

ESTATE AND FARM TRANSITION PLANNING FOR AGRICULTURAL PRODUCERS

Kynda Curtis¹

PART I: KEY CONCEPTS & STEPS IN AGRICULTURAL ESTATE PLANNING

A common misconception among farmers and ranchers is that “the best way to protect farmland is to farm it” (Crossgrove and Freedgood, 2002). While maintaining a working operation may be important as a personal or family goal, one of the best ways to protect farmland is proper estate planning.

Farming and ranching, like any business, can be a risky venture. Additionally, farmland preservation has become increasingly endangered, as the market value of farmland is often higher for non-farm uses. Farmland is especially vulnerable to conversion pressures when passing from one owner to the next. For these reasons even families that plan to pass on the farm/ranch to the next generation can lose their land without sound estate planning. Good estate planning can help transfer both the land and the business from generation to generation.

Reasons People Avoid Estate Planning

There are three common reasons that people avoid estate planning.

“Our family knows how we want to divide our assets-we don't need a will.”

Some families believe that they don't need a will because they have made their intentions known to the next generation, or because they only have a limited number of heirs or a small amount of assets. However, if a decedent doesn't have a will in place at the time of death, the state has the authority to allocate the assets per state law, regardless of the decedent's wishes or the wishes of the decedent's heirs.

“We've had a will for years-our estate is planned.”

Although drafting a will is a very important part of estate planning, it is not enough. Estate planning outlines the distribution of assets like a will, but it can also create financial security for heirs, address business organization issues, and grant peace of mind to heirs and the grantor. As tax laws constantly change and families grow, it is important to revisit and update your will at least every few years.

“We don't need an estate plan-we'll divide everything equally among our children.”

A major estate planning issue with farm and ranch families is the allocation of assets among farm and non-farm children. While giving each child an equal share of the assets may seem like the most equitable solution, such a plan could result in the future loss of the farm or ranch.

For example, consider a family with four children, three off-farm, one on-farm. If the parents leave equal shares of the family assets to each child, the on-farm child may not be able to afford to buy the farm shares from his/her siblings who want a cash settlement, resulting in a farm sale

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in the end. Estate planning can help families find the most equitable distribution of assets, which may not be a completely equal distribution.

Five Goals of Estate Planning

The five basic goals behind estate planning are the following:

Transfer Ownership: The primary goal of estate planning is to facilitate the transfer of ownership and management of the farm business, farmland, and other assets. Estate planning ensures that the farm/ranch will be passed along to the intended party with as few complications as possible.

Reduce Estate Taxes: The second goal of estate planning is avoiding unnecessary transfer taxes. Transferring ownership of assets can be very complicated for the layman, and amid the complex laws and confusing language is the potential for extreme transfer taxes. Planning the estate with the assistance of a knowledgeable professional (a lawyer well-versed in tax law would be best) will help limit the taxes the estate has to pay.

Secure Financial Future: The third goal of estate planning is to ensure financial security for all generations. As mentioned before, without proper documentation showing how assets should be allocated, the state has the ability to distribute the estate as it sees fit. Just as important, the estate can be set up so that the costs of medical care, funeral costs, and the costs of settling the estate are covered by the estate, rather than on the shoulders of the estate's beneficiaries. The estate can also be set up to provide living costs, educational costs and more for the surviving heirs.

Develop Management Skills: The fourth goal of estate planning in the farm/ranch context is to develop the next generation's management skills. With a properly planned estate, you and your family can choose the business ownership structure and asset transfer methods that allow the younger generation to participate in the management and ownership of your farm/ranch as soon as both generations are ready.

Keep Land in Agriculture: The fifth goal of estate planning may be to keep productive land in agriculture. There are different mechanisms that can be used to ensure that the farm/ranch will continue to be actively used in agriculture in the future, such as conservation easements.

Starting an Estate Plan

The following tips can help give farmers and ranchers an idea of how to start their estate plan.

Set Goals: As you begin to consider the estate planning process, take some time to set basic goals for your estate and keep these goals in mind throughout the entire process. This will help keep you on track.

