

# Transferring Your Farm Business to the Next Generation

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# Transferring Your Farm Business to the Next Generation

## Five Key Questions Answered

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## 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 tax?

Each of the five parts of the 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.

The bulletin is designed to be a reference used over and over. We do not expect anyone to read it cover to cover in one sitting to learn "all I need 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.

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## About the Authors

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# Part I

## 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 the 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 OSU Extension Bulletin 595, "Estate Planning Considerations for Ohio Families." A business transfer plan may choose to use a combination of all methods. The first question to answer, however, is, "Do we have an economically viable business to transfer?"

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

### Guidelines for Measuring Financial Viability

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

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

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

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.

### Enterprise Size Guidelines

The guidelines can be either input or output measures. Most economies of size can be reached utilizing no more than two full-time workers. Therefore, getting up to at least a two-person operation may be the goal for least-cost production and efficiency. With typical technology, the following enterprise sizes should provide full employment for two people where the farm produces most of the grain and roughage if there is livestock:

- Dairy** ..... More than 90 cows with at least 250 acres of crops for feed
- Feeder Pigs** ..... 150–175 sows with 750 acres of crops
- Farrow-Finish** ..... 100–125 sows with 750 acres of crops
- Cattle Feeding** ..... 750–1,000 head with 750 acres of crops
- General Crops** ..... 1,400–1,500 acres of crops

It is important to recognize that minimum or near minimum cost of production per unit may be possible at these sizes, however, the resulting net income may not be satisfactory.

### Rates of Production

Production efficiency is critical due to its effect on profitability. Following, are some enterprise guidelines that should be met or exceeded over time:

*Most economies of size can be reached utilizing no more than two full-time workers.*

*Production efficiency is critical due to its effect on profitability.*



## Livestock

**Table 1. Dairy Breed Ohio D.H.I.A. Averages, 1994**

	Pounds/Cow/Year		
	Milk	Fat	Protein
Ayrshire	15,230	599	517
Brown Swiss	17,190	702	614
Guernsey	14,570	657	513
Holstein	19,710	721	633
Jersey	13,510	644	509

### Dairy

Feed costs for total herd of less than \$6.50 per cwt of milk produced.  
Feed costs of less than \$1.00 per day for replacements and dry cows.

### Beef Cow/Calf

500–600 lbs of calf weaned per cow/year.  
85–90% calf crop  
Less than 20% annual cow replacement rate  
Less than 5% calf loss  
Ave Daily Gain >2 lbs  
Weaning Rate—100%

### Ewe/Lamb

1.50 lambs sold per ewe per year  
Market lambs gain 0.4 lb./day  
Under 4.25 lb of concentrate per lb of gain

### Farrow/Finish Swine

18 pigs marketed per female per year  
Under 360 lbs/feed per 100 lbs. of pork produced (whole herd)  
Market hogs gain over 1.8 lb per head per day  
\$35 or less cost/cwt. pork produced  
9.7 pigs weaned per litter  
85% of carcasses in premium weight and quality category

### Finishing Cattle

Less than 7 lbs. of feed/lb. of gain  
Market animals gain over 2.5–3.0 lbs. per head per day  
Market weight—1000-1300 lbs  
Carcass weight—650-800 lbs  
More than 75% of carcasses  $\geq$  low choice grade and 2-3.5 Yield Grade

### Crop Yields

Following, are average crop yields for Ohio for two five-year periods. 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.

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

**Table 2. Ohio Average Crop Yield/Acre, 1986–1993**

	<u>1986-90</u>	<u>1989-93</u>
Corn <sup>1</sup> (bu.)	114.00	118.00
Oats <sup>1</sup> (bu.)	65.00	65.00
Soybeans <sup>1</sup> (bu.)	35.00	36.00
Tomatoes <sup>1</sup> (bu.)	23.40	23.50
Wheat <sup>1</sup> (bu.)	53.00	53.00
Sugar Beets <sup>1</sup> (tons)	17.70	15.90
Corn Silage <sup>1</sup> (tons)	14.20	13.30
Canola <sup>2</sup> (bu.)	38.00	38.00
Mixed Hay <sup>1</sup> (tons)	2.85	2.90

<sup>1</sup>Ohio Agricultural Statistics Service

<sup>2</sup>OSU Extension Estimates

### 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 following guidelines are desirable minimum levels of labor productivity for output and typical labor input. Use the input measures to estimate the size of the operation needed to require 2,500–3,000 hours of labor per full-time worker.

**Table 3. Output Measures**

(production sold per full-time worker for a single enterprise)

Corn	90,000–100,000 bu.
Milk	800,000–1,500,000 lbs.
Soybeans	30,000–40,000 bu.
Beef Cows/Calf	250,000–300,000 lbs.
Wheat	50,000–65,000 bu.
Cattle Feeding	500,000–1,000,000 lbs.
Hay	3,000–4,000 tons
Farrow/Finish	400,000–500,000 lbs. pork
Feeder Pigs	2,500–3,000 pigs
Ewes/Lambs	1,300–1,500 lambs
Gross Farm Receipts	\$200,000–\$250,000

**Table 4. Annual Input Measures**

(Operator Labor/Unit of Production)

	<u>Hours/Acre</u>		<u>Hours/Head</u>
Corn	2	Feeder Pig Production	20/sow
Soybeans	2	Farrow-Finish	33/sow
Wheat	2	Beef Cow/Calf	10/hd.
Hay	4	Beef Feeding	4/hd.
Canola	1.2	Dairy	70/cow
Oats	2	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.

