



Retirement Planning- Providing Financial Security for Farmers in Transition

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Ohio Farm Example to Avoid

- 70 year old couple still milking cows, but need help.
- Not enough cows to justify full time hired labor.
- Raised & Educated Family, kids moved away and have families and careers of their own.
- Though they were able to cash flow the farm, even through lean times, they never really had or reported much of a profit, therefore...
- Receiving very low social security payments.
- Capital gains on sale of assets leaves little money.....because there is still considerable mortgage! Can not afford to move to town.
- Began to use “zero percent” credit cards to fill-in shortfall.

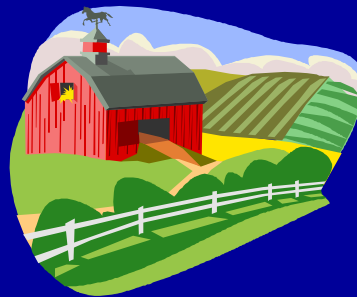
Farm Operators are Older

- 25% of farmers and about half of landlords are over age 65
- Older aged farmers and landlords control over a third of all farm assets
- Operators are farming longer, even a popular part-time retirement activity
- 3 % of overall labor force are over age 65
- Non-farmers are more dependent upon Social Security, during retirement, than are farm households

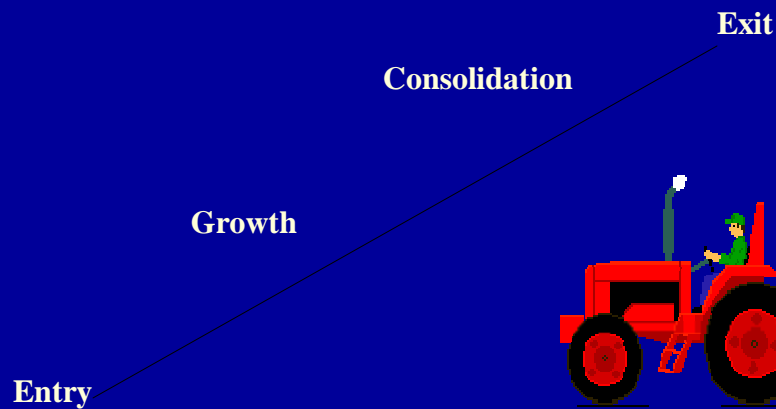
USDA Economic Research Service

Every Business will Transfer Someday

- **Installment/Outright Sale**
- **Gift**
- **Lease**
- **Buy/sale Agreement**
- **Inheritance**



Life Cycle of a Business



Detaching Older Generation from Financial Responsibility

- Farm financial crisis of the 1980's, about 2-300,000 commercial farms went out of business
- Children should get financing from a financial institution or other third party
- If parents must cosign a loan, do so as an accommodation party or limited guarantors, not as co-makers

Retirement Planning

1. The Planning Horizon

- Present Ages
- Retirement Dates
- No. of retirement years



2. Living Costs

- Now
- First year of retirement & beyond
- Business contribution to living costs?

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How Many Years?

	<u>M. Age 65</u>	<u>F. Age 60</u>
Mean Life Exp.	14 yrs.	22 yrs.
30% Prob.	20 yrs.	30 yrs.
Joint Prob.	33 yrs.	

**Plan on 20 years together plus 13 more for surviving spouse

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Life Expectancies Increasing

- *An 85 year old man can expect to live another 6 years to 91*
- *An 85 year old woman can expect to live another 7 years to 92*
- *The chance to outlive resources increase with age*
- *It is projected that in 2050 the average life expectancy will be about 89! (77 in 2000, 70 in 1960)*

Family Living & Farm Size

- Average family living cost \$40-47,000
- Requires \$225-300,000 gross revenue
- An average operating expense ratio of 74% (excluding interest & depreciation) leaves 26% for debt service, capital replacement, growth, investment and family living costs.

