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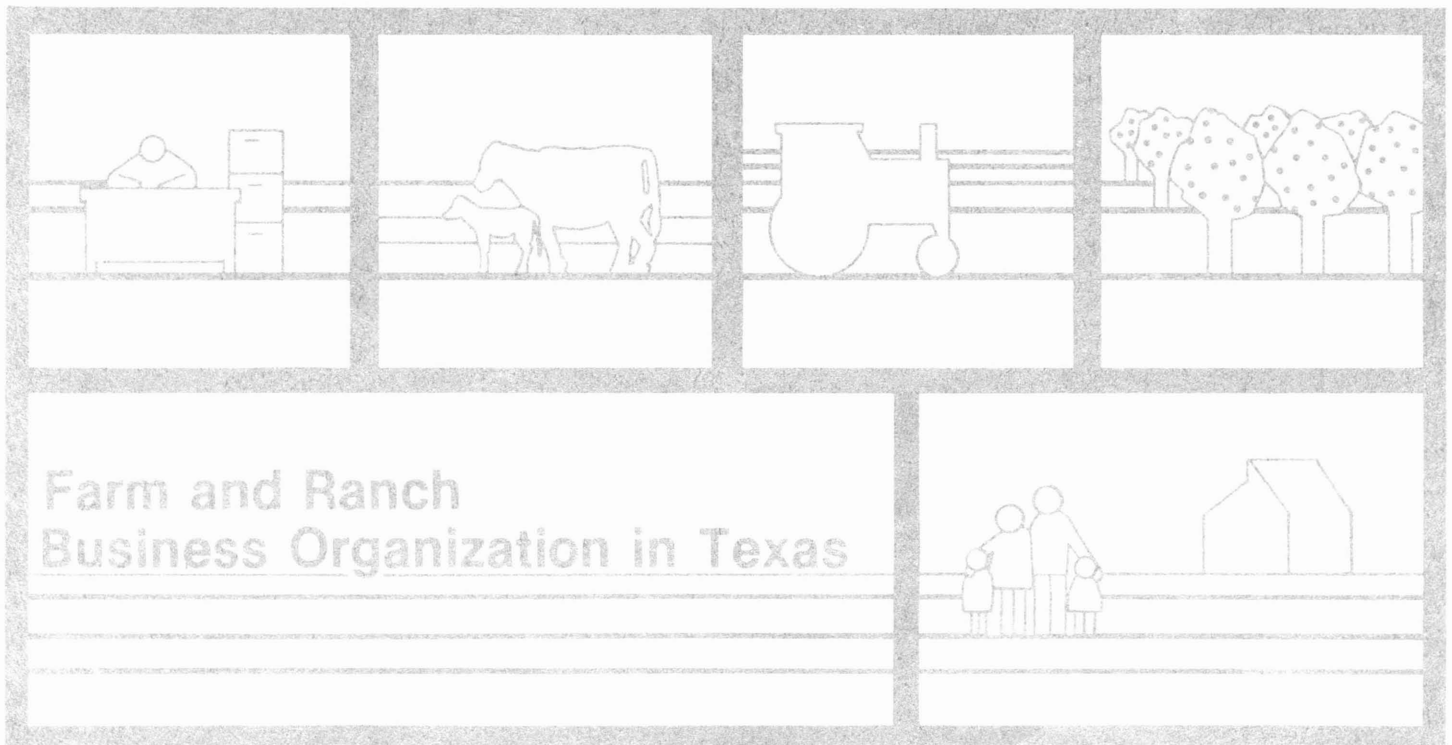
B-1335

