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Inter-Generational Transfer:

Opportunities for Agricultural Banks

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Partnership Agreements and Inter-Generational Transfer: Opportunities for Agricultural Banks

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Thank you John. Good afternoon.

Our topic for today is inter-generational transfer, or transition planning, as some would call it, because it is more than the transfer of assets from one generation to the next, **and** the opportunities that inter-generational or transition planning may provide for bankers. During the last three or four years I have been involved in a fairly major study of inter-generational transfer and the farming-together relationships that are usually part of the transfer process. In that study we looked at the problems and issues involved in the entry of the younger generation, farming together in a partnership or other relationship, and then the exit of the older generation. Our objective was to try to determine how it could be done and the keys to success. A major source of information for the study was about 150 hours of taped personal interviews with 46 farm families. We have published the results in bulletin and, partly, in magazine article format[2] . One of the by-products of that study was a clear indication that the inter-generation transfer or transition planning process represents a good opportunity for lenders, and particularly for agricultural bankers. What I am going to talk about during the next few minutes is that opportunity.

Transition Planning Becoming More Important

Lets start by looking at why transition planning is increasing in importance and why it will be an important issue for farmers and lenders in the future. There are three factors I would like to discuss, farm size, taxes and age. The first, and somewhat obvious, point is that farms are increasing in size. In the last 20 years the average assets per farm have gone from just over $100,000 to nearly $500,000 (Figure 1). The declining asset prices of the mid-1980's farm stress period caused a dip, or hesitation, in the increase of farm size, but it has resumed its upward trend. There is every reason to believe that this trend will continue. Farms continue to consolidate, farmers continue to buy out their neighbors and build new larger dairy barns, hog farrowing and feeding facilities and poultry houses. Also, inflation continues to be with us - at a much slower rate during the early 1980s - but, it continues to increase the dollar value of farm businesses. Equity has also quadrupled over the last 20 years. Farmers have a considerable amount of money in their businesses to retire on and/or pass on to the next generation.

One thing about this figure that we have to keep in mind is that the USDA data used for this graph includes a large number of small agricultural operations that many of us would not call farms. Thus, the average farm businesses that most banks work with would be larger in size than the absolute dollars indicated here.

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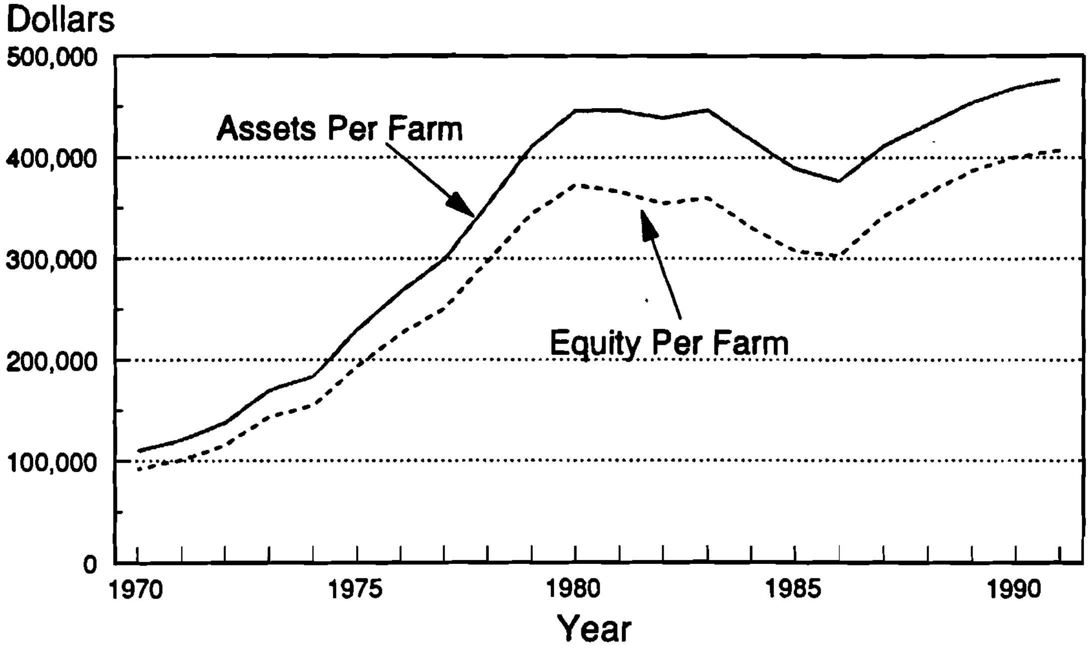
1 Professor of agricultural finance, Department of Agricultural, Resource and Managerial Economics, Cornell University. Thanks to John Brake for a helpful review of an earlier draft and to Elwyn Voss of Elwyn G. Voss Associates, Clifford Rode of Key Bank as well as Dave Kohl and Stephanie White of VPI for useful discussions. This paper was presented at the American Bankers Association National Agricultural Bankers Conference, Dallas, Texas, November 16, 1993 under the title "Changing Faces of Agriculture: Partnership Agreements and Inter-generational Transfer".