Cont'

- An average \$250,000 business will net \$65,000. After \$40,000 family living, only \$25,000 will remain for debt and investment.
- The top 20% of producers net \$80,000
- Lower 20% only nets \$30,000
 - Off farm income
 - Fugal living
 - Mining the equity

David Kohl, Virginia Tech

Income Needs Analysis

- Family living expense _____
- Term debt service (principal only) _____
- Carryover debts (principal only) _____
- Income/self employment taxes _____
- Reinvestment in the farm business _____
- **Saving for retirement**, college, etc. _____
- Other wants/needs _____
- Total income needed _____
- Less non-farm income available _____
- Income needed from the farm _____

Rule of 72

- How fast will income need to double due to inflation?
- At 4 % annual inflation, $(72 / 4)$ 18 years to double living costs.
- “Rule of 115” will estimate how long before living costs will need to triple.

Family Living Costs Midwest Farms

- 1980 \$15,600
- 1990 \$27,300
- 2000 \$38,400
- Now \$40-47,000
- Rule of “72” doubled money required in 18 years or so



A Virginia Tech Study:

- An average farmer with his \$500,000 farm, to finance his retirement, will outlive his equity by 14 years when taxes, cost of living and extended hospital care are considered!



Marginally Adequate Net Worth

- Must maintain net worth for retirement income
- The average (2004) social security income per month for a retired worker was \$ 922, or \$1523 for a couple
- If a retired couple needs 80% of previous family living (\$45,000), then social security only provides half of the \$36,000 required for a comfortable retirement
- A reasonable real (inflation adjusted) rate of return of 3% means a \$600,000 net worth is required to make up the \$18,000 difference.

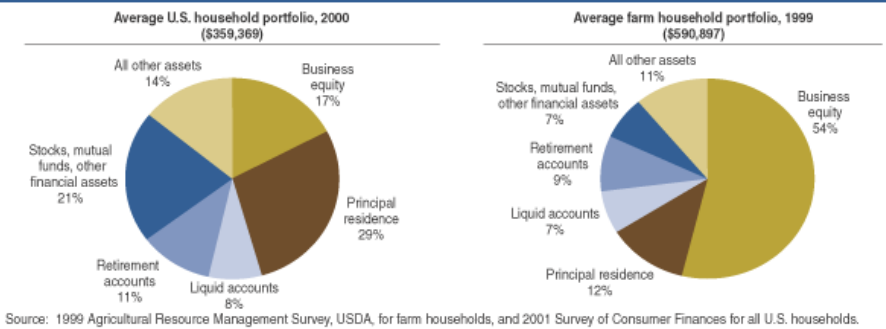
Net Worth is \$600,000 to \$1,000,000

- Adequate for retirement, but must be cautious about transferring large amounts of property
- Federal Estate Tax will not be a problem:

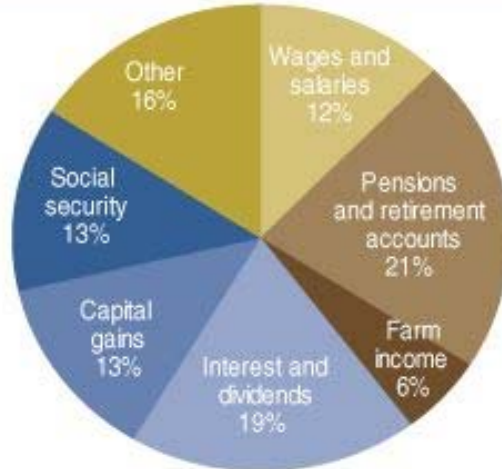
Year	Amount Excluded from Tax
2003	\$ 1,000,000
2004	\$ 1,500,000
2006	\$ 2,000,000
2009	\$ 3,500,000
2010	Repealed
2011-	\$ 1,000,000

USDA Economic Research Retirement Study

Farm households have a more diverse portfolio, with substantial business equity, than all U.S. households



Farm operators receiving social security also receive income from other sources



Source: Internal Revenue Service, Individual Public Use Tax File, 1999.