## 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. Minimum suggested turnover ratios are:

*Asset turnover measures capital efficiency in terms of output.*

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 (pct. 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. The following are conservative guidelines for these measures:

Investment/Unit		Total Debt Payment/Unit/Yr.
Grains	\$150 machinery/crop acre	\$90/A.
Dairy	\$6,000/cow	\$400/cow
Farrow-Finish	\$40/cwt. pork sold/yr.	\$300/sow
Feeder Pigs	\$60/pig sold/yr.	\$180/sow
Beef Feeding Facilities	\$300/head sold/yr.	\$50/head

## 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 following prices. These figures are the average prices received by Ohio farmers in recent years:

**Table 7. Season Average Prices Received by Ohio Farmers**

	<u>1989-93</u>	<u>1984-93</u>	<u>1979-93</u>
Corn/bu.	\$2.40	\$2.28	\$2.46
Soybeans/bu.	\$5.90	\$5.88	\$6.17
Wheat/bu.	\$3.02	\$3.02	\$3.23
Hay/ton	\$108.20	\$93.15	\$86.97
	<u>1989-93</u>	<u>1984-93</u>	<u>1979-93</u>
Farrow-Finish/cwt.	\$46.45	\$47.13	\$46.88
Feeder Pigs/cwt.	\$77.65	\$82.90	\$81.18
Cattle Feeding/cwt.	\$73.75	\$66.78	\$64.47
Lambs/cwt.	\$58.22	\$62.74	\$61.01
Milk/cwt.	\$13.30	\$13.00	\$13.08

Source: Lines, Allan, "Prices Paid and Received by Ohio Producers," Ohio State University, 1994

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 no. of units produced, both prices and costs require management attention.

**Table 8. Percent of Gross Farm Revenues**

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

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

## 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.

**Table 9. 1989-93 Ohio Monthly Average Prices**

	High Month	Low Month	Season Ave.
Corn/bu.	\$2.53	\$2.23	\$2.40
Soybeans/bu.	\$6.23	\$5.68	\$5.90
Wheat/bu.	\$3.54	\$3.01	\$3.02
Barrows/Gilts/cwt.	\$52.51	\$42.92	\$46.45
Steers/Heifers/cwt.	\$76.08	\$72.28	\$73.75
Lambs/cwt.	\$70.52	\$50.70	\$58.22
Milk/cwt.	\$14.14	\$12.60	\$13.30

Source: Lines, Allan, "Prices Paid and Received by Ohio Producers," Ohio State University, 1994

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

Feeder Pigs	\$87.23
16% Dairy Feed	\$8.74
14-18% Hog Feed	\$9.88
44% Soybean Meal	\$12.48
Beef Cattle Concentrate	\$13.95

## Farm Financial Ratios

Financial ratios can also be used to help evaluate the financial efficiency of the business. The Farm Financial Standards Task Force,<sup>2</sup> a national committee charged with suggesting uniform financial records, has recommended 16 measures including the following financial measures and definitions. 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.

<u>Measure</u>	<u>Definition</u>	<u>Desirable Range</u>
<b>Liquidity</b>		
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
<b>Solvency</b>		
3. Debt/Asset	Total Farm Liabilities ÷ Total Farm Assets	Less than .4
4. Equity/Asset	Total Farm Equity ÷ Total Farm Assets	Greater than .6
5. Debt/Equity Ratio	Total Farm Liabilities ÷ Total Farm Equity	Less than .66
<b>Profitability</b>		
6. Rate of Return on Total Farm Assets	Net Farm Income + Interest Expense <u>- Unpaid Operator Labor &amp; Mgmt.</u> ÷ Average Total Farm Assets (Market Value)	Over 4% ROR
7. Rate of Return on Farm Equity	Net Farm Income <u>- Unpaid Operator Labor &amp; Mgmt.</u> ÷ Average Total Farm Equity	Greater than ROR on Total Farm Assets

<u>Measure</u>	<u>Definition</u>	<u>Desirable Range</u>
8. Operating Profit Margin	Net Farm Income + Interest Expense <u>- Unpaid Operator Labor &amp; Mgmt.</u> + 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 <u>+/- Change in Interest Payable</u> = Net Farm Income From Operations +/- Gain/Loss on Sale of Farm Capital Assets = Net Farm Income	No Standard
<b>Repayment Capacity</b>		
10. Term Debt & Capital Lease Coverage Ratio (T.D. & C.L.C. Ratio)	Net Farm Income From Operations + Non-Farm Income + Depreciation + Interest Paid - Income Tax Expense <u>- Family Living Withdrawals</u> + Scheduled Principal & Interest Payments on Term Debt + Capital Lease Payments = T.D. & C.L.C. Ratio	Greater than 1.25
11. Capital Replacement & Term Debt Repayment Margin (C.R. & T.D. R. Margin)	Net Farm Income + Non-Farm Income + Depreciation - Income Tax Expense <u>- Family Living Withdrawals</u> = C.R. & T.D.R. Capacity - Payment on Unpaid Operating Debt - Principal Payment of Term Debt - Capital Lease Payments <u>- Payments on Personal Liabilities</u> = C.R. & T.D.R. Margin	At least 25% more dollars than scheduled payments on debts and leases
<b>Financial Efficiency</b>		
12. Asset Turnover Ratio (See p. 9)	Gross Revenues ÷ Average Total Farm Assets	Greater than 25-30%
13. Operational Expenses Ratio	Total Operating Expenses <u>- Depreciation</u> ÷ 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%
<sup>2</sup> 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 aid 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.

## Part II

# Retirement and Financial Issues

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

### 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, they 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,
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, and
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 No. 595, *Estate Planning Considerations for Ohio Families*, 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, and 7) maximize total family satisfaction.