2 LaDue, E.L. and C. Crispell. "Farming-Together Relationships in the Process of Inter-generational Transfer." Cornell Information Bulletin 223, June 1992. A series of articles published in Hoard's Dairyman starting with "How Families Work Children Into the Business." Vol. 138, no.18. October 25, 1993.

Figure 1.
Assets and Equity Per Farm
1970-91, Including Farm Households



Source: Economic Indicators of the Farm Sector, National Financial Summary, ECIFS 11-1, ERS, USDA, January 1993.

That increase in asset values and equity looks nice to the farmer, but it means a higher proportion of the assets will be subject to income taxation if they are sold, and estate taxation if they are passed on to the next generation. Some recent research at Cornell on deferred taxes indicates the magnitude of taxes that would have to be paid if the farm were sold on the date of the balance sheet to provide retirement income (Table 1). Even the smaller farms, those with less than $400,000 in assets, which had average assets of $306,000, would have to pay $45,000 in taxes if the farm were sold. The larger farms, with $1.7 million in assets, would have to pay $361,000. Now, this does include New York State taxes. The totals would be about 15 percent lower without them. If you are from a high tax state, your numbers would likely be similar. If your state imposes a lesser tax burden, your farms could experience up to 15 percent lower numbers. On average, including New York State taxes, these taxes will use up about one-third of the farmers equity. These taxes cannot be avoided. However, they can be minimized with a careful plan. Some may be delayed until the next generation by putting the assets through an estate. However, that will often involve payment of estate taxes.

My third point is that there are a large number of farmers at or near retirement age (Figure 2). About a third of all farms and a quarter of the farms with over $50,000 in sales have primary operators over 60 years of age. A high proportion of these farms will be sold or transferred to the next generation over the next few years.

The combination of larger farms, many with older operators, and a potentially large tax burden, indicates that there are a large number of farm operators who could benefit from careful estate planning. We are seeing increased interest in this area on the part of farmers. I think we will see more interest in the future. Does this provide an opportunity for commercial banks? I think it does. I think it provides an opportunity to sell a wide array of bank services. In the next few minutes I will discuss some of those services and some keys to taking advantage of this opportunity.