Family Farm Investments in Non-farm Assets (2001-2005 Average)

Stocks & Bonds	\$ 9266
Other Current Assents	\$ 3730
Cash Value of Life Insur.	\$ 8924
Retirement Accounts	\$ 25,065
Other Intermediate Assets	\$ 6,231
Total	\$ 53,216

FINBIN Data, average of 3227 Farms from MN, ND, NB, OH, MO, UT, and WI

Income for Retirement

- Land and/or Machinery Rent
- Employment plus (Health Care Benefits)
- Savings and Dividends
- Social Security
- Life Insurance
- Retirement Plans
- Selling Assets
- Deferred Compensation Agreements
- Consulting Agreements



Retirement Income

Retirement income received from the partnership, under a written plan, is not included in earnings subject to self-employment tax if:

- ✓ Performed no services for the partnership
- ✓ The retired partner is owed only the retirement payments
- ✓ Any share of partnership capital was fully paid
- ✓ Payments are lifelong, periodic payments

Deferred Compensation Agreement

Paid for Labor Performed

- May also provide medical reimbursement plan and health insurance coverage under IRC Section 105.



Land Rent



Factors About Ohio Farmland Leasing

- 47% of Ohio farmland is leased.
- Nearly 2/3 of land farmed by larger commercial farm operations is leased.
- Cash rent used on over 75% of leased land, 25% share rented.
- ***Will future generations have enough farmland in their portfolios to generate retirement income?***

Land Leasing Alternatives

- Fixed Cash Rent
- Flexible Cash Rent
- Share Rent
- Custom Farm



Sale of Assets



Avoid Unnecessary Taxes when Taking a Family Member into the Business

- Selling assets to younger generation over time, gifting assets to the younger generation or a combination of selling and gifting.
- Younger generation's cash flow is very important.

What Assets to Transfer & When Should Assets be Transferred?

- **Breeding Livestock First**
- **Inventories of Grain, Hay and Feed:**
Ignore, transfer when inventories are lowest (Mar-Apr), or sell over time.
- **Machinery & Equipment:**
Tax considerations, lease from older generation, trade away old/replace with new
- **Land and Buildings last**

Cash flow we don't control

- **Social Security**
- **Other pensions**
- **Why no control?**
 - When payments start, no longer paying in.
 - Set terms when payments start.
 - May or may not adjust for inflation
 - Generally for our life - & of our spouse

Social Security

- Based on lifetime earnings (35 highest years)
- Meet own work requirement or married to eligible worker for 10 years
- Benefit estimates sent annually
- Full retirement age increasing to age 67
- Earnings limits for “early” retirees (62 to full retirement age)

Never meant to be only \$ource.



Medicare

- Age 65 eligibility unchanged
- 7-month window to enroll in Part B (medical insurance)
- General enrollment period is first three months of each year
- Delayed enrollment increases premium 10% per year of delay

Resources we control

- **Tax Deferred Annuities or IRA's**
- **Securities**
- **Personal Residence**
- **Life Insurance**
- **Savings and CD's**
- **Other Investments** - Real estate, business, collectibles, etc.

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Saving & Investing Differ

Savings \$

- Kept in safe, low-risk vehicles
- Liquid
- Yield low returns
- Used for short-term goals

Investment \$

- Involve risk
- Value can go up and down in short time periods
- Offer potential for growth
- Used for mid- & long-term goals