What kind of goals should be considered? Ask yourself the following questions as a start:

- Do you want to generate income for retirement?
- How will you support yourself or your spouse in the case of a medical emergency or disability?
- Who do you want to make decisions about your property if you are ill or after you die?
- Who do you want to take charge of the farm after you die?
- How will the costs of settling your estate be paid?
- How will you ensure financial security of your surviving family members?
- How will you minimize estate taxes?

Inventory Your Assets & Assemble Your Team: To plan your estate properly, you must know your financial worth, so accurate estimates of your asset values are very important. When it comes time for you to inventory your assets, you should involve your accountant and/or lawyer for guidance. In addition to your personal assets, you should determine the exact value of your business assets as well as any debts you or your business owe.

Determine Ownership & Assets: Make sure you know all of the associated business and legal relationships involved in your estate. For example, many farm/ranch couples have joint ownership of their land and business with rights of survivorship. With this sort of a business ownership, the farm/ranch will be passed on to the surviving spouse regardless of the wishes of the other survivors. It is essential that you know how your business is structured. Below are several common forms of business ownership and their associated implications.

Sole proprietor: the most common form of agricultural business ownership. The business is owned by only one person, who is liable for all debts and obligations of the business.

Partnership: involves two or more parties, who are liable for all debts and obligations of the business. Often used as a way to bring family members into the business by sharing ownership and operating assets while giving the younger party the opportunity to build equity in the business.

Limited partnership: creates two classes of partners: general or managing partners and limited partners. General/managing partners control the partnership and are liable for the debts and obligations of the business. Limited partners are passive investors who do not manage the business and whose liability is limited to their investment. Often, farm/ranch families create a limited partnership to accommodate farm and off-farm children: the farm children become managing partners while the off-farm children are limited partners.

Corporation: established as a legal entity separate from the owner(s) to provide liability protection to shareholders. Aside from liability protection, one benefit of corporations is that they continue to exist even as individual owners change. Due to high income tax rates, corporations are better suited to large-scale farm/ranch operations.

Limited liability corporation (LLC): combines the limited liability of a corporation with the flexibility and tax schedule of a partnership. An LLC can also be used as the general partner in a limited partnership, giving the individual owner(s) protection from liability.

Estate Planning Examples

Joint Ownership With Rights of Survivorship

Jim and Frances Smith own and operate a 500-acre dairy farm with 300 cows. They have four grown children, two who live on-farm, and two who are off-farm. Jim and Frances share ownership of the farm through joint tenancy with rights of survivorship. Although they do have a will, it was drafted when the children were young and does not reflect their current \$1.3 million net worth. Jim and Frances would like to pass ownership of the farm along to their on-farm children, and would like to bequest an equitable monetary amount to their off-farm children.

With no additional estate planning, if Jim and Frances were involved in an accident and passed on at the same time, or within several weeks of one another, it is likely that their assets would be divided equally among their four children. If this was the case, how would the on-farm children come up with the money to buy the farm shares from the off-farm children? If the on-farm children were unable to come up with the money necessary to buy out their siblings, the farm may end up being sold off, opening up the possibility that the land would not stay in agriculture, nor would it stay in the family.

One solution would be to draft a buy/sell agreement. A buy/sell agreement could set the price and terms of the siblings' buyout and could address potential financing options as well. A well-structured buy/sell agreement would ensure that Jim and Frances' children could retain ownership of the farm after they pass on.

A second solution would be to split the estate. As the estate is set up now, if Jim passes on before Frances, with rights of survivorship Frances would receive Jim's half-interest in the farm. By changing the ownership of the farm from joint tenancy to tenancy in common, Jim and Frances could each leave their half-interest in the farm to the on-farm children in their will. Another option would be to leave each half-interest to a trust, with instructions to the trustee that keeping the land in agriculture is a priority and that the land must be sold to the on-farm children according to pre-arranged terms. In addition to creating more assurance that the farm stay in the family and in agriculture, such an estate split would allow Jim and Frances to maximize the use of their applied tax credits, doubling the amount of assets they can pass on to their children free from federal estate taxes.

Waiting Until the Last Minute

When Bill and Roberta purchased their farmland in the early 1960s, they paid \$250/acre. The current value of the land is \$1500/acre. Bill and Roberta would like to retire to Arizona, leaving the management and ownership of the farm to their son, Roy, the only of their four children who lives on-farm. Bill and Roberta have reached their mid-60s and would like to retire in the next two years, but have no estate planning in place. As the majority of Bill and Roberta's net worth is tied up in their land, an immediate sale of the land would mean huge capital gains tax for Roy.