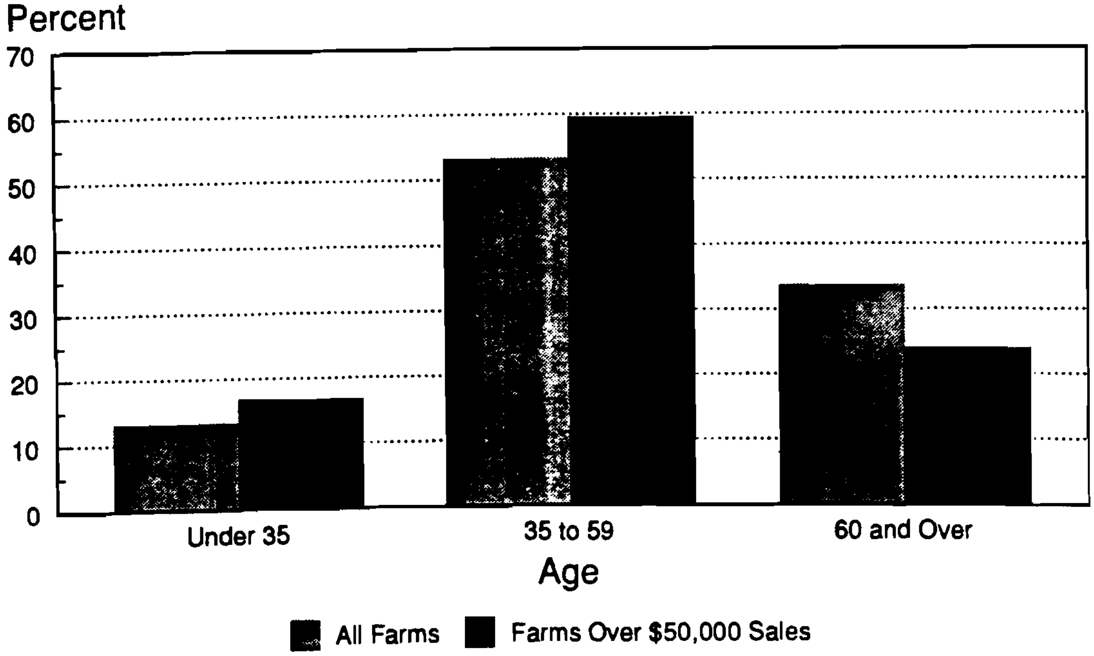
Table 1. Taxes Resulting from Sale of Farm Assets New York Dairy Farms[a]

Total Farm Assets	Taxes Resulting from Sale[b]
Less than $400,000	$45,000
400,000 to 599,999	98,000
600,000 to 799,999	135,000
800,000 to 999,999	194,000
$1,000,000 or More	351,000
All Farms	161,000

[a] December 31, 1991 farm values and 1993 tax rates and regulations.
[b] Includes Federal, New York State, and Self Employment taxes. Values are rounded to the nearest $1,000.

Source: LaDue, E.L. "The Effect of Deferred Taxes on Market Value Balance Sheets." Department of Agricultural Economics, Cornell University Staff Paper No. 93-19, November 1993.

Figure 2.
Age of Farm Population



Source: 1987 Census of Agriculture, 3(2).

Consulting

In the recent Cornell study, that I referred to earlier, of farming-together relationships in the process of inter-generational farm transfer, good consultants were listed as the second most important key to successful transfer arrangements. There are a number of good reasons for this. Since the steps of farming-together and transferring the business to the next generation occurs only once or twice per generation, most farmers are not expert in the many facets and alternatives for such arrangements. Family members may also be too close to and emotionally involved with the situation to make the best decisions without input from outside advisers. They need management and finance consultants to identify the best alternatives for the family or business and isolate problems and possible solutions. They need accounting and bookkeeping consultants to determine the tax consequences of alternatives as well as to document and monitor progress. They need legal consulting to put desires and plans into legal form.

The real problem is finding consultants who are familiar with farms and farming. They need to be familiar with the kinds of assets involved, the normal requirements for continuation of farm businesses and viable farm organization alternatives. Transferring a farm is much different than transferring a house and stock portfolio. Some people, particularly lawyers, think you do not need to know much about a farm to do the job. Most who are familiar with farm estate planning would beg to differ with that position.

Banks could provide the management and finance consulting that is needed. A few lenders are already doing this with success. Many more may want to consider getting involved. In many cases where the bank is not now providing an official consulting service, the lender is frequently drawn into estate planning conferences anyway. It may be time to do it on a more formal basis and put more planning into the role.

The returns to the bank come in two forms. First, if the consulting is formal, fees can be charged. Farmers, particularly the larger ones, are getting used to paying consulting fees if a useful service is provided. The fees can cover at least part of the salary and benefits of the consultant. Fee income is a key word in banking today. This could be a source of fee income.