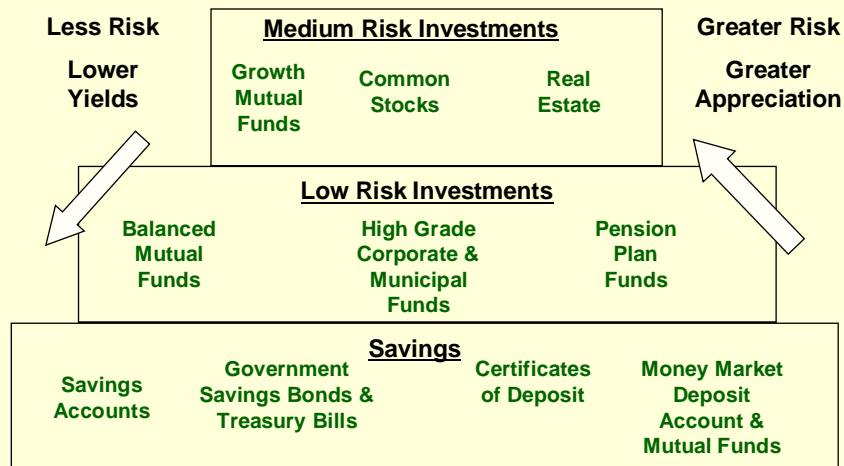
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Concepts of Investing

- **Return** - Why you invest
- **Risk** - Why you invest carefully
- **Diversification** - Spreading the risk
- **Balancing** - Capturing gains and maintaining the diversification necessary to keep risk at desired level
- **Management** Do it yourself or pay someone

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Risk and Return Are Related



Retirement Plans

- Traditional IRA- \$4000, 50+ \$500 catch-up
- Roth IRA- Earnings are tax free
- SEP- All employees included.
- SIMPLE IRA- Employer (self) \$10k plus \$1500 catch-up for 50+

May qualify for Retirement Savings Tax Credit

Ave. Annual Returns, 1926-1999

Asset	Mean*	Standard Deviation
Common Stocks	13.3	20.1
Farm Real Estate	10.5	8.5
Govt. Bonds	5.5	9.3
U.S. Treasury Bills	3.8	3.2
Inflation	3.2	4.5

Sources: Ibbotson & Associates, USDA.

*Includes income, dividends, etc. (+/-) capital gains

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Two-Thirds Ranges

<u>Investment</u>	<u>- One S.D</u>	<u>+One S.D.</u>
Common Stocks	-6.8%	+33.4%
Farmland	+2.0%	+19.0%
Govt. Bonds	-3.8%	+14.8%
T-Bills	+0.6%	+3.2%
Inflation	-1.2%	+7.8%

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Sample Correlations

	<u>T-Bills</u>	<u>Bonds</u>	<u>Land</u>
Bonds	.08		
Land	-.48	-.39	
Stocks	-.09	-.39	-.14

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Investment Choices

1. **Money Market** – Savings accounts, T-Bills, CD's, other, ...
Risks – inflation.
2. **Fixed income** – Bonds (treasury, corporate, municipal, ...)
Risks – Interest rate risk, business risk, inflation.

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Investments, Cont'd

3. **Equities** – Common & preferred stocks
Risks – Business risk, market risk.
4. **Tangibles** – Real estate, commodities, antiques, collectibles.
Risks – Business risk, liquidity.

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Diversification - Spreading the risk

- A mix of investments is prudent. Use a mix of cash, bonds & stocks.
- | <u>Risk</u> | <u>Cash, FI, Stocks %</u> | <u>Ave. return?</u> |
|-------------|---------------------------|---------------------|
| – Lower | 55, 20, 25 | 6% |
| – Medium | 20, 35, 45 | 8% |
| – Higher | 0, 35, 65 | 10% |
- Get more conservative as we age.

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TDA's or IRA's

- Can convert to cash flow as needed (after age 59-1/2).
- Payout can be lump sum, set period of years, for life, over joint lives, etc.
- IRS requires minimum distributions once the owner reaches 70 1/2
- Distributions will be taxed as ordinary income, i.e. up to 35% federal tax rate.