If Bill and Roberta were to pass on before resolving their estate issues, it would be virtually impossible for Roy to come up with the money necessary to buy out his siblings. No matter what estate plan Bill and Roberta end up choosing, the first step for them is to start the immediate transfer of assets to Roy by sale and by gift. This will reduce the amount of land retained by Bill and Roberta and will also provide Roy with additional liquidity to buy out his siblings if need be. The next move may be for Bill and Roberta to create a family limited partnership. The limited partnership would retain ownership of the land, while managing interest would be given to Roy and the other children would hold limited partnership investment interests.

Regardless of what Bill and Roberta decide to do, it is essential that they move quickly. Waiting until retirement age to begin estate planning limits the amount of assets that can be passed along as tax-free gifts and may limit estate planning options.

SUMMARY

Regardless of the techniques you use to plan your estate, keep in mind that estate planning involves some of the most important family, business, financial, legal, and tax decisions you will ever make. You must have confidence in your advisors and be able to work with them on an ongoing basis. Estate planning can be time consuming and costly, but neglecting to plan can cost your family a lot more than creating a plan.

PART II: ESTATE TAXES & ASSET TRANSFER MECHANISMS IN AGRICULTURE

Discussing the allocation of your family's farm/ranch assets in the event of death or retirement can be uncomfortable for both the older and younger generations. However, planning for these events in advance may reduce estate tax liability and help to ensure that all parties are satisfied with the plan. Basic elements of estate planning include completing a will and keeping it updated, creating a living will and power of attorney, and setting up both a management and transfer plan for land and other operating assets. The information presented in this fact sheet should not be substituted for professional advice, but can be used as a guide when planning for the future of your farm/ranch.

Estate Taxes

Every estate with a value of \$1,000,000 (2006) or more must file an estate tax return. This taxable amount is reduced by deductions for funeral expenses, debts, charitable contributions, and asset transfers to the decedent's spouse. The deductible amount for 2006 is \$2 million, but this figure will increase again in 2009. The maximum estate tax rate for 2006 is 46%, which will decrease in 2007. The values are all set forth in the Economic Growth and Tax Relief Reconciliation Act of 2001.

As farmers and ranchers (as well as other small business owners) hold significant amounts of wealth in the form of business assets, they are more likely to owe estate taxes. Combined with such factors as the appreciation of land values, the increase in average farm/ranch size, and increased investment in farm machinery and equipment, farm/ranch estate values have increased. Subsequently, estate taxes due from farmers/ranchers have increased as well.

The creation of the special farm/ranch provisions Federal estate and gift tax policy will increase the deductible amount and decrease the maximum rate in the coming years. These changes have greatly reduced the liquidity issues facing farm/ranch beneficiaries.

Both estate and gift taxes must be paid within nine months of passing or receipt of gift. If at least 35% of the estate's value is a farm or ranch, estate taxes may be paid over a 14-year period in installments. Keep in mind that tax laws change constantly.

Asset Transfer Mechanisms

The following sections outline techniques that may help you plan the future of your farm or ranch. As you read through this information, keep in mind that methods of transfer will greatly affect tax liability on the part of both the older and younger generations.

Trusts: Trusts are temporary legal arrangements that separate the ownership and benefits of an asset. They can be used as both an asset and as a source of income, and are categorized according to when they take effect and whether or not they can be changed. Although almost any type of asset, such as stocks and bonds, can be placed in trust, property is often placed in trust as a tool to transfer and manage the property. Farm/ranch families may consider placing farmland in trust, but should be aware that the trust document should specify how the farm is to be managed. To set up a trust, a trust document is created outlining the assets to be maintained in the trust. Additionally, the beneficiaries of the trust are designated, and the trustee(s) are appointed. Trustees are required by law to wisely and prudently manage the trust assets. Who should be a trustee? Banks and other financial institutions usually have trust administration departments, or family members or friends may be assigned as trustee(s). Both professional and

individual trustee fees are usually set by state law, based on a percentage of the value of assets in the trust. This percentage generally decreases as the value of the assets increase.