Secondly, and more importantly, the consultant can encourage use of the full range of services that the bank offers. Banks provide a wide array of services. This is an opportunity to take advantage of that fact. The consultant can be sure that the farmer knows about all the services offered and how to make use of them. Whenever a bank's service can be used to meet a particular need, that can be pointed out. Certainly, all of the banks services will not be used on any farm; and even if a service fits the need, an alternative service or supplier may be selected. But, it does insure that the farmer is aware of how the bank's service could be used and increases the probability that it will be selected. As the farmer uses more of the bank's services, he or she tends to be caught in the banks web of services and is more likely to use a bank service if it is offered, and less likely to switch lenders for a few basis points difference in the interest rate. The tighter that web of services the more likely the farmer is to identify with the bank, and thus, its services. In a sense the consultant becomes the master cross seller for the bank.

There are also some side effects of consulting that can be important to the bank. First, having a consultant work with the farm families can result in an improvement in the quality of the loan portfolio. A farm with a good partnership agreement, a plan for transferring the business to the next generation, an agreement on what happens in case the family is hit with one of the dastardly D's (divorce, disability, death or disinterest), is a stronger business. A consultant with good rapport may be able to help the family with other problems. In some cases the loan officer may believe the family or business has a problem that should be given some consideration, but does not dare force it at the time of the loan request for fear of losing the loan. A consultant working with the farm business may have an opportunity to at least raise the issue, and in some cases will be able to help solve it. A portfolio full of strong businesses is a high quality portfolio.

Second, this consulting can be a way to get that (approximately) 40 percent of the farmers who do not borrow money into the bank. Many of those farmers who borrow no money simply no longer need to. These people could be important users of nonlending services of the bank. This is a way to make them aware of the services offered and get them into **your** bank.

Third, as banks merge and become larger, providing the farm customer with a feeling that he or she is an individual who is important to the bank becomes more difficult. Efficient lending practices frequently reduce individual attention. Having a bank consultant who works with individuals and their problems on an indepth basis may help. It is also a way to get the customer to pay for that individual attention.

A consultant can be either full time or part time. In some cases, it may make sense to have someone become qualified and work in the consulting role part time as he or she builds up the consulting activity for the bank.

If you think to yourself, "well, that sounds good, but we do not really want to get into the consulting business," you may want to consider, or at least start with, a less involved approach. One of those is to cultivate consultants. That is, make sure the consultants in your area know the services that your bank offers and how farmers could use them. Make sure they know who the agricultural lenders are and that you are really interested in getting business from farm customers. This can be done by inviting the consultants into the bank, maybe as a group, and having the trust officer, loan officer, investment advisors etc., explain the services that are offered. This process also has the advantage of introducing the consultants to the people of the bank, so that they will feel more comfortable in using the banks services.

An even lesser step that could still bear some fruit would be for the bank's loan officers to develop a good relationship with the consultants in the area. Make sure that the consultants know that your bank is interested in working with farm families. Make sure they know that your bank is interested in providing all of your services to farm customers and that the loan officers are interested in helping consultants and farmers use those services: or, at least, know who in the bank to talk to about the various services. A technique that is sometimes used to facilitate this process is for the bank to sponsor programs that get the farmers and the consultants together. A free lunch can get a lot of farmers in to hear consultants discuss transition planning issues. As part of the program, the bank could review its services that may be of value. The process can also improve relationships between the bank and consultants in the area.

Services Sold Through Transition Planning

A number of services could be sold through transition planning. The old standby, **money**, is one of them. Money is often needed to expand the farm to bring the younger generation into the business. It has been said that the largest expense of sending a farm son or daughter to Cornell is not the tuition, which is high, but expanding the business after they come home! Being a consultant helping with the plan to bring the younger generation into the business puts you on the ground floor for the half-million or million dollar expansion loan.