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Securities

- **These are primarily stocks, bonds and mutual funds.**
- **Current interest, dividends and capital gains may be used for cash or reinvested.**
- **You decide when to convert the principal to cash.**
- **Taxed on gain. Max 15% if capital gain.**

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Life Insurance

- **Quit paying premiums, if cash value & dividends can pay them.**
- **Terminally ill? You may be able to get proceeds advanced for use during lifetime.**
- **Some recommend you cash in policies and invest proceeds elsewhere.**
 - **What cash can you get from policy?**
 - **What are you giving up?**

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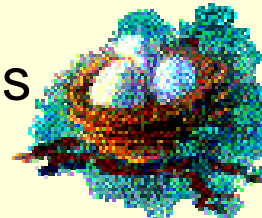
Personal Residence

- Can convert to cash, but still need housing.
- Sale will generally be tax free.
 - Gain up to \$500,000 for couples.
 - Gain up to \$250,000 for singles.
- If want to stay in house, but need cash:
 - Home equity loan
 - Reverse mortgage



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Saving's and CD's



- Ready cash whenever needed.
- Possible uses during lifetime:
 - Unexpected medical expenses
 - Major household repairs
- Possible uses upon death:
 - Funeral expenses
 - Estate settlement costs, including taxes

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Other Investments

- Investments in real estate or a business
 - Takes longer to convert to cash.
 - Typically most gain will be capital gain, taxed at up to 15% rate.
- Collectibles - stamps, coins, etc.
 - Capital gain, but taxed at up to 28%.

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Assumptions

Current incomes & expenses = \$40,000

Pensions, SS = \$30,000

Income from investments = \$10,000

Return on investments = 8%

Inflation = 3%

Real return = 5%

Nest egg = $\$10,000 / .05 = \$200,000$???

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Spending the Nest Egg (5% Real Return)

<u>Years</u>	<u>Nest Egg Needed for \$10,000 / Yr.</u>
5	\$43,296
10	83,063
15	103,799
20	124,626
25	140,944
30	153,728

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Final Thoughts

- Review your plans from time to time
- Calculate retirement income needs- 80 to 100% of pre-retirement income
- Plan half of retirement income from non-farm investments or social security
- Consider Long Term Care Insurance
- Plan for living arrangements after retirement
- Look to live longer than you would expect, (just not forever).

