Bulletin 862

THE OHIO STATE UNIVERSITY
EXTENSION

Transferring Your Farm Business to the Next Generation

T·H·E OHIO STATE UNIVERSITY EXTENSION

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Bulletin 862 Revised

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

Revised May 2008 — 1,000 - 3672

Transferring Your Farm Business to the Next Generation

Five Key Questions Answered

Part 1. How can you tell if the business is profitable enough to provide for the next generation? 7

Part 2. Are there enough income and assets to provide for the older generation's wants and needs? 28

Part 3. How can you help the two generations get along? 43

Part 4. What should you transfer? In what order? Some guidelines, tools, and alternatives 59

Part 5. How do you avoid paying too much income, gift, and estate taxes? 66

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

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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

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.

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

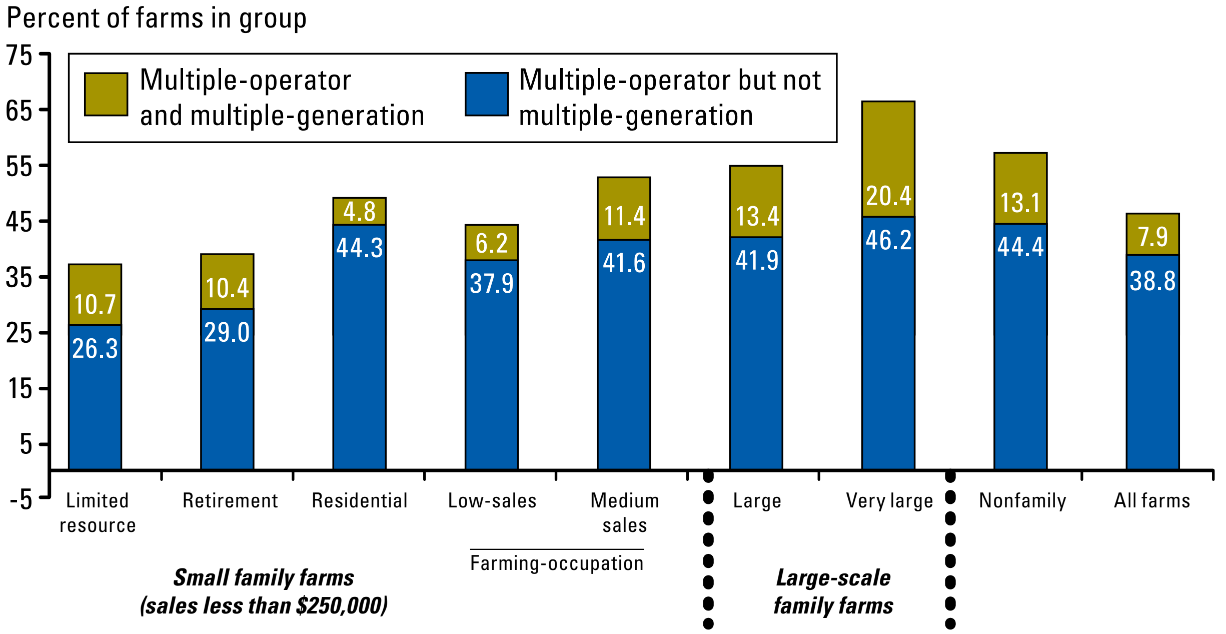
Many farms have multiple operators, and many large farms have multiple generations of farm operators.

- 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.