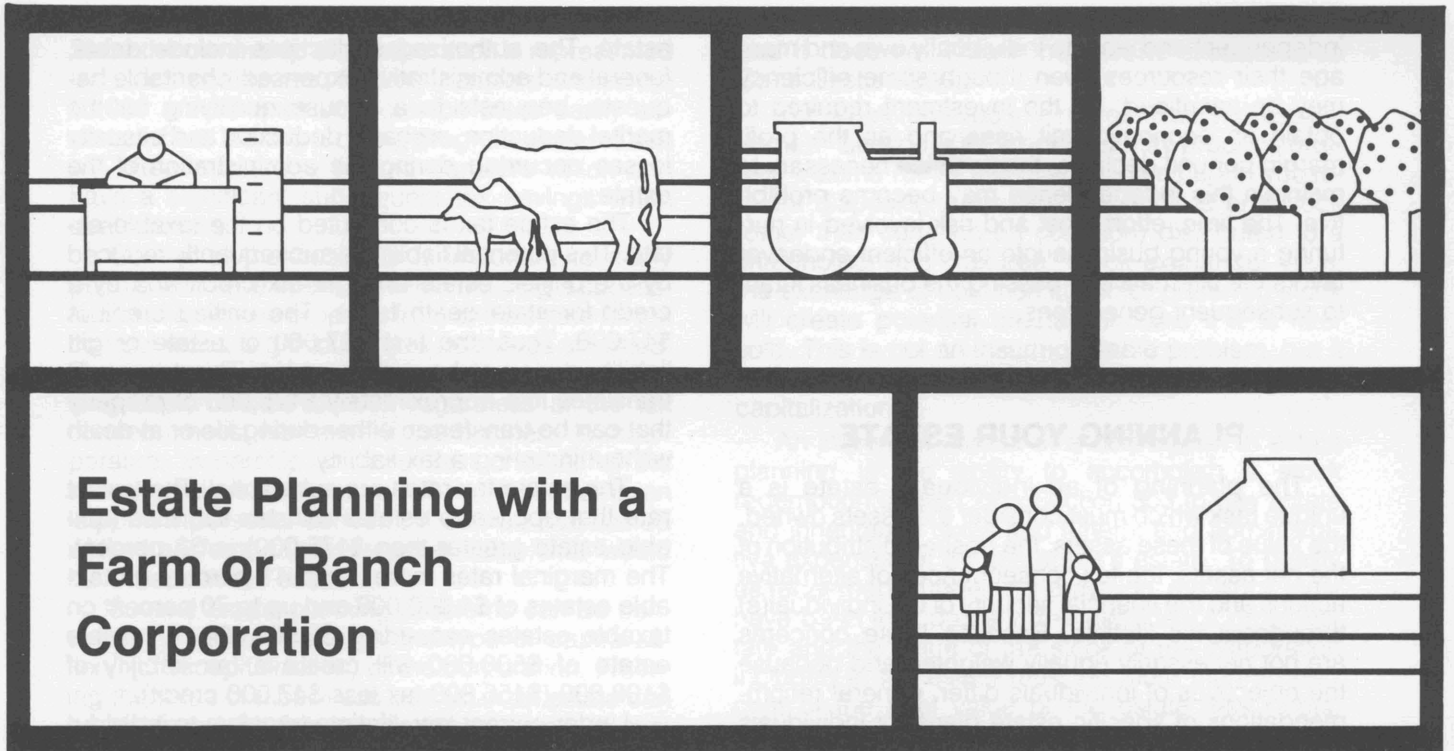
Estate Planning with a Farm or Ranch Corporation



PREFACE

This publication is one of a series on the incorporation of farms and ranches and is intended for laymen who want to develop an understanding of the basic tax issues encountered by incorporated businesses. The authors have attempted to interpret our complex and technical tax law into understandable language and concepts. However, any dilution of the complexities of the law will necessarily involve omission of some details and exceptions to general rules. This publication is intended to convey the type of information useful to businessmen who are considering the organization of a corporation or who currently are operating a corporation. It is not intended as legal advice nor should it be construed as an exhaustive treatment of tax implications.

While the authors have written in a manner that should be understandable by most persons who are concerned with the incorporation of a business, certain terminology that is common in tax matters is used. These terms may not be used often in the everyday conversations of farmers and ranchers. However, as businessmen, farmers and ranchers should develop a basic understanding of this terminology so they can effectively communicate with their professional advisors. For those not intimately familiar with such terms, this publication may not be easy to read. Even so, the technical nature of the subjects treated herein require some of them, and the benefits that the readers can acquire through development of the ability to use these terms outweigh the initial detriment.