When the family develops a partnership, it is often suggested that the younger generation buy half, or a proportional share, of the operating business. That could be an intra-family loan, but it does not have to be. An external loan to the son, possibly with a FmHA guarantee, may fit the situation better and will provide the younger generation an opportunity to build up a good credit rating and work on his or her credit management skills.

Additional borrowed money in the business may allow the senior generation to take some of their equity out of the business and put it into nonfarm investments. This could provide retirement income diversification and reduce the amount of farm income needed during the retirement years. It may also improve the liquidity of the senior generation's estate.

A reverse mortgage, where the money is effectively borrowed each month or year for retirement living, using the farm real estate as security, may be a useful way for the senior generation to live off the farm investment during retirement. It also gives the senior generation a direct monthly or annual tie to the bank.

Probably the service that could be sold through transition planning with the most benefit to the bank is **trust and investment services**. This is a general category of services that could be different for each bank but I will mention some of the common ones. They include:

1. Service as corporate executor. With complex estates, or where no one in the family wants to, or feels qualified to, serve as executor, a trust officer may be a preferred solution.

2. Service as trustee or co-trustee. Trusts are frequently established for a surviving spouse or children who either cannot or do not want to manage the assets in the trust. Other members of the family may not be qualified to be, or not want to serve, as trustee. From a different point of view, the trust officer may be able to do a superior job of managing the assets. A consultant should be able to explain why a bank trust officer may be expected to do a better job of managing the assets than many family members. Or, the consultant may plant the seed, which may get the trust officer a chance to explain the bank's expertise and services.

3. Management of nonfarm assets for the retired or elderly. In some cases the older generation will have considerable nonfarm assets that they would rather not, or feel they are incapable, of managing. By using the bank investment services they can maintain their independence from other family members. Most prefer a conservative investment strategy, at which bank trust departments are best.

4. Custodian of gifts to minors. Gifts to grandchildren, and in some cases children, who are still minors may be a useful estate planning strategy. Placing the gift in the custody of the bank insures that the gifts will be invested responsibly until the child is given control of the funds.

5. Off farm investments: mutual funds, etc. It is often good advice for the farm families to develop off farm investments to provide liquidity for the transfer, diversify retirement investments and insure that some funds are removed from the farm business. These investments need to be managed by someone. Often the farmer will want to focus on the farm business. Placing these funds with the bank trust department may provide peace of mind that they are being invested responsibly.

The third type of products that could be sold through transition planning is **IRA (Individual Retirement Accounts) and Keogh (HR 10) plans**. All farming partners should be interested in these type of plans as a way to set aside funds for retirement. The thing about them that makes them of great interest to many farmers is that they are at least partially tax deductible. Farmers place a very high priority on not paying taxes! At retirement time such plans provide liquidity and flexibility that may be very valuable if all other assets are in the farm business.

Use of these accounts is a natural part of the transition planning discussion. Many transition plans call for the generations to farm together for a number of years. Participation in these types of plans may be a very important part of the plan during these years. A good consultant could be sure that the bank's products are given consideration.

The final type of product that may be sold through transition planning is **insurance**. Admittedly, most banks are limited in the types of insurance they can offer. However, credit life insurance can be useful in some instances. It could be of value in small estates where paying off the debt with the insurance does not make the estate large enough to create an estate tax issue. If the planners do not want to use other types of insurance, credit life insurance may be better than no insurance at all. It can be used in larger estates if handled with care so that it does not become part of the estate. Keeping it out of the estate can be tricky. My point is that credit life insurance could be sold as part of transition planning in some situations.

Now, the services that I have mentioned are services that banks already offer. You might also consider developing some new products. For example, you might offer a seller financing loan servicing program for a fee. The retiring generation, or its surviving member, may be willing to pay you a fee for servicing the mortgage they took back when the farm was sold. That way they would not have to deal with reminding the buyer that payment is due, or past due. They do not have to deal with requests or extensions or early payment. Also, a payment that has to go to the bank may be more likely to be made than one that goes to the former owners widow. Other new products can be developed.

Keys to Success

If you decide to consider providing consulting service, there are a few keys to success, or do's and don'ts to keep in mind. