businesses
  - ✓ Churches
  - ✓ Schools

What to do with the Farm/Ranch?

Do you want to transfer the ranch/farm as a "business" or simply as a "group of assets"?

A. Transfer Plan

B. Estate Plan


FARM
Business
Assets
Succession Plan
Financial Viability
Goals
Retirement Plan
Estate Plan
Estate Plan

Estate Planning Quiz

When assets pass to a child, Nebraska state inheritance tax can be as high as?

20%

15%

10%

5%

1%

Estate Planning Quiz

Probate is required if a decedent's estate includes more than?

$10,000

$25,000

$50,000

$100,000

Only when a trust is involved?

Estate Planning Quiz

2/3 of all men over age 65 will spend at least one year in a nursing home?

Yes

No

Estate Planning Quiz

For an individual the annual gift exclusion amount is?

$10,000

$12,000

$15,000

$100,000

Unlimited

Estate Planning Quiz

Federal estate tax impacts what $ of farm deaths?

<50%

30%

20%

10%

>2%

Estate Planning
Key Questions

- What do you own?

Estate Planning
Key Questions

- What do you own?
- What is it worth?

Estate Planning
Key Questions

- What do you own?
- What is it worth?
- How much do you owe?

Estate Planning
Key Questions

- What do you own?
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- How are your assets titled?

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Estate Planning
Key Questions

- What do you own?
- What is it worth?
- How much do you owe?
- How are your assets titled?
- Who do you want to give them to?
- When do you want to give it to them?
- How long do you want to exert control?

Estate Planning
Key Questions

- What do you own?
- What is it worth?
- How much do you owe?
- How are your assets titled?
- Who do you want to give them to?
- When do you want to give it to them?
- How long do you want to exert control?
- What about long term care?

Key Notions to Keep in Mind

- What happens when someone dies?
  - ✓ Probate
    - What is probate?
    - Probate estate vs. taxable estate
    - Avoiding probate?
- Minimize Tax
- Property Ownership
- Transferring Assets
- Long Term Care

What is Probate?

- Legal process for proving the validity of a will
- Identify and inventory property of decedent
- Appraise property
- Pay debts and taxes
- Distribute property as the will directs
- Can take time; ties up distributions; costs money – maybe more than alternatives

Key Concept:
Probate Estate vs. Taxable Estate

- Assets may be part of one estate and not the other

- Anything a person has an interest in at the time of death goes into the taxable estate to the extent of that interest: this includes more than probate property, such as
  - ✓ Property transferred with strings attached
  - ✓ Value of an annuity
  - ✓ Joint tenancy property
  - ✓ Life insurance proceeds
  - ✓ Interests retained from previous inter vivos transfers

Avoiding Probate

- Reduce your probate estate to below $25,000
- How to accomplish and still control assets:
  - ✓ Joint tenancies
  - ✓ Payment on death bank accounts
  - ✓ Naming beneficiaries for retirement accounts
  - ✓ Register stock, bonds, brokerage accounts in "transfer on death" forms
  - ✓ Life estate deed
  - ✓ Living trust
  - ✓ Insurance
  - ✓ Gifting (you lose control with this option)

Avoiding Probate

- A word of caution: assets that pass to others outside of probate are generally not available to help pay costs of probate (if a probate is occurring at all), including taxes. This may mean that some heirs bear an unequal share of transfer costs.
- A spouse may generally reach assets that pass outside of probate with the spousal interest

Key Notions to Keep in Mind

- What happens when someone dies?
- Minimizing Taxes
  - ✓ Nebraska state inheritance tax
  - ✓ Federal estate and gift taxes
  - ✓ Unified credit
  - ✓ Marital deduction
- Property Ownership
- Transferring Assets
- Long Term Care

Minimizing Taxes

- Policy – at each generational level, assets will pass through a tax screen…..transfer taxes
- Nebraska State Inheritance tax
- Estate tax occurs on time-of-death transfers
- Gift tax occurs on inter vivos transfers
- Estate and gift taxes tied together in Unified Credit, as is generation-skipping tax

Nebraska State Inheritance Tax

Relationship	Rate	Exclusion	Range
Spouse	0%	Unlimited	
Immediate	1%	$10,000	Unlimited
Remote	6%	$ 2,000	$2K to $60K
Remote	9%		Unlimited
Other	6%		$ 5,000
Other	9%		$5K to $10K
Other	12%		$10K to $20K
Other	15%		$20K to $50K
Other	18%		$50K +

Estate Tax Marital Deduction

- No estate or gift tax imposed on transfers between spouses
  - ✓ Treat spouses as one economic unit
  - ✓ Expose assets to estate tax at each generational level
- If all property owned jointly, no estate tax imposed on death of first spouse, but all assets will be taxed on death of surviving spouse
  - ✓ No tax problem, <u>if</u> assets are worth less than exclusion amount/unified credit
- For larger estates, may not want all assets to pass to surviving spouse under the marital deduction – take advantage of both spouse's unified credits

Unified Credit

- Offsets cumulative gift and estate tax liabilities
  - ✓ No longer "unified" after 2003
- After 2003, gift tax exclusion amount is $1 million per person
- Estate tax exclusion amount is $2 million per person for 2006-2008
- $3.5 million per person for 2009
- Unlimited for 2010
- In 2011, the Act sunsets: back to unified credit of $1 million per person for gift and estate tax

Federal Estate Tax

Tax Year	Tax Rate	Exclusion
2006	46%	$2,000,000
2007	45%	$2,000,000
2008	45%	$2,000,000
2009	45%	$3,500,000
2010	NA	Unlimited
2011		$1,000,000

Gift Tax

- 46% rate for 2006; 45% for 2007-2009; 35% for 2010
- Annual exclusion amount equal to $12,000
  - ✓ Does not reduce Unified Credit
  - ✓ No need to file return
  - ✓ Additional unlimited exclusion for education gifts and medical
  - ✓ Gift-splitting allows spouses to double annual exclusion to each donee
- $1 Million exclusion (tied to Unified Credit) –Call Them Transfer Taxes
- Gift tax return to be filed on annual basis and tax paid, if any
- Gift tax imposed only on completed gift – transfer of possession and enjoyment: life estate deed is not completed gift

Unified Credit II

- Each person has ONE unified credit
- Where an estate is large, take advantage of both spouses' unified credit
  - ✓ Do not use joint tenancy
  - ✓ Use tenancy in common
  - ✓ Use credit shelter trust as part of will or living revocable trust

Estate Planning Zones

- Estates of less than $2,000,000
  - ✓ Avoid probate, if desired
- Estates between $2,000,000 and $4,000,000
  - ✓ Take advantage of each individual's exclusions
  - ✓ Reduce value of taxable estate
- Estates over $2,000,000 and $4,000,000
  - ✓ Double Unified Credit, if possible
  - ✓ Reduce taxable estate: completed gifts, installment sales, special use valuations, closely held discounts

Credit Shelter Trust

- Also called by-pass or family trust
- Used to take full advantage of exclusion amount or unified credit
  - ✓ On death of first spouse, assets are transferred into trust for life-time benefit of surviving spouse
  - ✓ These assets are included in first-to-die's taxable estate and are not later included in surviving spouse's taxable estate
  - ✓ Value of assets transferred into trust equal an amount necessary to avoid federal estate tax
- Typically included in a will or living trust document

Very Large Estates

- If doubling of unified credit by spouses would still leave assets subject to federal estate tax, planning becomes more complicated.
- Reducing the size of the estate
  - ✓ Irrevocable trusts
  - ✓ Use of annual gift tax exclusion
  - ✓ Use of special valuation procedures
  - ✓ Discounting value for lack of liquidity or control
  - ✓ Installment sales
  - ✓ Insurance owned by someone else (three year look-back)

Special Use Valuation

- Real estate used in family farm or closely held business: Section 2032A
  - ✓ Land is valued on basis of value as a farm and not at fair market value
  - ✓ Maximum reduction in value is $750,000
  - ✓ Heirs must farm for 10 years

Discounted Value

- Interests in closely-held family corporations, family partnerships or LLCs
  - ✓ May be discounted for lack of marketability/liquidity
  - ✓ Also discounted for lack of controlling interests
- A useful tool for transferring assets within the exclusion amount

Key Notions to Keep in Mind

- What happens when someone dies?
- Minimizing Taxes
- Property Ownership
  - ✓ Joint tenancy
  - ✓ Tenants in common
  - ✓ Life estate deed
- Transferring Assets
- Long Term Care

Property Ownership Basics

- Ownership of property
  - ✓ Real property…..land and structures attached
  - ✓ Personal property…..everything else
- Title of property
  - ✓ Sole ownership – a single owner
  - ✓ Tenants in common – multiple owners with undivided interests
  - ✓ Joint tenancy – multiple owners with right of survivorship
  - ✓ Life estate – ownership for the period of the possessors life

Property Ownership Basics

- *Joint Tenancy*: typical land ownership for married couple
  - ✓ surviving spouse automatically inherits
- *Common Tenancy*: typical land ownership for siblings (e.g. inheriting from parents)
  - ✓ property passes to the deceased heirs
- No limited liability protection—exposure to creditors
- Partition actions

Joint Tenancy

- **Distinguished by WROS With Right Of Survivorship: on death of one owner, other owner(s) automatically succeeds to entire property**
  - ✓ **Not part of probate estate – avoids probate**
  - ✓ **Included in taxable estate**
  - ✓ **After death, not subject to decedent's creditors' claims**
- **All joint tenants own property together**
  - ✓ **Joint tenancy can be destroyed by any owner; also destroys right of survivorship.**
  - ✓ **If mortgage given by one tenant, joint tenancy destroyed; parties become tenants-in-common**
  - ✓ **Joint tenant's creditor can attach interest in joint tenancy property during life; creditor and other tenant(s) become tenants-in-common**

Taxation of Joint Tenancies

- Joint tenancy between spouses
  - ✓ One-half of value of property included in estate of first-to-die; survivor gets step-up in basis
  - ✓ No estate tax payable because property passes under unlimited marital deduction, depending on value
    - No doubling of unified credit
- Joint tenancy between non-spouses
  - ✓ All of value of property included in decedent's estate
  - ✓ Except to extent survivor contributed to acquisition

Tenancy in Common

- Owners have distinct and separate interests
- No right of survivorship
- Right of possession is undivided
- Each owner may transfer interest, including by will
- Value of interest is included in taxable and probate estates

Life Estate Deed

- Property owner (grantor) deeds property to heir but reserves a life estate
  - ✓ Owns property for duration of life but cannot transfer/will
  - ✓ No changing mind without heir's consent
  - ✓ Avoids probate
  - ✓ Value of property is included in taxable estate
  - ✓ Inexpensive tools for estate planning
- Heir acquires legal interest
  - ✓ Heir becomes "remainderman"
  - ✓ Remainder interest can be pledged, transferred or attached
  - ✓ Heir acquires stepped-up basis on death of life tenant

Key Notions to Keep in Mind

- What happens when someone dies?
- Minimizing Taxes
- Property Ownership
- Transferring Assets
  - ✓ Give it to them now with no strings attached
    - Gift
  - ✓ Give it to them now with strings attached
    - Trusts
    - Deed with life estate
    - Contract sales
  - ✓ Give it to them when you die
    - Intestate
    - Wills
    - Trusts
  - ✓ Basis adjustment
- Long Term Care

Give it to them now with NO strings attached

- Gifts
  - ✓ Elements of a gift
    - Must have a donor
    - Must have a donee (recipient) of the gift
    - Must have actual or constructive receipt of the gift
  - ✓ Gifts must be given free of any restrictions
  - ✓ Gifts in any amount are not income to the recipient
  - ✓ Gifts in excess of $12,000/year to any one recipient will effect the unified credit of the giver, gift tax return filed
  - ✓ Basis considerations