Living trust: A living trust is created to permit the separation of management and benefits of trust assets during the grantor's lifetime (hence the name "living trust"). Living trusts are useful in managing assets, or avoiding probate in particularly sensitive or complicated situations. In most farm family businesses, living trusts may be cumbersome as title to the grantor's assets, including all farm assets, must be transferred into the trust (ex. title to any bank accounts, stock certificates, real estate). The grantor must make this transfer, which is called "funding" the trust. Executing the living trust itself will not cause the trust to be funded. When a living trust is created, a pour-over will should also be drawn to address the allocation of any assets the grantor purchases or inherits after the living trust was created. Assets obtained after the creation of the trust will be "poured over" into the trust, avoiding probate.

Credit Shelter Trust: A credit shelter trust is specifically created under a will to take advantage of the federal estate tax exemption. Assets equal to the current federal exemption amount are used to fund a trust that typically will pay income to a spouse and distribute the principal to children at the spouse's death. As exemption amounts are slated to rise dramatically over the next several years, this type of trust should be considered very carefully and revisited regularly.

Enterprise Operating Agreement: An enterprise operating agreement can be used as the initial agreement for a two-generation arrangement. The younger party invests capital in the personal property, operating capital, or livestock of one specific enterprise of the family farm/ranch. In exchange for this investment, the younger party receives a portion of the income from the enterprise in the same ratio as his/her contribution of capital, labor, and management. The younger party has no management responsibility and receives a wage for labor performed for enterprises he/she is not invested in.

Buy/Sell Agreements: A buy/sell agreement allows you and your family to prepare for such events as death, divorce, bankruptcy, or retirement that may affect the ownership and operation of your farm/ranch. A buy/sell agreement is a legal document that outlines who can purchase the shares of a departing partner of the business, exactly what events will trigger such a buyout, and the price of the departing member's shares. While a buy/sell agreement can be an excellent way to transfer the ownership of your farm/ranch to the next generation, it is important to keep in mind that a buy/sell agreement will not work if the buyers cannot come up with the money to exercise their right to buy the farm/ranch business.

Gifts: Each individual is allowed to transfer up to \$12,000 (2006) annually to an unlimited number of individuals in the form of a gift. Gifts under the allowable amount are not subject to tax, do not count against the amount exempted from the unified tax credit, and can be in the form of either cash or assets. For example, a husband and wife can each give \$12,000 to each individual for a total of \$24,000. However, gifts in excess of \$12,000 per person are subject to estate taxes.

Life Estate: A life estate allows you to donate your farm or home to a charity or nonprofit organization while retaining lifetime use of it for yourself and your spouse, without having it included in your estate. A life estate accomplishes several objectives: it allows you to support your favorite charity or nonprofit organization; you can use an income tax deduction for the present value of your remainder interest in your home or farm; your farm or residence may not be taxed as a part of your estate; and you and your spouse can enjoy your home or farm for the rest of your lives, knowing that it will support a worthy cause in the future. On the downside, putting your home and/or land into a life estate may make it more difficult to operate your farm,

because the future owner may want to have a say in how the property is managed. However, a life estate can be a safe way to keep your farm/ranch property in agriculture after you pass on. This may be of particular importance to families without children, or whose children do not wish to continue working the land.

Machinery Transfer: When passing ownership of farm/ranch machinery and equipment, you must consider the cash flow needs of the buyer as well as the tax consequences to the seller. For example, with an outright sale, taxes from depreciation recapture and capital gains are due in the year of sale. With an installment sale, depreciation recapture and capital gains taxes are still due in the year of sale, but the cash payments are spread out over a number of years. An installment sale may help relieve some of the cash flow issues for the younger generation. Another option is to sell machinery/equipment to the younger generation one piece at a time so the taxes to both parties are spread out over a number of years. There is also the option of joint ownership, meaning each party retains half-ownership of each piece of equipment, or that each party owns specific items, but continues to use all items. As with all other assets, gifting machinery/equipment may have gift tax implications depending on the value of the item. If you are considering passing machinery/equipment to the next generation in the form of a gift, consult your attorney to be sure it is the best choice for all parties. If gifting seems like the best choice because the younger party has limited capital, leasing machinery/equipment can be considered. When leasing machinery/equipment, the size of the lease payment may be based on the cost of owning the machine and the amount of time the two parties would like to allow to complete payment. Before entering into a lease agreement, both parties should come to a decision on which party will pay for any repairs during the term of the agreement. Another option for the case of limited capital is a labor/machinery sharing agreements. Sharing agreements can be used when the younger party "spins off," establishing his/her own separate farming operation. The younger party contributes labor to the older party in exchange for use of machinery, which should be an even exchange. The younger party should be given a wage for labor in excess of machinery contribution.

Land Transfer: An outright cash sale of the farm/ranch and/or farmland/ranchland is not always the best choice for transfer between generations. It is often assumed that selling the property and land to the younger generation rather than bequeathing it will reduce estate and inheritance tax liability. This is not always the case, and is something that should be considered with your tax professional. If cash flow is an issue for either party, an installment sale may be used. Installment sales of property and land can be spread out over several years, which can help reduce cash flow issues for the younger generation while the older generation uses the payments to cover living and retirement expenses. There are two considerations in an installment sale. First, inflation will reduce the purchasing power of installment payments, especially if payment is spread out over many years. Both parties should plan for this in advance. Second, there is the possibility that the older generation will outlive the payment stream, which is especially important if the older generation has no other source of retirement income. Again, both parties should plan for this situation in advance of the sale. An option that takes cash flow into account is gifting the land. The gift of land can be included in the gift tax-exempt \$12,000 each donor can gift per year (2006). However, a gift is a transfer of property and will not generate income for the older party. If income from the sale of the property is needed to sustain the older party's retirement and/or living expenses, then a gift may not be the best choice.

A final land-transfer option is to simply leave the property to the next generation through a will. This method allows the older party to continue using the property and/or to continue

receiving income from the property through their retirement. However, with a will, all taxes will be assessed on the property at the time of passing and may total a significant percentage of the value of the property.

Livestock Transfer: There are several common practices used to pass ownership of livestock from one generation to the next. For breeding livestock, the older party may choose to sell a portion of the herd at a time, while retaining ownership of some of the stock. There is also the roll-over approach, where the older generation retains ownership of the breeding herd, but the offspring of the breeding herd is owned jointly with the younger generation. Over time, all ownership has been "rolled-over" to the younger generation. Feed and market livestock may be transferred in a slightly different manner. One common method is for the older generation to transfer ownership of the herd to the younger generation at the low point of the feed inventory. Ownership can also be transferred between the sale and replacement of livestock.

Life Insurance

Term and whole life insurance can be valuable elements of your estate plan. Term life insurance pays benefits if the insured party passes on during the term of the contract, while whole life insurance pays benefits and also accumulates a savings account within the policy. Whole life insurance is generally more expensive than term life insurance.

Regardless of the type of life insurance, the proceeds are often income tax-free, and can be used to:

- Generate a tax-free inheritance for your heirs.
- Create a more equitable estate in the case of farm and off-farm heirs: you can transfer the farm to farm children and give the insurance proceeds to off-farm children.
- Pay estate taxes: life insurance can serve as a cost-effective way to make sure that your heirs have cash on hand to pay estate taxes.
- Fund a buy/sell agreement for your heirs. A life insurance policy can also be owned by the business entity and can be used to buy out the deceased person's share of the business.

If used correctly, life insurance may be used to lessen the financial impact of a loss to the farm business.

SUMMARY

Choose the farm transfer and estate planning methods that feel most comfortable for you and your family. As the owner/operator of your business, you are in the best position to decide what's best for you, your family, and your farm/ranch.

For tax purposes, it may make sense for your family to start transferring assets from one generation to the next sooner rather than later. The more time that is allowed for transfer, the more options all parties have to minimize estate, gift, and inheritance taxes. However, it may be wise to delay asset transfers until both generations are comfortable with the commitment. As the owner of your farm/ranch, you are in the best position to evaluate the options and determine what will work best for you, with the guidance of a trained professional.