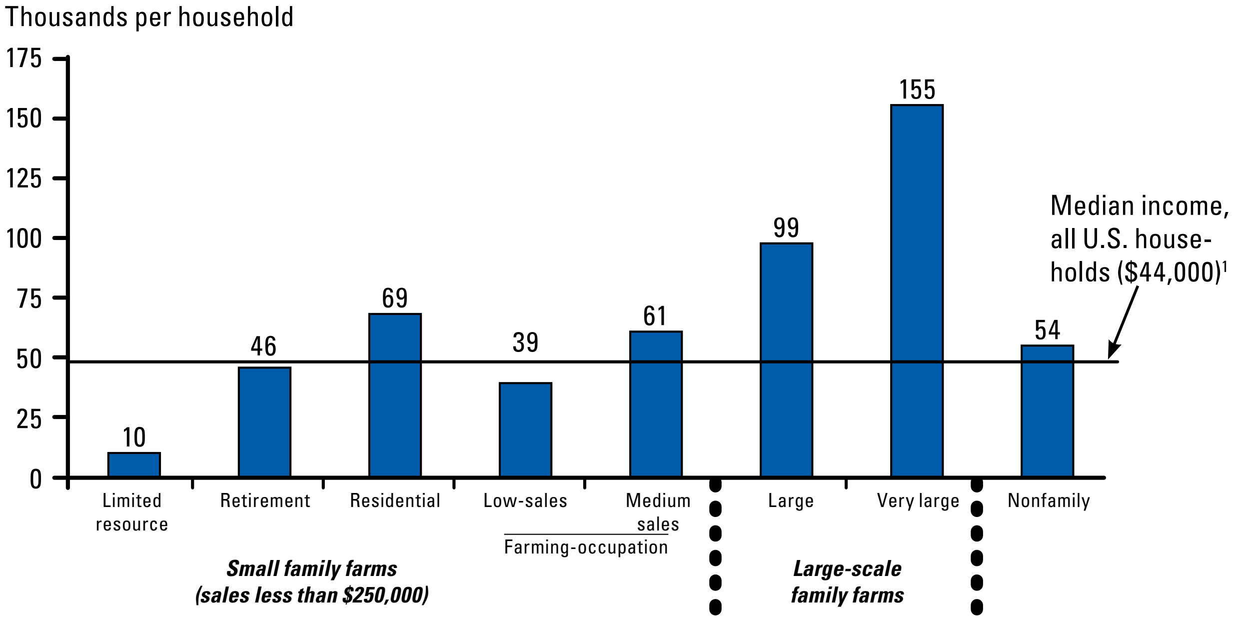
> *Retirement planning is essential to any transition plan.*

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 $\geq$ 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.

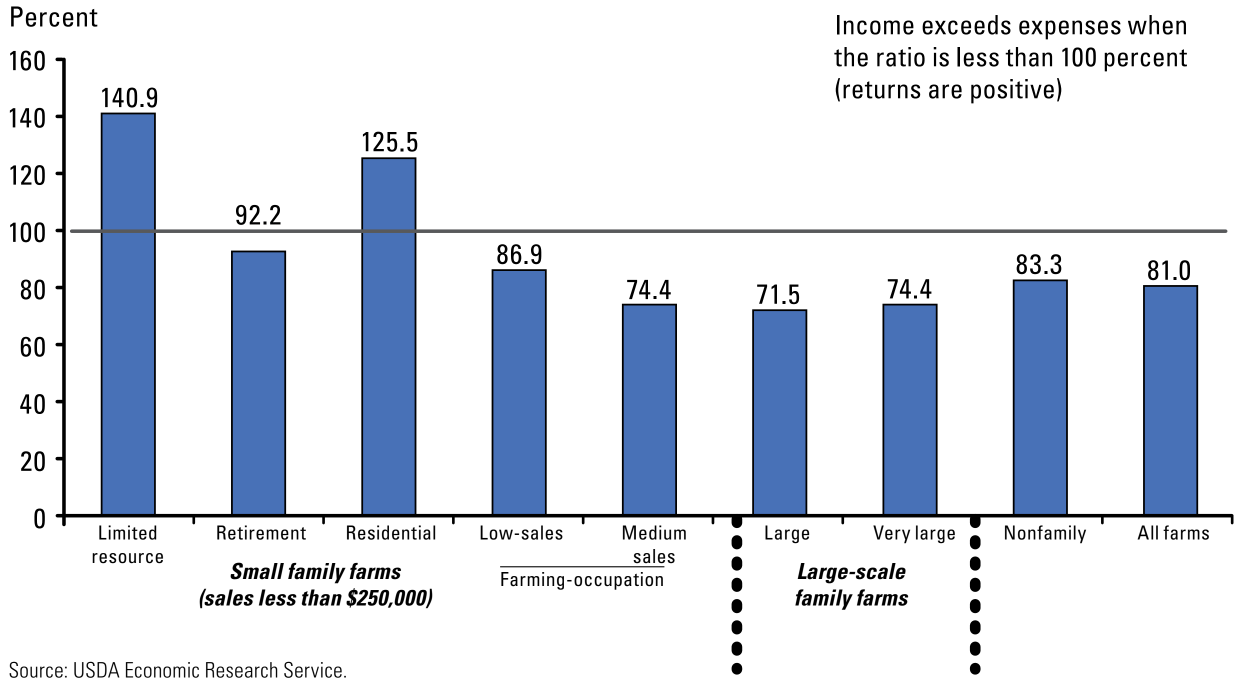
Table 1.13. Percent of Gross Farm Revenues.