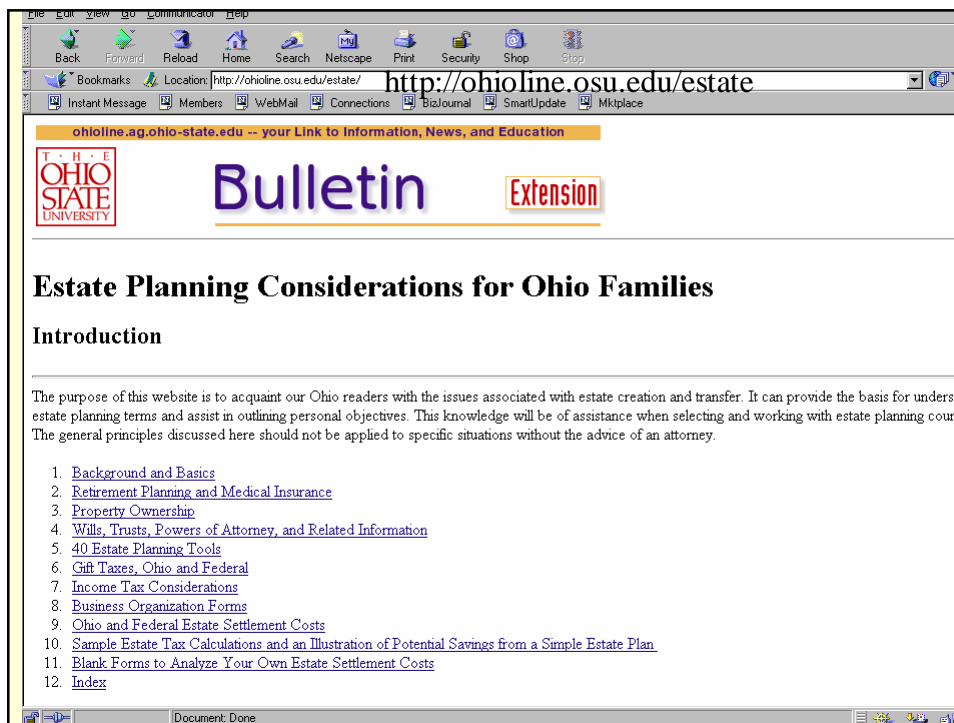
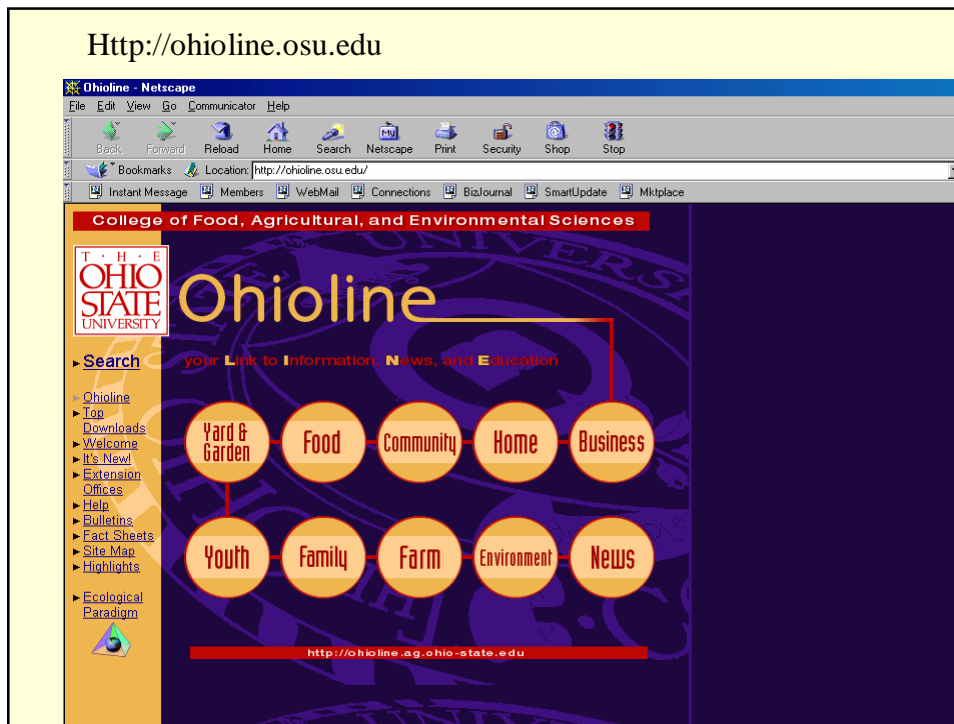


Table 1. Asset and Liability Ownership and Value*

Asset	Total (\$)	Owned as Sole Proprietorship, Tenants in Common, or Joint with Rights of Survivorship with Spouse.		Joint with Rights of Survivorship with Someone Other Than Spouse	
		Spouse 1 (\$)	Spouse 2 (\$)	Spouse 1 (\$)	Spouse 2 (\$)
Real Estate					
Farm 1					
Farm 2					
Cash on Hand or in Banks					
Automobiles & Trucks					
Machinery					
Livestock					
Crops					
Household Goods					
Life Insurance					
Retirement Plans & Annuities					
Transfers Subject to Tax					
Stocks, Bonds, & Mutual Funds					
Other Business Investments					
Notes, mort. & Acct. Rec.					
ASSET TOTALS					
- Indebtedness					
NET WORTH					

<http://ohioline.osu.edu>

Fact sheets---Farm Rental Series



Family and Consumer Science Educational Efforts in Ohio

- “All about Money” fact sheet series
- Financial Security in Later Life programs

http://extension.osu.edu/home_family_and_youth/financial_security.php



2006 North Central Risk Management Education Center Grant

- “Building for the Successful Transition of Your Family Business”
- Development of fact sheets, a bulletin, a teaching team of Extension Educators, and four (two day) workshops across the state of Ohio during the winter of 2007



“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”

**Transferring Your Farm Business to the Next Generation
OSU Extension Bulletin 857 (1996)**