Locating an Estate Tax Professional

It is essential that you discuss your estate planning and asset transfer plans with an attorney or other tax professional before making any formal decisions. To locate a professional near you, look under "accountants" and/or "attorneys" in your local phone book. Additionally, the State

Bar of Nevada runs a free, non-profit Lawyer Referral & Information Service (LRIS). LRIS will help you find an experienced professional based on your needs and location at no cost. For more information, call LRIS at (800) 789-5747 or visit them online at: <http://www.nvbar.org/lris/lris.htm>.

PART III: RETIREMENT STRATEGIES FOR AGRIBUSINESS OWNERS

Farm and ranch households are affected by savings and retirement plans differently than most households in the United States. Due to the nature of farm business, farm households have different savings habits and more diverse financial portfolios than typical U.S. households. In general, farm households have more personal savings than the average household and have less dependence on social security income during retirement. Additionally, farm households earn income from both farm and off-farm sources. Commercial farm operators are less likely to have an employer-sponsored pension and more likely to receive a larger share of their retirement income from farm assets.

Retirement planning is especially important for farmers who would like to retire in the next five to fifteen years. Currently, nearly 80% of Nevada's farmers are 45 or older, while 25% are 65 and older (NAS, 2005). Older age-group farm operators and landowners are staying in farming longer than previous generations, due in part to improved health and longevity, and to technological advances that have enabled farmers/ranchers to perform physical tasks longer than previous generations could.

Develop a Financial/Retirement Plan

There are four key steps to developing your financial/retirement plan:

Identify Your Goals: Determining your financial goals in advance is the best way to ensure that you follow the investment path that best meets those goals. Keep in mind that while long-term goals may not change much over the years (i.e. retirement planning, passing your business to the next generation) your asset allocation strategy will change as you age: as you move closer to retirement, you may want less risky investments. This combined with market fluctuations makes updating your goals and investments an important part of any financial strategy.

Estimate Net Worth, Income, & Expenses: Your net worth is a comparison of what you own (assets) with what you owe (liabilities). When developing your investment strategy, first estimate your monthly income and expenses to measure your monthly disposable income, or the income that's left over after paying your required expenses. Your monthly disposable income determines the amount you can afford to contribute to your investments each month.

If you discover that your monthly expenses exceed your income, you have the opportunity to see which expenditures can be eliminated or postponed, or if additional income can be earned. If your income exceeds your expenses, it is time to determine how your excess income should be allocated to meet your financial goals.

Estimate Your Risk Tolerance: Risk tolerance is your psychological and financial ability to tolerate market volatility. Your risk tolerance will adjust as you age. For example, young people can afford to be risky with their investments because retirement is far enough away that they can handle potential losses. People approaching retirement should use a more conservative approach.

While making investments that are too risky for your financial standing can have obvious negative impacts on your investments, it is also unwise to be too conservative with your

investments. Taking risks with your investments while you are young may improve your chances of reaching your financial goals, especially if those goals involve creating retirement income.

Investment Terms

- Liquidity:** the speed and ease with which an asset can be converted into cash.
 - High liquidity: cash, savings accounts, mutual funds, stocks
 - Medium liquidity: certificates of deposit (CDs), savings bonds
 - Low liquidity: long-term bonds, real estate
- Inflation:** a general increase in the price of goods and services that reduces purchasing power.
- Time Value of Money:** due to inflation, the value of a dollar is greater today than it will be in the future.
- Return on Investment (ROI):** a payment made to an investor in return for use of the investor's money; may be distributed as interest, dividends, or growth in the value of the asset/investment.
- Risk:** the probability that an investment will perform below expectations.

The Financial Pyramid

Speculation
Income Generation
Wealth Building
Stable Foundation

Choose an Investment Strategy: Financial planners suggest that investors "layer" their investments according to the financial pyramid. For a pyramid to be sturdy, it needs a stable foundation. Your financial pyramid should have a stable foundation composed of cash assets, the most liquid type of asset. Although cash assets pay the lowest interest rates, they are liquid, convenient, safe (banks, credit unions, and savings and loans insured by the FDIC offer a high degree of safety for both principle and interest) and are easier to obtain in an emergency than other assets. Cash assets include savings accounts, life insurance, CDs, U.S. Treasury bills (T-bills), U.S. Savings bonds, and money market accounts.

Emergency/opportunity funds are a key element of your stable financial foundation. You should have emergency/opportunity funds on hand to handle emergency situations, or to provide you with the ability to take advantage of a particular situation, such as a special purchase or vacation funding. Personal insurance, such as life insurance, and disability insurance, should also be considered as a part of your foundation, as they protect your dependants from hardship in the event of death or disability.

The next level is wealth building, including assets such as stocks and stock mutual funds. Purchasing a stock is purchasing a small price of the corporation. In effect, the investor becomes part owner of the business. Investors make money from stock ownership in two ways, through capital appreciation or through dividends. A mutual fund is a pool of money, owned by a group

of investors, and invested in various stocks and/or bonds under the guidance of a professional portfolio manager. When an investor purchases a mutual fund, he/she becomes part owner in the securities held in that fund.

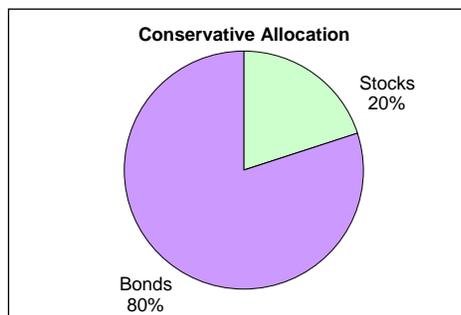
Moving up the pyramid, the next layer of your investment strategy should be income-generating assets, such as bonds. Bonds are a loan to a government or corporation, where the investor acts like a bank, receiving interest on the loan until the loan is paid off on the maturity date of the bond. Bonds offer a steady income from interest payments and flexible durations for investing, from one to thirty years. Bonds may be issued by corporations, and state, local, and national governments.

The top layer of your financial pyramid is speculative assets. Speculation is the act of choosing very risky assets, such as emerging market securities or junk bonds, in hopes that they will perform well and turn a high profit. These assets are considered riskier than others because they are highly volatile. It is wise to invest the least amount of money in speculation, because the risk of the asset underperforming is high. Investors approaching retirement should be especially careful with speculation.

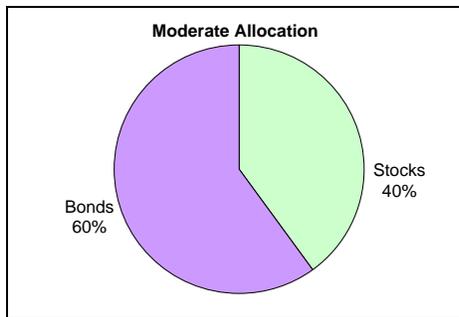
What is Asset Allocation?

Each asset type has its own return and risk characteristics, and combining them appropriately within a portfolio can reduce the overall risk of the portfolio. The goal of asset allocation (focusing on the two middle layers of the pyramid) is to mix assets that tend to rise and fall somewhat independently of each other. Investors usually base allocation decisions on four main factors: risk tolerance; personal financial goals; the time horizon for those goals; and the need for liquidity.

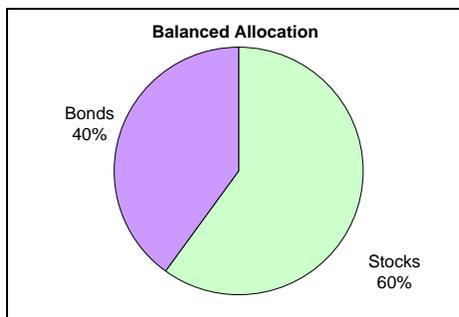
A conservative asset allocation is made up of about 80% bonds and 20% stocks. Over the period of 1946-1998, this asset mix had an average annual return of 8% (Russell University (RU), 1999). A conservative allocation is appropriate for investors who will be retiring in the near future.



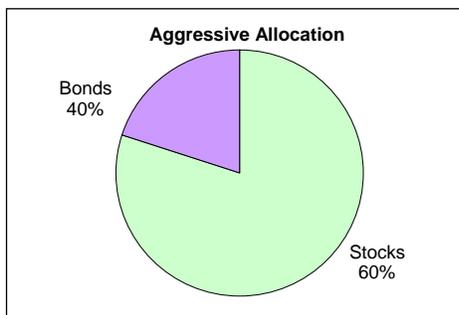
A moderate asset allocation is comprised of about 60% bonds and 40% stocks. The moderate allocation strategy has had an historical average annual return of 9% (RU, 1999). A moderate investment allocation is ideal for investors who have in the neighborhood of ten years until retirement.



A balanced asset allocation is composed of 40% bonds and 60% stocks. The balanced allocation has had an historical average annual return of 11% (RU, 1999). The balanced allocation is good for investors who have approximately ten years to retirement and who can handle a bit more risk than that of the moderate allocation.



Asset allocations are considered to be aggressive when made up of about 20% bonds and 80% stocks. The aggressive allocation has had an annual average return of 12% (RU, 1999). This allocation mix is right for investors who have more than ten years until retirement.



The asset allocation with the greatest amount of return is the equity aggressive allocation strategy, made up entirely of stocks. Stocks have had an average annual return of 14% (RU, 1999). This might be the right asset mix for someone just starting out in the work force, or someone who will not need access to their investments for at least fifteen years.

Choosing the right allocation and making regular monthly investments can help you take advantage of an investment strategy known as dollar cost averaging. Dollar cost averaging is the process of making equal payments into an investment at regular intervals, so that you are buying

shares at low prices when the market goes down and at higher prices when the market goes up. Over time, this strategy averages out the per-share cost.

Small Business Retirement Plans

In the past, small business owners including agribusiness owners, and employees had few options for retirement planning. However, over the past decade, more options have become available. The following provides a description of a few of the current available options. A *401(k)* retirement plan allows your employer to contribute a certain amount of your pre-tax income to investment options that you choose from your employer's list. This money is taxed when withdrawn, on both the state and federal levels. Most farm/ranch owners will probably not qualify for 401(k) programs, as they require at least twenty-five employees and can be expensive to administrate.

Nearly every type of asset can be held in an individual retirement account (*IRA*, also referred to as individual retirement annuity), including stocks, bonds, mutual funds, and real estate (moneycentral.msn.com). Traditional IRA contributions can be tax deductible depending on income and tax status, and are not taxed until you withdraw. Upon withdrawal, the account is taxed as ordinary income. Penalty-free withdrawals can be made for qualifying expenses, including education, medical expenses over a certain amount, certain health insurance, a first-time home purchase, disability, and death.

Roth IRA accounts differ from Traditional IRAs in that you are able to grow and cash out your account tax-free. Roth IRAs do have some restrictions. For example, you can only invest money you earned as income from a job. This means you cannot save more money than you earned in a year, and cannot make contributions from leftover student scholarships, gift money, etc. However, benefits of the Roth include the ability to withdraw contributions at any time, tax-free and without penalty, without having to pay it back. Note that you can only withdraw contributions without penalty; there are high taxes applied to the withdrawal of earnings.

The Savings Incentive Match Plans for Employees (*SIMPLE*) IRA allows small businesses to establish a simplified retirement plan for their employees. To be eligible for a SIMPLE IRA, you must have one hundred or fewer employees. The employer makes tax-deductible contributions, and employees are allowed to defer a percentage of their income into the retirement plan. Employees are allowed to make their own contributions, but the business must match all contributions up to \$10,000 annually.

To be eligible for a Simplified Employee Pension (*SEP*) IRA program, a business only needs to have a handful of employees. SEP IRAs are low cost and low maintenance as business owners do not need to file annual reports with the IRS. SEP IRAs are funded with tax-deductible employer contributions, the amount which can vary from year to year. Employee contributions are not allowed.

Any small business is eligible to set up a *defined benefit plan*. If you are looking to retire in the next 10 years or so and haven't built up a nest egg, a defined benefit plan can be a good opportunity to save. Employers make all contributions based on actuarial estimates, with the annual retirement payout not to exceed either \$175,000 or the average of the employee's three highest-earning years annually. The downside of defined benefit plans is that they can be expensive, including the cost of required actuarial services. Additionally, there is no employee control over investment options and the plans are not very flexible.

Further Information

Cooperative State Research, Education, and Extension Service (CSREES) maintains a website that features articles about finances and retirement, with an emphasis on later life financial planning. (www.csrees.usda.gov/nea/economics/fsll/cons_planning.html)

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