Estate Planning with a Farm or Ranch Corporation

Marvin Sartin and Norman Brints*

Farmers and ranchers must be concerned with estate planning. Inflation, progressive income and estate tax schedules, high interest rates and the continuing price-cost squeeze on agricultural producers make efficient intergeneration transfer of businesses increasingly important. Minimizing transfer taxes conserves wealth which can be important in the maintenance of a high level of operating efficiency.

Commercial farms and ranches are businesses in every sense of the word. Agriculturalists have too long avoided admission of this fact and have neglected to learn from their nonagricultural counterparts in the business world. Traditionally, the life and the operating efficiency of a farm or ranch business have paralleled that of individuals. As a young business, the enterprise usually lacks sufficient size and financing ability to operate at maximum efficiency. The mature years of the successful ones reflect an economic size and a high level of efficiency. As the owner becomes older and slows down, the efficiency of the business decreases. Each generation goes through these stages because farms and ranches are tied to individuals. Such need not be the case if the individuals involved develop a farsighted view and a harmonious working relationship.

A corporation is a legal entity. The existence of a corporation is not necessarily dependent upon the lifetime of any individual; therefore, the opportunity exists for a corporate operation to span generations. The management of resources owned by the corporation can be shifted to others simply by advancement of their positions as corporate employees. Because each generation does not have to begin at a less efficient level, the accumulation of profits over time will be greater.

The estate of each individual will include the stock owned by him. Various techniques can be used to limit the taxable value of the stock owned at death, and stock can more easily be transferred during life than can the operating assets of a farm or ranch business. Reduced death taxes also will contribute to the wealth of the business and the owners. Therefore, the operating efficiency of the business may be enhanced and the transfer taxes may be reduced by incorporation.

The primary limitation involves the attitudes of

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the individuals. Many agricultural producers are independent and want to individually own and manage their resources even though some efficiency may be sacrificed. As the investment required to obtain an economic unit rises and as the profit margin per unit declines, the sacrifice necessary to maintain this independence may become prohibitive. The time, effort, cost and risk involved in nurturing a young business into an efficient endeavor favors the alternative of passing the business intact to subsequent generations.

PLANNING YOUR ESTATE

The planning of an individual's estate is a unique task which must consider the assets owned, the value of these assets, the desired distribution of the net assets, the tax consequences of alternative actions and the financial security of the individual(s) throughout his lifetime. Because these concerns are not necessarily equally weighted and because the objectives of individuals differ, general recommendations of specific estate plans for individuals cannot be made in a publication. Each person must work with professional legal and accounting advisors in developing his own estate plan.

However, a general knowledge about the federal estate tax and the transfer of property is necessary to allow an individual to evaluate alternatives. A brief outline of the primary rules of lifetime and post-death transfers is included in this section to provide a basis for understanding subsequent discussions.

Three taxes are of concern to persons evaluating alternative ways of transferring their property. Lifetime transfers (gifts) may incur a gift tax liability. Transfers after death are subject to estate and inheritance taxes. The Tax Reform Act of 1976 unified the gift and estate tax rates and the tax credit available for each individual to apply against these taxes. State inheritance tax rates vary depending upon a person's place of residence, but in general are much less severe than the federal taxes.

A person's estate includes all property, property interests or future interests of value owned at death. Also, any property transferred within 3 years of death for less than full and adequate considerations will be included in the estate, along with any gift taxes paid on transfer. Lifetime transfers of property that are recoverable, that are conditioned on the transferee's surviving the transferor, that retain enjoyment and control by the transferor or that constitute a general power of appointment also are includable in the gross estate. Generally, all of these includable items are valued at fair market value.

From the gross value of one's estate, certain deductions are allowed to arrive at the taxable estate. The authorized deductions include debts, funeral and administrative expenses, charitable bequests, bequests to a spouse qualifying for the marital deduction, orphan's deduction and casualty losses occurring during the administration of the estate.

The estate tax is computed on the taxable estate. This potential liability is subsequently reduced by the unified estate and gift tax credit and by a credit for state death taxes. The unified credit is $47,000. Thus, the first $47,000 of estate or gift liability does not have to be paid. This tax credit translates into approximately $175,000 of property that can be transferred either during life or at death without incurring a tax liability.

The estate tax rates are substantial. The lowest rate that applies to estates with tax liabilities (taxable estate greater than $175,000) is 32 percent. The marginal rates increase to 41 percent on taxable estates of $1,000,000 and up to 70 percent on taxable estates exceeding $5,000,000. A taxable estate of $500,000 will create a tax liability of $108,800 ($155,800 tax less $47,000 credit).

Under current law, lifetime transfers to individuals in excess of $3,000 per year per donee create potential gift tax liabilities. The unified credit can be used to offset the gift tax liability, but once it is completely used, the credit is not available to apply against estate taxes. The $3,000 per year limitation and the unification of gift and estate tax rates have reduced the incentive for lifetime giving and have increased the need for advanced planning of gifting programs. Gifts in excess of the $3,000 per year are most advantageous when property that is expected to appreciate substantially is transferred.

A basic principle of estate planning that does not always receive adequate consideration is the need for individuals to provide for their own financial security. The desire to save taxes can lead to an individual's severing control of his resources to the extent that his financial independence can be threatened in later years. However, proper planning can be effective in avoiding unnecessary taxes and simultaneously providing for the individual's security.

THE ROLE OF THE CORPORATION

Ownership of a Corporation

The primary benefits associated with incorporated businesses in estate planning will be covered briefly in this section. Subsequent discussions will treat these items in more detail.

An obvious advantage in structuring a business as a corporation is the divisibility of ownership. Farms and ranches are composed of few high-

value assets that make a gifting program difficult. Since the ownership of a corporation is represented by stock certificates, lifetime transfers within the $3,000 annual exclusion can be more easily accomplished. Making a gifting program easier to use will often encourage lifetime transfers which can have a significant subsequent tax savings when death occurs.

Control of the business is important to many people who have spent a lifetime building a sucessful unit. To remove property from one's estate for tax computations, a gift must have no strings attached. The giving away of part of one's business and lifelong effort can be difficult regardless of the tax consequences. However, if the business is incorporated, ownership of more than one-half of the voting stock retains control. Thus, if control is an important personal concern, it can be maintained while transferring a substantial value that would have been in the estate.

Several estate planning problems can be conveniently handled through the type of capitalization[1] (or recapitalization) of the corporation. Freezing the value of a business interest in an estate can be achieved by issuing preferred stock to that individual(s) and/or through the use of buy-sell agreements. The preferred stock, with a specified stated return and subject to a valid buy-sell arrangement, is of a fixed dollar value that will not increase or decrease over time. Any increase (decrease) in the value of the business will accrue to the common stock.

Voting rights may be associated with the preferred shares, if desired, to provide the owners with the power to influence dividend declarations and management policies. Voting rights increase the value of the stock, especially if they constitute a controlling interest. Thus, influence in the management of the business is available only at the cost of increased value of the stock that will be in the estate.

When estate planning motivates the organization of a corporation, the classes of stock issued can be determined to provide the desired benefits. However, an incorporation for other purposes may not have given adequate consideration to the capitalization to obtain estate planning objectives. The recapitalization of an existing corporation can be accomplished to achieve the same results.

Recapitalization essentially entails the transfer of stock to the corporation in exchange for a different kind or class of the corporation's stock. Exchanges can be made wherein common stock is traded for preferred stock or where preferred stock is traded for common. A recapitalization is "tax-free" to both the corporation and shareholders as long as it accomplishes a valid business purpose and it does not violate the several exceptions to Code Section 305.

[1]The initial capitalization of a corporation refers to the stock and securities issued to the individual in exchange for value or assets.

The stock received in a reorganization is usually termed "Section 306" stock and may produce ordinary income rather than capital gains upon subsequent disposition. Section 306 stock is any stock (other than common on common) distributed to a shareholder in a "tax-free" stock exchange. Thus, the exchange of common stock for preferred stock will create potential ordinary income if it is later sold. This is not an insurmountable problem, but it should be recognized by those considering recapitalizations.

An important aspect of a corporation in estate planning is the ability to accomplish a stock redemption under Code Section 303 to pay estate and inheritance taxes and funeral and administrative expenses of the decedent's estate. To qualify as redeemable under this provision, the stock must have been includable in the decedent's gross estate and the value of the stock of the corporation included in the estate must be more than 50 percent of the total value of the estate less debts, administrative expenses and casualty losses. Since this provision provides a technique to withdraw funds accumulated in a corporation with little or no individual tax consequences, it should not be overlooked.

Gifts

The reduction of one's wealth for estate tax purposes can be accomplished by simply transferring the ownership and enjoyment of the property to someone else. A transfer for less than fair value constitutes a gift and may have tax consequences if the gift exceeds $3,000 ($6,000 for a couple) per year per individual.

Gifts must be arm's-length transfers with no strings attached to successfully remove the property from an estate.[2] Agricultural businesses are generally composed of land, equipment and livestock which are not conducive to the divisibility necessary in an annual gifting program within the $3,000 exclusion. The transfer of the individual productive assets of the business also can create problems in maintaining an efficient operation. Because the annual exclusion is small, the initiation of a gifting program may be advisable many years before the anticipated retirement of the current generation of management.

Shares of stock can be easily and conveniently transferred without creating potential problems of losing individual business assets. Stock can be transferred to children, including minors (in trust),

[2]Transferor must give up all rights of ownership and enjoyment of property to constitute a gift.

and may encourage their interest and participation in the business.

Lifetime transfers should involve assets that will increase in value. Gifts that are limited to $3,000 per year cannot easily consist of land or other agricultural assets which have been rapidly appreciating. Common stock represents the residual ownership of the business and will increase in value in relation to the accumulated profits and the appreciation of assets. For a profitable business, gifts of common stock may be an ideal vehicle to transfer wealth to successive generations.

The initial organization of a corporation may provide an opportune time to transfer a significant amount of future appreciation to a younger generation. If a complex capital structure[3] is selected, most of the value of assets transferred to the corporation can be represented by preferred stock. With only a minimal value left to associate with the common shares, gifts of these shares involve minimum tax consequences. For example, if a corporation were organized and $500,000 of assets transferred, the following type of capitalization could be used.

FMV of total assets transferred	$500,000
Preferred stock $1,000 par, 400 shares	$400,000
Common stock 1,000 shares	100,000
Total value of stock	$500,000

A gift of 25 percent of the common stock at this point would be valued at $25,000. One-fourth of the future appreciation of the business would accrue to the donee(s). A husband and wife could then begin an annual giving program where at least $6,000 of common stock is transferred each year. Within a few years, a substantial portion of the remaining residual business equity (common stock) could be transferred with no additional gift tax consequences.

Capitalization of a Corporation

A capital structure involving more than one class of stock and/or debt is usually advantageous in meeting estate planning objectives. With the incorporation of a business, the owner can limit the future growth of his estate, control the transfer of the management to a younger generation and provide for his future financial independence and security.

To limit the future growth of his estate, the incorporator should receive preferred stock and/or long term debt instruments. Preferred stock has a par value and has preference over common in the receipt of dividends and in the liquidation of assets. It usually also has a stated rate of return (on par value), may or may not participate with common on dividends declared above the stated rate, and may or may not be cumulative[4] with regard to dividends. While preferred stock usually does not have voting rights, such rights can be associated with preferred shares.

The details of determining the specific characteristics of preferred issues that should be used in various situations is beyond the scope of this publication. Let it suffice to understand that the characteristics and the return combine to determine the value of the stock. For example, a $1,000 preferred share with a six percent return is not valued at $1,000 in today's economy with high interest rates. Shares with voting rights may be accorded some of the residual equity normally reserved for common stock if those rights essentially represent control of the corporation. When a complex capital structure is needed, the businessman must rely on his professional advisors to determine the specific classes and characteristics of the various issues.

Long-term debt from the corporation can be used to provide interest income for the individual's retirement, a means of withdrawing funds from the corporation and an asset that can be distributed to children who will not be involved in the business. To qualify as a security, the debt should have a minimum maturity of 10 years. The amount of debt that can be taken in the organization of a corporation is subject to limitations so classification as a "thinly capitalized" corporation is avoided. If this problem is not circumvented, receipts of interest on the debt can be classified as dividends.

In situations where the business interest is the primary asset of a family and all children do not plan to participate in the business, the initial capitalization can be structured to provide differentiated assets to distribute to children who participate in the business and those who do not. Usually, common stock is passed (lifetime and/or testamentary transfers) to the participating children so that they will benefit from their managerial skills and labor. Preferred stock and/or debt may be passed to the nonparticipating individuals. A stock purchase agreement may be advantageous to provide the nonparticipating children with a vehicle to realize something from their inheritance. If the preferred stock does not have voting rights, the nonparticipating heirs cannot force the declaration of a dividend.

Stock Purchase Agreements

Stock purchase agreements, also called buy-sell agreements, impose restrictions on the transferability of the stock. The primary uses of these

[3]Complex capital structure means the issue of classes of stock in addition to common.

[4]Cumulative preferred stock has a right to the stated return on par value each year. If this is not paid, the dividend accumulates and this accumulation against preferred must be paid before any dividends can be paid to common stock.

agreements in estate planning are to (1) assure convertibility of stock into cash or other liquid assets, (2) diversify assets received by beneficiaries, (3) avoid the use of oppressive tactics by those in control of the corporation and (4) establish the value of the stock for estate tax purposes.

The potential purchaser of the stock can be the corporation and/or the other shareholders. A redemption plan by the corporation usually will result in a smaller after-tax combined cost. If a redemption plan is used, the corporation must have the liquid assets necessary to culminate the transaction. This can be accomplished by accumulations by the corporation for this purpose (subject to accumulated earnings penalty) or through the purchase of life insurance policies. The corporation can purchase life insurance with the proceeds payable to it. The premiums are not tax deductible, but the proceeds are not treated as taxable income. The proceeds provide the liquidity to redeem the stock. While a stock redemption can create ordinary income (dividends) to shareholders, the redemption of all of a shareholder's interest will circumvent this problem.

Purchase of the shares by other shareholder(s) places the burden of funding the purchase requirements on the individual(s). The agreement may be drafted to provide for simultaneous redemption of some shares by the corporation and purchase of the remainder by the other shareholder(s). Provisions also can be included to allow payments for the stock to be made in installments rather than as a lump sum. The procedure(s) for determining the value of the stock can (and probably should) be specified in the agreement.

Recapitalization

Many existing corporations lack the capital structure to meet estate planning objectives. A recapitalization may be used to obtain a more preferable distribution of the net assets[5] of the business among classes of stock.

The transfer of stock of a corporation to that corporation in exchange for other classes of stock of that corporation is a recapitalization. The normal type that occurs to assist in estate planning involves the exchange of common for preferred stock. The exchange is usually "tax free" except for the Section 306 problem discussed previously, and the logic follows that discussed in the previous subsection entitled capitalization.

Any time common stock is exchanged for preferred stock, the "306" problem is encountered. A later sale of the stock is likely to cause some of the gain to be ordinary income rather than capital gains. A gift of "306" stock to an individual will cause the problem to carry over into the hands of the donee. However, if a holder of this stock maintains ownership until his death, the problem disappears. Also, a complete redemption of the stock by the corporation will circumvent this problem.

Redemption to Pay Estate Taxes

A special provision allows stock redemption by a corporation to pay estate tax, inheritance tax, funeral costs and administrative expenses of the estate without creating dividend income. The redeemed stock must be included in the decedent's estate; therefore, he must have owned it at death or transferred it by gift within 3 years of his death. Also, the value of the stock of this corporation included in the estate must be more than one-half of the total gross estate less the debts, administrative expenses and casualty losses during administration.

An immediate redemption under this section is tax-free. Redemptions carried out over a period of years will incur capital gain treatment on the excess of the value of the stock at redemption over the value at the date of death. While the amount is limited to the total death taxes and funeral and administrative expenses, there is no requirement that the funds be used for these purposes. Section 306 stock can be redeemed under this provision with no tax consequence.