Capital Gains Tax

- Capital gain, put simply, is the difference between what you paid for an asset and what it is presently worth
  - ✓ Basis equals your "cost" in the asset – what you paid for it and the cost of improvements to it
- If you sell the asset, you pay capital gains tax (current maximum rate is about 22% combined federal and Nebraska state)
- If you give away an asset, the recipient of the gift receives a basis in the asset equal to your own

Capital Gains Tax Example

- Selling Price $480,000
- Basis $160,000
- Capital Gain = $320,000 @ 22%
- Tax Due = $70,400

Basis Adjustment

- Only a time-of-death transfer wipes out locked-in capital gain tax liability
- Heir receives the asset with a basis equal to FMV at time of death
- Time of death transfers only occurs in
  - ✓Wills – probate transfers
  - ✓Living revocable trusts
  - ✓Life estate deeds

Give it to them now with Strings Attached

- **Trusts**
- **My brother's lunch**
  - ✓ My younger brother and I are going to the carnival and our mom gives me $10. She says: $5 is for you and with the other $5 make sure your brother eats lunch. The first $5 is mine; the second $5 I hold as trustee. I possess the second $5 and I have the right to spend it, but only as I have been told. My brother is the beneficiary, he does not possess the money but has the right to have it spent on his lunch. In legal terms, I have legal ownership and my brother has equitable or beneficial ownership.
  - ✓ If I were to spend part of that $5 on myself, I would have violated my fiduciary duties to my brother. My brother would then.....

Elements of a Trust

- Settlor
  - ✓ Creator of the trust (My Mother)
- Trustee
  - ✓ Holds title to and manages trust property (Me)
- Fiduciary
  - ✓ The relationship between trustee and beneficiaries. Position of trust and confidence
- Beneficiary
  - ✓ Person for whose benefit trustee owns and manages the trust property (Brother)
- Corpus
  - ✓ The property that is held in trust (also called trust res, trust assets, principal, or trust estate) ($5)
- Trust instrument
  - ✓ Document that embodies the terms of the trust

Transferring Assets

- Trusts
  - ✓ Revocable or Irrevocable
  - ✓ Inter vivos or living trusts are established during the settlor's life
  - ✓ All trusts become irrevocable at the death of the settlor
  - ✓ Testamentary, credit shelter or pour over trusts are established by a will
  - ✓ A living trust has no greater effect on Tax than a will

Uses of Trusts

- Protect assets from beneficiaries: separate management from enjoyment
- Manage property or investments
- Avoid probate or minimize probate costs
- Avoid guardianship requirements of transfers to minors or incapacitated persons
- Protect privacy in property transfers
- Guard against will contests
- May help to save estate tax, Irrevocable trust

Irrevocable Inter Vivos Trust

- Can reduce value of taxable estate
- If grantor/settlor does not retain interest in income or corpus of trust
  - Trust must benefit others
  - No retention of life estate in income
  - Enjoyment by beneficiaries cannot be contingent on death of settlor – must be present interest (some room to plan for minors)
  - Cannot retain power to change the transfer of property
  - ✓ Use of trust to reduce value of estate runs against desire to control enjoyment or management of assets
  - ✓ Planning for retention of some non-fiduciary powers can be risky
- Transfers still subject to Gift Tax: over $12,000 per person reduces unified credit but appreciation occurs outside of estate

Inter Vivos Revocable Trust
"Living Trusts"

- Will substitute – avoids probate of trust assets
  - ✓ Assets can be quickly transferred after death
  - ✓ Costs more to create than a will, but avoids probate costs
  - ✓ Particularly useful to avoid probate in another state where property is held
- Property remains part of taxable estate
  - ✓ Not useful for reducing value of estate for estate tax planning
  - ✓ Heirs do receive step-up in basis
  - ✓ Spouses can use to double unified credit
- Less susceptible to attack than will
  - ✓ Not subject to rules of testamentary proof (contract not a will)
  - ✓ "Seasoned" or in existence for some time before death
- Can be fully funded at creation or subject to pour-over provisions of will
- Can be used to manage assets