Some of these goals are the same as 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 chil-

dren. 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

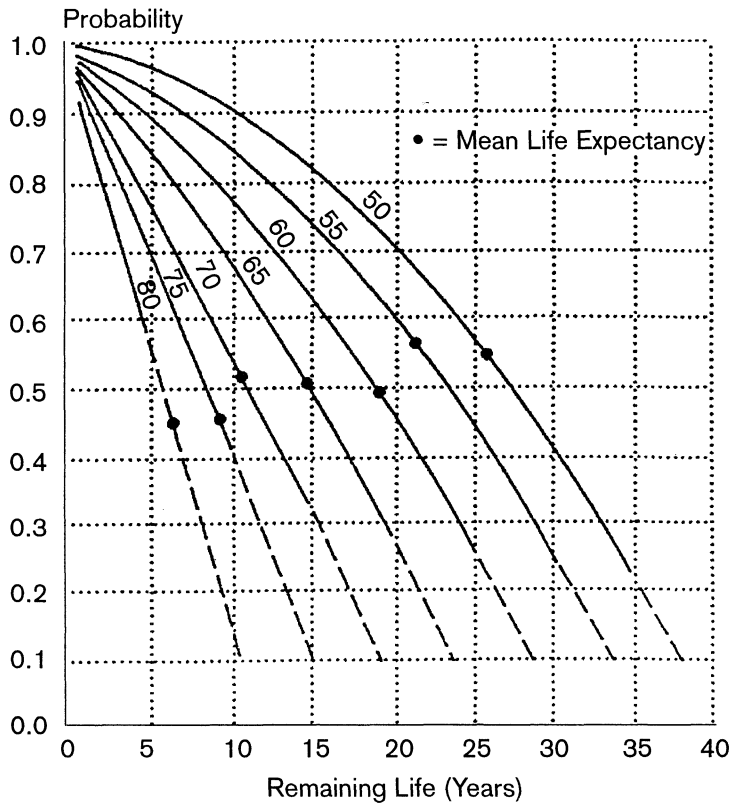
Plans for retirement and transfer must include a realistic estimate of the life expectancies of the parents. Figures 1 and 2 were prepared from U.S. Vital Statistics Life Tables to show individual life expectancies for males and females ages 50 to 80. These graphs help us go beyond mean (average) life expectancies, which are a poor basis for retirement planning.

In Figure 1, the dot on the line for 65-year-old males shows that they have a mean life expectancy of about 15 years. However, the horizontal line tells us that 65-year-old males have a 50 percent chance of living more than 15 more years. Following the age 65 line down shows a 40 percent chance of living another 17 or more years, a 30 percent chance of living another 19 or more years, and so on. The dashed portions of the age lines in Figures 1 and 2 are our projections beyond the range of the data in the Life Tables.

The planning process also should consider the joint life expectancies of both parents. 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. Consider a 65-year-old male and his 60-year-old spouse who are willing to assume a 30 percent chance of living beyond their planning horizon. As noted above, the 65-year-old male has a 30 percent chance of living another 19 or more years. The line for 60-year-old females in Figure 2 shows that the spouse has a 30 percent chance of living about 29 or more years. Since Figures 1 and 2 are based on average population data for individuals, a reasonable approximation suggests that this couple should plan on nearly 20 years together, followed by another 12 years for the surviving spouse. Prospective heirs should use a similar planning horizon to project when they are likely to inherit their parents' estate.

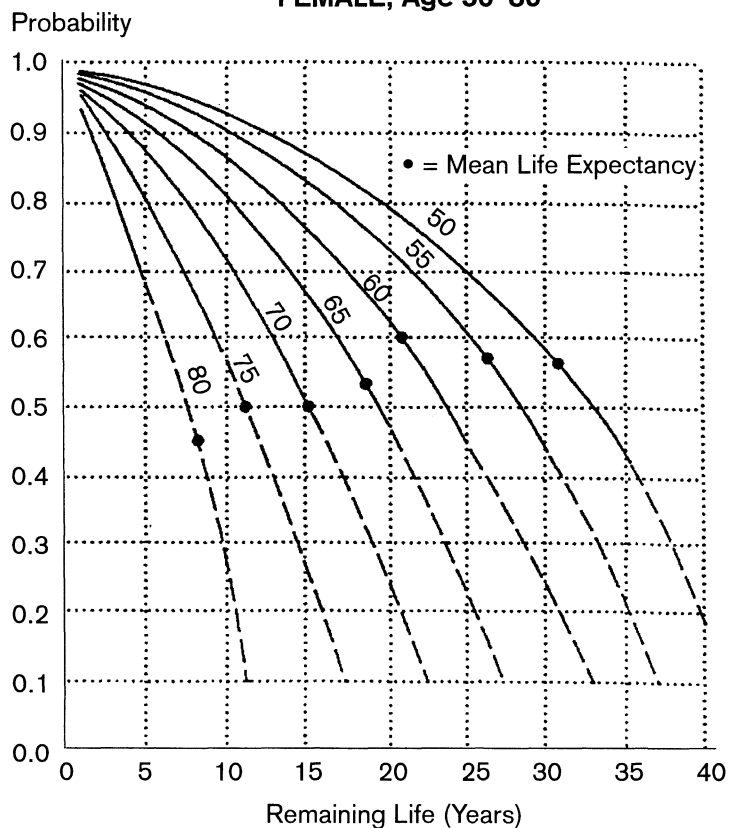
*Actuarial data suggest that one of the two lifetimes should exceed the longest individual life expectancy by about three years.*

**Figure 1. Remaining Life Probabilities  
MALE, Age 50–80**



*A 65-year-old male has a 30 percent chance of living 19 or more years.*

**Figure 2. Remaining Life Probabilities  
FEMALE, Age 50–80**



*His 60-year-old spouse has a 30 percent chance of living about 29 or more years.*

*They should plan on nearly 20 years together followed by another 12 years for the surviving spouse.*

## Effects of Inflation on Retirement Income

The life expectancy graphs in the preceding section illustrate 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 12 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 12 tells us that it will take \$1.63 in ten years to buy what \$1.00 will buy today.