	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

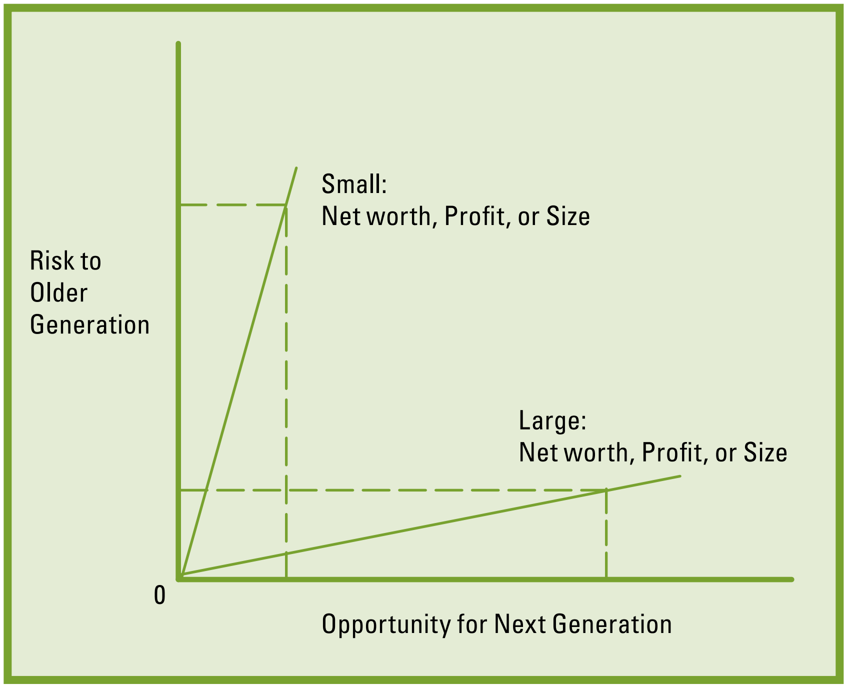
Some Financial Rules of Thumb

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

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.

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

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.

Family farm businesses mix business and family.

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. Some principles or guidelines can help, but each successful transfer is a unique challenge.

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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.

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.

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.

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.

Equal treatment may be virtually impossible when transferring a business.

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.

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

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.

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.

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.

It is the current owners' responsibility to make clear the goals to be accomplished through transfer and the preferred means for transfer.

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

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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.

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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.

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.

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

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."

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.

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

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.

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

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.

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.

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.

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.

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.

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

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.

Residences receive special income tax treatment.

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.

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

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.

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

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.

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

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

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.

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

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.

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.

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

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.

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.

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

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.

Try to include all contingencies when drafting a multi-year lease.

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.

Consider a Farm Purchase Option for Family Members

Unlike some purchase options, the children do not have the right to purchase at any time.

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.

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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