Redemptions under this section can be accomplished any time after the death and within the period when the estate taxes are due. Thus, the election of one of the installment methods of paying the estate tax will allow stretching the redemption out over the same period of time.

Because successful closely-held corporations do not usually declare dividends in significant amounts and opportunities to withdraw accumulated earnings of the corporation are limited, this opportunity should not be overlooked.

USE VALUATION OF REAL PROPERTY

Farmland, ranchland and real property used in other closely-held businesses can be valued (for estate tax purposes) on "use value" rather than market value if certain conditions are met. Use value can produce a substantial reduction in the value of the estate and in the estate tax. However, the aggregate decrease in the value of qualified real property cannot exceed $500,000.

The criteria for qualifying for use valuation include:

(1) The value of the farm, ranch or other closely-held business interest must represent at

[5]Net assets are total assets less total liabilities, also equal to stockholders' equity.

least 50 percent of the decedent's adjusted gross estate. The value of all of the business assets (real and personal) must be reduced by liabilities attributable to them. If the business assets are community property, the value of the entire property will be considered in meeting this percentage test.

(2) At least 25 percent of the gross estate (less debts) must consist of the value of qualified real property (net of mortgages). A spouse's community interest can be used to meet this test.

(3) The qualified real property must pass to a member of the decedent's family.

(4) The real property must have been owned by the decedent or a member of his family and used in a trade or business for 5 of the last 8 years, and

(5) The decedent or a member of his family must have materially participated in the operation of the trade or business in 5 of the last 8 years. Material participation is defined to coincide with material participation for purposes of self-employment tax.

Several problems can arise in an individual's meeting the qualifying conditions. Passive rental of real estate is not a trade or business and, therefore, is not a qualifying use unless the decedent or a member of his family materially participates in the active conduct of a business. For example, a nonparticipation lease of farmland to a son is a qualifying use. A participating lease of a farm to a nonrelative is a qualifying use, but the nonparticipating crop-share or cash lease to a nonrelative is not a qualifying use. Likewise, the passive rental of land to a corporation, even though you own the corporation, is not a qualifying use.

When a farm or ranch is incorporated, the decedent's interest in the corporation must qualify under the following conditions, as well as those cited above:

(1) Twenty percent or more in value of the voting stock of the corporation must be included in the gross estate of the decedent. A spouse's community interest in stock can be included in meeting this test.

(2) The corporation must have 15 or fewer shareholders.

The primary method of determining use value is by dividing the annual gross cash rental (less real estate taxes) on comparable property by the average annual effective interest rate charged on new Federal Land Bank loans for the five most recent calendar years ending before the date of death. For example, assume a cash rental of $55 per acre less $5 per acre real estate tax. If the 5-year average FLB interest rate is 10 percent, the use value would be $500 ($50 ÷ .10) per acre.

In the case of real property meeting the use requirements, the value of residental buildings and related improvements occupied on a regular basis by the owner, lessee or their employees can be included along with other improvements directly related to the business activity. Other elements of value not related to the business will not qualify (e.g. mineral rights).

The election of the "use value" for estate tax valuation subjects the property to recapture of the avoided estate taxes if the property is disposed of to a nonqualified person or if it ceases to be used in a qualifying manner during the 15 years following the death of the decedent. The subsequent death of an heir during the 15-year period releases his property from the recapture provisions.

A disposition or change in use during the first 10 years will cause the entire amount of tax savings that was attributable to the property being disposed of or used differently to become due. Thereafter, the potential recapture declines by 20 percent per year until after the 15th year when no recapture remains.

A special lien is imposed on all qualified real property when the "use value" is used. In addition, each heir is personally liable for the additional tax that could be imposed in a recapture with respect to his interest in the qualifying property.

The "use value" can be very beneficial to agricultural operations and must be considered in the structuring of a corporation and an individual's estate plan. If "use value" is to be important, the various ownership tests must be kept in mind when capitalization of the corporation is determined and when gifting programs are undertaken. Also, note that the "use value" will be the heir's income tax basis in the property if it is used for estate tax valuation.