Life Estate Deed

- Property owner (grantor) deeds property to heir but reserves a life estate
  - ✓ Owns property for duration of life but cannot transfer/will
  - ✓ No changing mind without heir's consent
  - ✓ Avoids probate
  - ✓ Value of property is included in taxable estate
  - ✓ Inexpensive tools for estate planning
- Heir acquires legal interest
  - ✓ Heir becomes "remainderman"
  - ✓ Remainder interest can be pledged, transferred or attached
  - ✓ Heir acquires stepped-up basis on death of life tenant

Give it to them when you die

Wills

- ✓ **Competency required to make a will**
  - ➢ **Know the nature and extent of your estate**
  - ➢ **Be able to formulate a plan of distribution**
  - ➢ **Know the natural objects of you bounty**
  - ➢ **Understand the relationship of the above**
- ✓ **Must be witnessed by two witnesses in the presence of the testator and each other**
- ✓ **Must be revoked and/or amended with the same formality with which they are made**

Living Will

- Medical directive or "living will"
  - ✓ Permanent vegetative state – what are your wishes with respect to life support
  - ✓ May ease difficult decisions for survivors
  - ✓ Should be part of estate planning documents
- Medical power of attorney
  - ✓ Who do you want to make the decision

Durable Power of Attorney

- Grant of power to another to look after assets and manage affairs
- Anticipates possibility of incompetence: avoids need for incompetency hearing or approval of guardian
- Statute defines powers (plenary – complete, unqualified)
  - ✓ Should also include express powers for tax returns, life insurance matters, making gifts, transferring property into trust, accessing safe deposit box, dealing with retirement plans and Social Security
- May be *contingent* or *present*
  - ✓ Contingent – effective only upon incompetence
  - ✓ Present – effective when executed and continues in spite of incompetence

Powers of Appointment

- Useful tool for postponing decision as to ultimate disposition of an asset; allows post-mortem modification of plan
  - ✓ Circumstances may change
  - ✓ Unforeseen events occur
  - ✓ Power of Appointment survives death, unlike power of attorney
- Used in trusts and wills
- Example: Ted gives farm to Kathy, his wife, for her lifetime, with the power to direct in her will how the farm should be divided among their children after her death
  - ✓ E.g. They want it to go to the "farming" child, but do not yet know who that is

Powers of Appointment II

- Different kinds of Powers of Appointment
  - ✓ General Power – Kathy has power to appoint anyone, including herself
  - ✓ Special Power of Appointment - Kathy can appoint one or more of their children
  - ✓ Testamentary Power – Kathy can appoint only in her will
  - ✓ Collateral Power – Ted gives farm to Kathy for life and power to appoint to their son John
- Taxation of Powers of Appointment can be complicated
  - ✓ General powers usually included in taxable estate of recipient of power (Kathy); some exceptions

Key Notions to Keep in Mind

- What happens when someone dies?
- Minimizing Taxes
- Property Ownership
- Transferring Assets
- Long Term Care
  - ✓ Statistics
  - ✓ Income from earnings and assets liquidation
  - ✓ Long term care insurance
  - ✓ Medicaid = safety net

Long-Term Care

- Cost of Nursing Homes
  - ✓ Assisted Living
  - ✓ Adult Day Care
- $3,000/month to $6,000/month
  - ✓ Inflation faster than general economy
- Wipe out a lifetime of work and savings

Long-Term Care

- Limited ability for Activities of Daily Living
  - ✓Eating Meals
  - ✓Personal Hygiene

- Aging Population
  - ✓36 Million over age 65
  - ✓72 Million over age 65 in 25 years

Odds of needing Long-Term Care

- 6.4 Million (18%) over 65 need some type of Long-Term Care
  - ✓ Nursing Homes
  - ✓ Assisted Living
  - ✓ Adult Day Care