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. 264, *Financial Planning for Retirement*, provides many useful guidelines for estimating retirement living expenses and projecting retirement income. This bulletin lays out the following 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. 264 will help you decide whether the transfer of assets to the next generation should begin before retirement, during retirement or at death. One of the worksheets from Publication

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

**Table 12. 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

No. 264 is included below to illustrate the procedure. The Joneses have projected that their living costs in the first year of retirement will be \$34,884. 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 \$56,860 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.

## 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

*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 3. 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 .....	\$ 4,924	1.63	\$ _____
Household Operation and Maintenance .....	\$ 2,736	"	\$ _____
Home Improvement .....	\$ 855	"	\$ _____
Automobile and Transportation .....	\$ 4,275	"	\$ _____
Food .....	\$ 5,643	"	\$ _____
Clothing .....	\$ 1,368	"	\$ _____
Personal .....	\$ 855	"	\$ _____
Medical and Health .....	\$ 5,130	"	\$ _____
Recreation, Education .....	\$ 4,275	"	\$ _____
Contributions .....	\$ 2,052	"	\$ _____
Taxes and Insurance .....	\$ 1,112	"	\$ _____
Savings, Investments .....	\$ 0	"	\$ _____
Any Future irregular Expense (ex. new roof, new car, new furnace) .....	\$ 1,658	"	\$ _____
<b>TOTAL .....</b>	<b>\$ 34,884</b>	<b>1.63</b>	<b>\$ 56,860</b>

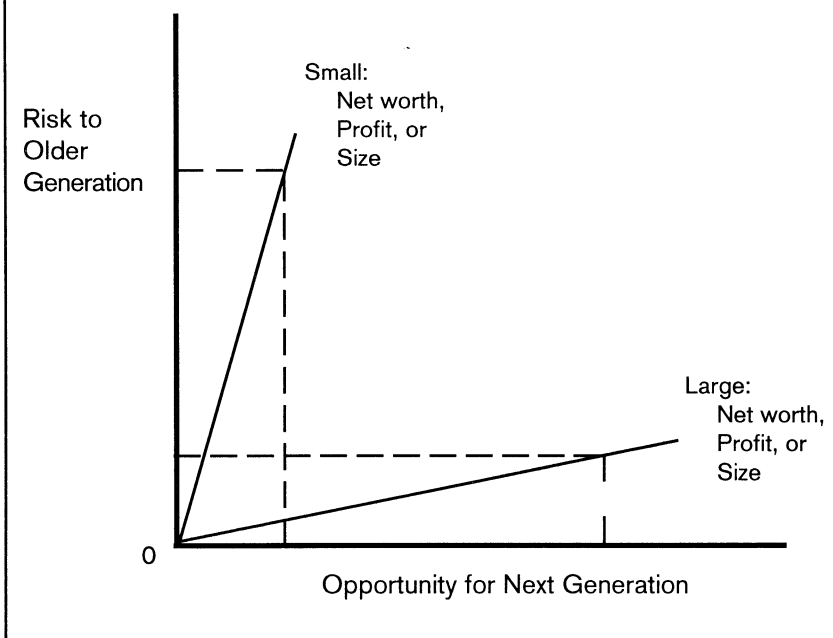
Figure 4. The parents whose situation is depicted in the upper left of Figure 4 have a low net worth in a less profitable, small business. Therefore, they would assume considerable risk to their financial security even if they provide relatively little opportunity for their children to take over the business. The parents in the lower right corner of Figure 4 have a high net worth in a profitable, large business. They are in a position to provide a significant opportunity for the children to become established in farming with very little risk to their financial security in retirement.

## **Net Worth Under \$400,000**

As a guideline, retirement age parents with less than \$400,000 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 \$400,000 net worth would yield an income of \$12,000 per year. This \$12,000 would be

Figure 4. Risk Versus Opportunity



needed to supplement social security benefits so that the parents would have enough retirement income to support a modest lifestyle. A net worth below \$400,000 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.

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 by having 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 \$400,000 or so frequently is evidence of a marginally profitable farming operation for children

*A net worth below \$400,000 or so in a farming operation can barely support one family, much less two.*

wanting to farm full-time. It is even more difficult when the parents need \$15,000 to \$20,000 per year or more from their investment to live on.

### **Net Worth \$400,000 to \$800,000**

Parents with between \$400,000 and \$800,000 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 \$600,000, they also have a potential federal 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 \$600,000 or more. Estate settlement costs will take nearly 50% of every dollar above \$600,000 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 Bulletin 595, *Estate Planning Considerations for Ohio Families*.

### **More Than \$800,000 in Net Worth**

Parents with more than \$800,000 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 \$600,000 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.

**P**rospective 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 1980’s, 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.

*Whenever possible, the children should get financing from a financial institution or other third party.*

### 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, lend-

ers 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: 1) the location of the signature on the note, 2) the language of the note itself, 3) whether the cosigner received any proceeds of the loan and 4) 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 above 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

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

should carefully explain their status of surety in the note. In addition, the parent should sign the note as “John Doe, Surety” to clarify the 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.

### **Selling Property With Debt On It**

If parents transfer property to children that 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.*

## Part III

# People Issues in Transferring the Farm Business

## Some Reasons 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:

*Family farm businesses mix business and family.*

1. Family farm businesses **mix business and family**. For example, family Thanksgiving dinners, often involve more farm talk than family talk. Family problems are mixed with business problems. Solutions are rarely pure business or pure family in nature.
2. It is **difficult** for any one farm business to **provide opportunities that fit all family members' strengths**. The strengths may be in skills not applicable to a farm. For example, a dairy farmer's three children may have limited mechanical, financial management and animal husbandry skills. Their outstanding artistic, musical and finish carpentry skills do not provide a strong pool of talent for a dairy farm's next generation of managers.
3. Farm businesses typically provide **limited career growth opportunities for family and employees**. The vast majority of family farms have fewer than 25 key, year-round people. They usually have one or two levels of management and only one or two top level managers. So, even a highly motivated and talented 35 year old may have a 20-year wait for an opening higher in the business.
4. Health, marriage, weather, and economic **calamities can bring ruin** to even the strongest of family farm

businesses. Planning and insurance can only provide some of the needed protection.

5. **Business continuity requires generation to generation transition.** Correct timing is essential. However, the parents may be unwilling to give up control and authority at the time the next generation wants it and should have it. On the other hand, the next generation may not be ready for their responsibilities when they should take them.
6. **No two farms and no two families are alike.** Each family must discover its own strengths and weaknesses, its own opportunities and its own niche. What has worked beautifully for one farm family business may be a recipe for failure in another.
7. The farm family **must continuously deal with change.** The changes are diverse and pervasive: technology, public policies and regulations, growth and aging of people, and economic opportunities. Farm families must manage change, not avoid it.
8. **Lack of parents' acceptance and affirmation of their children.** Parents may not take their children's emotional needs into consideration. Parents' assertion that 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.

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-per-

*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.*

ception 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; and
- 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 transfer, the two generations work together to make the transfer, and the next generation determines the success of the business after the transfer. The following guidelines are aimed at parents. However, the next generation should find these guidelines helpful in understanding the steps being taken and parents’ decisions.

### Have a Plan

A plan for transfer of the business starts with the parents accepting the fact that someday the business will either have new owners or will not exist. Base a plan on realistic assessments of the past and present, and reasonable expectations for the future. A plan for transfer must be more than a dream to work a little less and have fewer responsi-

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

bilities 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), and arrangements for a testing stage. It 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”**

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.

*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.*

## **Prepare Family Members for Their Responsibilities in the Business**

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

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

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

## **Treat People Fairly Not Necessarily Equally**

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

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

## **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

*Equal treatment may be virtually impossible when transferring a business.*



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. 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.

*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. They 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 a business' culture 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.

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

The amount and kinds of information needed depends on the potential impact of the transfer on their future and the extent of their involvement in the current and future business.

### **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.

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 daughter of the owners, should have a written job description. The employee's perfor-

*Typically, a future owner should first come into the business as an employee.*

*The possibility of leaving, rather than joining the business, is an important argument in favor of a testing period.*

mance 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**

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

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.

### **Involve Outsiders**

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

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.

The committee needs to meet at least once a year and be compensated for their services. It is advisory to the business rather than a decision making body. Call it a board of advisers, 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, talents and expertise is preferable. Regular rotation of committee members assures a continuous source of new ideas and perspectives.

### **Accompany the Transfer 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, and the management team.

The plan needs to be in writing. A variety of business planning tools, e.g., FINPACK, has made business planning possible even for those inexperienced with computers and budgeting.

### **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 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 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.

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

## 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, and
- to keep doing these things over and over even when the children are grown.

## Importance of Parental Affirmation

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

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

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

*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.*

## 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 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."

### **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

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



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 TV, 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 transfer-

ring 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!”

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

### **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.

### **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.

### **Being 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.

### **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

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

too often their attempt fails. Sometimes one or both parents have died. For whatever reason, they 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 Trent, 1986, Thomas Nelson, Inc. may also be helpful.

# **P**art IV

## **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 agents, etc. The next generation needs to understand the history and background of these key relationships.

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

## 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 tractor? A \$75,000 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. 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 they learn 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

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*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.*

completely. The older generation having more at stake financially makes this a logical arrangement. Having control of the checkbook, however, should not relieve the parents of their responsibility of regularly sharing financial information with the children.

## 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 they are going to run the operation in the future.

Frequently someone from the next generation starts helping with the books before they take possession of the farm. They usually learn 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.

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,

*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.*

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.”

## In What Order Do You Transfer Tangible Property?

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

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

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:

- 1) It is easy. Frequently it begins with the parents giving young children a heifer calf, gilt or foal.
- 2) No money changes hands and the animals are still in the herd, so it does not seem to cost much at this point.
- 3) 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.

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

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

*Livestock can be “good investments” for the next generation.*

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.

- 4) 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 their money out of them, if necessary.
- 5) Livestock are mobile. The next generation can take livestock with them or sell them if they decide to leave.
- 6) If the next generation leaves and takes their livestock with them, their livestock may be identifiable and can be sorted out.
- 7) The parents can replace the livestock if the next generation leaves, although there is a cost.
- 8) 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 possible a next generation with limited capital becoming 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 they have received a desired percentage of the breeding herd, if any, and before they buy 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 they have a means of paying for it and are fully committed to staying in the operation.

Income taxes are a major consideration when thinking about selling machinery and equipment to the next generation. In the following 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 their 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.

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

### **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 V 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 which 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. Following are some circumstances that suggest making a real estate transfer:

- 1) The older generation family has a net worth approaching \$1,200,000 or more and wants to reduce potential federal estate taxes.
- 2) Child(ren) live in a home owned by their parents.
- 3) 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.

### 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 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 example above, it was the \$20,000 originally paid for the unimproved farm.

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

“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 it 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 lose the benefits of ownership and the children receive the parent’s \$20,000 income tax basis. The low basis means the children must pay tax on \$80,000 of gain if they sell it for \$100,000.

### When It Pays Not to Sell

**From the 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, it is likely to be sold later by the person(s) who receive it, it may appreciate significantly in value before the death of the current owners, and the parents have a short life expectancy.

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

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

## Alternative Strategies

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

## 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 the 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 the 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.

*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.*

*In general, you cannot avoid income taxes by reinvesting proceeds, but here are five exceptions.*

### **Can't Avoid Tax By Reinvesting the Proceeds**

Some people incorrectly believe that when they sell a farm they can avoid paying taxes on the sale by reinvesting the proceeds in another farm. In general, you cannot avoid income taxes by doing that, but here are five exceptions.

**First**, if you sell your residence and buy a new one of equal or higher value, within two years of selling the old one, you can avoid taxes on gain from the sale of the first home.

**Second**, taxpayers who are at least 55 years old, are allowed a limited one-time exclusion on the sale of a personal residence. Both rules apply to the portion of a farm sale that is the residence of the seller(s). We discuss this in more detail later.

**Third**, when property is involuntarily converted (stolen, destroyed by accident, or seized in condemnation proceedings) the insurance proceeds or condemnation award is not taxable when all the insurance or condemnation proceeds are invested in a similar property within prescribed time limits. Also, there is no tax if the amount received is less than the property's tax basis—a tax loss.

**Fourth**, it is also possible to make a tax-free exchange—where you trade property held for productive use in a trade or business for similar property. Usually, the potential seller asks the potential buyer to purchase property that the seller wants, so they can trade. There frequently is some tax if money exchanges hands or one party assumes another's mortgage. However, the taxes are frequently much less than a sale and a purchase. You need professional help to work out the details.

**Fifth**, there is a special kind of "tax-free exchange" where it is possible to make a deferred property exchange where you have 45 days to designate in writing up to three properties you would accept from the person who wants to get your farm. You have 180 days or by the date your tax return is due, including any extensions in the year the exchange takes place, to complete the trade. Again, this is not a do-it-yourself project.

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.

### **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,

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

“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.

### **\$10,000 Annual Exclusion**

Under federal law, any individual can give away up to \$10,000 to any other individual in one year without having to file a federal gift tax return. The \$10,000 is the “annual exclusion.”

Someone giving away assets with an uncertain value, which may be \$10,000 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 IRS.

Usually a person can make gifts much larger than the \$10,000 annual exclusion without paying any gift tax or other tax on the transfer. A person must file an IRS form 709 anytime they make gifts totalling \$10,000 or more to one person in one year.

For example, each parent can give up to \$10,000 to each child. Similarly, a parent can make separate gifts up to \$10,000 to the child’s spouse, each grandchild, and anyone else, without filing a gift tax return. They can do the same thing each year.

### **\$600,000 Tax-Free Transfers**

The “unified credit” is another important part of federal law that applies to gift taxes and estate taxes.

Under the federal unified credit, every individual can transfer property with a “fair market value” of up to \$600,000 to persons other than their spouse (spouse transfers discussed below), free of federal tax.

We each may transfer \$600,000 by gift during our life *or* through our estate. Under federal law, each of us can transfer \$600,000 tax free to anyone we wish. We can do it while we are alive by making gifts or at death through bequests. We can use part of the \$600,000 to make gifts during life and any remainder to reduce federal estate taxes on the estate.

Every individual may transfer \$600,000. Thus, a couple can transfer up to \$1,200,000 by gift or through their estates, tax free. However, when the first spouse to die leaves all their property outright to the surviving spouse they reduce the tax free transfer to \$600,000. (See OSU Extension

**W**e each may transfer \$600,000 by gift during our life or through our estate.

Bulletin 595, “Estate Planning Considerations for Ohio Families” for a fuller explanation.)

For gifts, the \$600,000 is in addition to the \$10,000 annual gift exclusion. Since the annual exclusion is available each year, you use it first. For example, assume that a widow who had never used any of her “unified credit” gave one granddaughter \$100,000 in one year. The first \$10,000 would transfer tax free under the annual exclusion. She would have to file an IRS Form 709 telling the IRS that she made a gift over \$10,000, but the remaining \$90,000 is not taxed because of the “unified credit.” She could make additional gifts up to \$510,000 or pass that amount through her estate, federal tax free using the unified credit.

The \$600,000 that each of us can pass tax free under the unified credit means most people don’t pay federal estate taxes. Most of our estates are subject to state taxes, attorney fees and other probate costs.

## **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 “unified credit” to do so. Sometimes it is appropriate to make gifts between spouses to balance estates and make maximum use of the unified credit.

## **You Must Give Up Control**

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

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

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

## **“Income Tax Basis” Considerations**

We discussed “income tax basis” in some detail earlier in the section on selling the farm. One important point that



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

## Gifts Aren't Easy Answers

Under current law a family will usually pay less taxes 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 (under \$600,000).

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

## Some Additional Considerations When Considering a Sale or Gift

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

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

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

The operating generation may be bringing a third generation into the business, and they may need the security of a base of operations which 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 generations's security. Long-term leases, options, etc. (discussed later) could be used with the retained parcel(s).

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

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

*Residences receive special income tax treatment.*

“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.

## **Sale of the Personal Residence**

Sale of a personal residence, alone or as part of a farm sale, offers some unique opportunities for postponing or avoiding 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 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 twenty percent of a property's value to the personal residence the seller might attribute twenty 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.

### **Seller 55 or Older**

Persons at least 55 years old are allowed a limited one-time exclusion of the first \$125,000 of gain on the sale of a personal residence. One spouse may be under 55 as long as the other spouse is at least 55 years old. At least one of them must have used the property as a principal residence for at least three-years during the five-year period ending on the date of sale. A person is eligible if he or she (or the person's spouse) did not previously elect the exclusion.

You don't have to use this exclusion unless you want to. Some may want to save it for possible later use. There are other details related to this exclusion that go beyond this text. (See Department of the Treasury, Internal Revenue Service, Publication 523, "Selling Your Home.")

*Persons at least 55 years old are allowed a limited one-time exclusion of the first \$125,000 of gain on the sale of a personal residence.*

### **Buy a Home of Equal or Higher Value**

Usually you can avoid taxes on gain from the sale of a principal residence, by buying another one of equal or higher value, within two years of selling the old one. Usually there are adjustments to the sales price of the old residence and the purchase price of the new one before computing the gain, if any. Keep closing statements as a record of expenses, disbursements and adjustments made at closing. Check current law for particular requirements.

### **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

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

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 \$ 30,000  
- Depreciation - 20,000  
= Adjusted Basis \$ 10,000

This farmer bought a machine for \$30,000. He has taken \$20,000 in depreciation, leaving an adjusted basis of \$10,000. Further assume that the current "fair market value" of this machinery is \$22,000.

### 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 \$12,000 because the fair market value of the tractor is \$22,000.

If the farmer sold the tractor to one person, the result is a \$12,000 gift to that person, and the farmer must file an IRS gift tax return reporting the gift. There is no gift tax unless the farmer has already used up the \$600,000 unified credit (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 \$6,000, and no gift tax return is required.

### Gain Taxed in Year of Sale

If the farmer sells the machine for \$22,000, there is a \$12,000 gain (sales price \$22,000 minus \$10,000 basis). The \$12,000 gain is fully taxable. The income has some additional characteristics that apply to machinery, equipment and similar property.

First, the \$12,000 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 \$12,000 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.

**G**ain, due to depreciation previously taken, is fully taxable in the year of sale.

## 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 2/3 of your total gross income is from farming in the current or prior year. If less than 2/3 of your income is from farming, you fail the 2/3 income test in the year of sale. If you didn’t meet the 2/3 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 1 year (more than 2 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 basis (zero). Thus, when the per-

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

son 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 aren't depreciable and don't qualify for capital gains.

Let's look at purchased breeding stock first, using a simplified example. Assume that a farmer bought a 2-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. 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 3 years of the date of filing the original return, or within 2 years of the time the tax was paid, whichever is later. That would not eliminate the gain, but it would reduce taxable income in previous years and possibly generate a refund.

### **Purchased Market Livestock**

*Purchased market livestock have a basis equal to their cost.*

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

## Selling Raised Grain, Hay, and Inventories

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

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

### Sales After Retirement

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

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

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

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

### Required Minimum Interest Rates

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

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

## **Seller-Financed Sales**

The minimum rate for most seller-financed transactions is 9%, or the “applicable federal rate,” whichever is lower. However, there is a special 6% rate available for certain farm real estate transactions (discussed below). 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 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 is the lesser of the rate for the month of the seller-financed sale or the previous two months. For seller-financed sales for \$2.8 million or less, the required rate cannot exceed 9% compounded semi-annually (9.2% compounded annually, 8.9% compounded quarterly, or 8.84% compounded monthly).

## **6% Farm Real Estate Loans**

The required minimum interest rate for **land** sales of \$500,000 or less (per year) between family members is 6% compounded semi-annually. Buildings, tile lines, fences, personal residences, etc. are not land and do not qualify for the 6% 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 to the borrower's net investment income on any day the total outstanding loans between the borrower and lender is \$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.

*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.*

## 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 gift. It allows the parents to maintain the financial security of ownership. The lease payments are taxable income to the parents, but since they are unearned, they are not subject to social security tax and do not reduce social security payments. 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 I)

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? Main-

taining 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. 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 10-25% 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.

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

## 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. 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 gift. When we say “long-term lease,” we are thinking of a farm lease that spans 3 to 8 years, although the actual length is somewhat arbitrary.

For our purposes, it makes little difference whether it is a cash lease or 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 3 to 8 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.

### **Why a 3 to 8 Year Lease?**

A 3 to 8 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 3 more years remaining when the child’s widowed mother dies, the child has at least 3 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

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

always extends 3 to 8 years into the future until it is terminated. For example, each year when it is renewed, the renewal could extend it for another 3 to 8 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 under age 70, "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 1 year cannot be legally enforced unless it is in writing. A lease of 3 years or more can be enforced against persons other than the original parties (such as a new owner) only if it is both written and recorded. An abbreviated memo of lease can be recorded to avoid public disclosure of lease details.

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

### **Some Disadvantages of Leases**

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

One of the biggest potential disadvantages of a multi-year lease is that all parties are stuck with the others for what may be a considerable period of time. It can be quite a problem if one party wants out, others will not let him or her out and the lease has another 5 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 the lease is fair. Some leases unduly favor one party over the other.

For those reasons, it may be best to begin with a 1-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

*A lease with a term of more than 1 year cannot be legally enforced unless it is in writing.*

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

specify the terms for making such improvements, or an attorney should prepare a separate legal document.