INSTALLMENT PAYMENT OF ESTATE TAX

Provisions exist for extensions of time to pay estate tax where the estate consists largely of an interest in a closely-held business. The basic purpose of these sections is to permit the continuation of the business and avoid a "forced sale" to pay the tax. Extending the period to pay the tax will allow it to be paid out of later earnings.

Section 6166 provides the executor of the estate the opportunity to defer the tax associated with the closely-held business interest for 5 years and then to pay the tax in equal annual installments over a period not to exceed 10 years. To be eligible for this provision, the closely-held business interest must constitute more than 65 percent of the adjust-

ed gross estate. The value used in these computations is the value for purposes of estate taxation. Therefore, "use value" on farmland would be used to meet the tests of this section if it is elected for computing the tax liability.

The stock in a corporation is considered an interest in a closely-held business if:

(1) Twenty percent or more in value of the voting stock of the corporation is included in the gross estate, and

(2) The corporation has 15 or fewer shareholders.

Stock that is held as community property can be treated as owned only by the decedent for purposes of the 65 percent and 20 percent tests. Interests in two or more closely-held businesses can be aggregated to meet the 65 percent test if at least 20 percent of the total value of each business is included in the gross estate.

The deferred tax under this provision bears interest at the rate of four percent on the first $1 million of closely-held business interests. The deferred tax attributable to amounts in excess of $1 million bear interest at the regular rate which is periodically adjusted.

Disposition of one-third of the closely-held business will terminate the installment privilege. In addition, if the estate has undistributed net income after the due date of the first installment, acceleration will be required to the extent of the undistributed net income. Procedures are implemented to require the executor to furnish a bond, to hold the executor personally liable and/or to place a special lien on real property and other assets expected to survive the installment period.

Section 6166A is an installment provision that can be elected if the closely-held business interest constitutes at least 35 percent of the gross estate or 50 percent of the taxable estate. If at least 50 percent of two or more closely-held businesses are included in the estate, they can be aggregated for purposes of the above percentage tests. Stock in a corporation will qualify as a closely-held business interest if 20 percent or more of the voting stock is included in the estate and the corporation has ten or fewer shareholders.

Under this section, the tax can be paid in not more than 10 annual installments. The deferred portion bears interest at the regular rate. The installment privilege will be terminated if 50 percent or more of the value of the business is withdrawn or disposed of, or if 50 percent of the decedent's interest in the business is sold or exchanged.

For these sections, the definition of a closely-held business interest involves the active conduct of a trade or an operating business. The rental of property, management of personal investments and other similar activities do not qualify as businesses in this regard. Therefore, farmers and ranchers must consider the implications of organizing a corporation without inclusion of the land. Exclusion of the farm or ranch land from the corporation can prevent the use of installment payment of estate tax.

The installment payment of tax liabilities can be used to advantage in many farm and ranch situations. Because of the many qualifications imposed by these sections, a person must be wary of commitment to a course of action that may preclude the utilization of them. Incorporating a farm or ranch adds an additional complexity to the situation; however, professional advisors should consider all of these factors in helping you develop a specific plan.

SUMMARY

A corporation can be of material benefit to some individuals in structuring their businesses to minimize estate tax and to maximize efficiency and profits over time. Shares of stock make gifts more convenient, complex capital structures can limit the appreciation of one's taxable estate, and the benefits of use value and installment payment of tax need not be foregone.

The redemption of stock to pay funeral costs, administrative expenses and taxes can be an effective way to benefit from corporate tax rates that are lower than the personal rate. Children who do not wish to participate in the business can be given or bequeathed assets they can use, while management of the business and its subsequent growth can accrue to those who stay on the farm.

The structuring of a corporation to best meet an individual's objectives is a substantial task. Seek advisors that are knowledgeable and with whom you are willing to establish a continuing relationship. The complexities of this business structure require attention to detail, additional legal and accounting fees and recognition of certain formalities of operation. But, the benefits can be substantial in today's commercial agriculture.

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5M — 1-81, New ECO 7-2