- 1.5 Million over 65 reside in a Nursing Home

✓ 65-74	1.1%	210,159
✓ 75-84	4.7%	574,909
✓ 85 +	18.2%	772,733
✓ Over 65	4.5%	1,553,800

Long-Term Care Statistics

- 2/3 of all men over 65 and 1/3 of all women over 65 will not spend 1 single day in a nursing home
- 50% of all nursing home facility stays will last less than 6 months
- 25% of all women over age 65 and 10% of all men over age 65 will stay more than one year in a nursing home facility

Long-Term Care Statistics

- 10 % of those over 65 will stay more than 3 years in a nursing home facility
- The average length of stay in a nursing home facility is between 18 months and 20 months
- Vast majority of people will not need an extended period of Long-Term Care

Strategies to Provide for Long-Term Care

- Adequate income or reduction of assets
  - ✓ After tax available income
  - ✓ Earnings and asset sales
- Long-Term Care Insurance
- Medicaid safety net

Medicaid

- Eligibility
  - ✓ Status
    - Citizen
    - 65 years of age
    - If not 65 years of age be blind or disabled

Medicaid

- Eligibility
  - ✓ Resources
    - $4,000 if single
    - $6,000 if a married couple
    - Spousal Impoverishment
      - Community Spouse may keep all assets up to $18,552 + $4,000 if assets are worth less than $18,552
      - Community Spouse may keep ½ of all assets up to $92,760 + $4,000 if assets are worth more than $18,552

Medicaid

- Eligibility
  - ✓ Resources
    - Excluded Resources
      - A house, in some cases
      - Life insurance cash surrender value up to $1,500
      - Moderate household goods
      - Burial account up to $3,000
      - One vehicle, in some cases
      - Certain trusts
      - Life Estate in real property (no deprivation of assets)
      - Land contracts
      - Business equipment, machinery and real estate

Medicaid

- Eligibility
  - ✓ Income
    - Income in institutionalized spouses name
      - MMMNA Community spouse may keep up to $1,562 from institutionalized spouse's income
      - Remaining income must be used for nursing home expenses
    - Income in both spouses names
      - Prorated
    - Income in community spouses name
      - Community spouses income does not apply

Medicaid

- Eligibility
  - ✓ Deprivation of Resources
    - Less than "fair market value"
    - 60 month "Look Back" period
    - 60 month "Look Back" period Trusts
    - Ineligibility determination calculations

Estate Planning
Key Questions

- What do you own?
- What is it worth?
- How much do you owe?
- How are your assets titled?
- Who do you want to give them to?
- When do you want to give it to them?
- How long do you want to exert control?
- What about long term care?

Time Management Matrix

	Urgent	Not Urgent
Important	I. Activities Crisis Management Deadline Projects	II. Activities Planning Relationship Building
Not Important	III. Activities Some Calls, Mail, Popular Activities	IV. Activities Time Wasters Busy Work

Resources

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Need For Personal Legal Advice

The information in this presentation and accompanying material is provided for educational purposes only. It is not a substitute for competent legal advice. Farmers and ranchers need professional legal and financial counsel in evaluating alternatives for legally structuring the farm business. This information is provided to help you better communicate with your professional advisors in analyzing your specific situation.

Whole Farm Decisions - Transition & Estate Planning

Many of the Information Files listed below are accompanied by companion tools such as Decision Tools, Teaching Activities and Voiced Media Presentations

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Getting Started

Information Files	*Decision Tools (xls)*	*Teaching Activities (doc)*	Voiced Media
Understanding Farm Business Transfers -- C4-10			
Planning your Future Together -- C4-11			
Critical Success Factors for Business Transfers -- C4-12			
The Farm Business Transfer Process -- C4-13			
Transferring Business Ownership -- C4-14			
Transferring Business Management -- C4-15			
Dividing Business Income -- C4-16			
Constructing a Succession Plan -- C4-17			
Wills and Probate			
Trusts			
Real Property Ownership			
Buy-Sell Agreements			
Option Agreements			
Power of Attorney			
General Partnership			
Limited Partnership and Family Limited Partnerships			
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