## Consider a Farm Purchase Option for Family Members

Earlier we looked at sales, gifts, and leases of farm property from parents to children. We saw that when a sale or gift from the parents to the children does not seem appropriate, it may make sense for the parents to consider leasing the property to the children on a multi-year lease. This provides some additional security for the children.

Buy/sell agreements are a type of purchase option frequently included in a farm partnership or farm corporation to provide for purchasing a partner's or shareholder's stock when he 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.

**U**nlike some purchase options, the children do not have the right to purchase at any time.

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, disability, or divorce that makes a sale less desirable. Sometimes the parents can buy back the option. Other times they may simply refuse to sell, or they may have to sell to children other than those to whom they would prefer to sell.

## **Valuation Concerns**

There are many ways to set the selling price to the person holding an option. Sometimes the price is determined by the price offered by some bona fide third party purchaser.

The option itself could specify a set purchase price. If the price is near fair market value when set, and the buyer pays reasonable consideration for the option, it probably will be acceptable to the IRS. However, any attempt to set the price artificially low, freeze prices, or avoid estate or gift taxes is likely to come under the scrutiny of the IRS.

You could put a method for determining price in the agreement. The method could require an appraisal, valuation by formula, capitalization of earnings, or another reasonable method.



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*Planning Your General Farm Partnership Arrangement*, OSU Extension, NCR 224.

*Prices Paid and Received by Ohio Producers, 1979–93*, OSU Extension, ESO 2153.

*Understanding Social Security*, Department of Health and Human Services.

# County Extension Offices

<b>Adams</b> (513) 544-2339	<b>Delaware</b> (614) 368-1925	<b>Jefferson</b> (614) 264-2212	<b>Noble</b> (614) 732-5681	<b>Vinton</b> (614) 596-5212
<b>Allen</b> (419) 222-9946	<b>Erie</b> (419) 627-7631	<b>Knox</b> (614) 397-0401	<b>Ottawa</b> (419) 898-1618	<b>Warren</b> (513) 932-1891
<b>Ashland</b> (419) 281-8242	<b>Fairfield</b> (614) 653-5419	<b>Lake</b> (216) 350-2582	<b>Paulding</b> (419) 399-8225	<b>Washington</b> (614) 373-6623 Ext. 274
<b>Ashtabula</b> (216) 576-9008	<b>Fayette</b> (614) 335-1150	<b>Lawrence</b> (614) 533-4322	<b>Perry</b> (614) 743-1602	<b>Wayne</b> (330) 264-8722
<b>Athens</b> (614) 593-8555	<b>Franklin</b> (614) 462-6700	<b>Licking</b> (614) 349-6900	<b>Pickaway</b> (614) 474-7534	<b>Williams</b> (419) 636-5608
<b>Auglaize</b> (419) 738-2219	<b>Fulton</b> (419) 337-9210	<b>Logan</b> (513) 599-4227	<b>Pike</b> (614) 947-2121	<b>Wood</b> (419) 354-9050
<b>Belmont</b> (614) 695-1455	<b>Gallia</b> (614) 446-7007	<b>Lorain</b> (216) 322-0127	<b>Portage</b> (330) 296-6432	<b>Wyandot</b> (419) 294-4931
<b>Brown</b> (513) 378-6716	<b>Geauga</b> (216) 834-4656	<b>Lucas</b> (419) 245-4254	<b>Preble</b> (513) 456-8174	
<b>Butler</b> (513) 887-3722	<b>Greene</b> (513) 372-9971	<b>Madison</b> (614) 852-0975	<b>Putnam</b> (419) 523-6294	<b>East District</b> (614) 732-2381
<b>Carroll</b> (330) 627-4310	<b>Guernsey</b> (614) 432-9300	<b>Mahoning</b> (330) 533-5538	<b>Richland</b> (419) 589-2919	<b>Northeast District</b> (330) 263-3831, 263-3832
<b>Champaign</b> (513) 652-2204	<b>Hamilton</b> (513) 825-6000	<b>Marion</b> (614) 387-2260	<b>Ross</b> (614) 775-3200	<b>Northwest District</b> (419) 422-6106
<b>Clark</b> (513) 328-4607	<b>Hancock</b> (419) 422-3851	<b>Medina</b> (330) 725-4911	<b>Sandusky</b> (419) 334-6340	<b>South District</b> (614) 286-2177
<b>Clermont</b> (513) 732-7070	<b>Hardin</b> (419) 674-2297	<b>Meigs</b> (614) 992-6696	<b>Scioto</b> (614) 354-7879	<b>Southwest District</b> (513) 454-5002
<b>Clinton</b> (513) 382-0901	<b>Harrison</b> (614) 942-8823	<b>Mercer</b> (419) 586-2179	<b>Seneca</b> (419) 447-9722	
<b>Columbiana</b> (330) 424-7291	<b>Henry</b> (419) 592-0806	<b>Miami</b> (513) 332-6829	<b>Shelby</b> (513) 498-7239	
<b>Coshocton</b> (614) 622-2265	<b>Highland</b> (513) 393-1918	<b>Monroe</b> (614) 472-0810	<b>Stark/Summit</b> (330) 497-1611	
<b>Crawford</b> (419) 562-8731	<b>Hocking</b> (614) 385-3222	<b>Montgomery</b> (513) 224-9654	<b>Trumbull</b> (330) 675-2595	
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<b>Darke</b> (513) 548-5215	<b>Huron</b> (419) 668-8219	<b>Morrow</b> (419) 947-1070	<b>Union</b> (513) 644-8117	
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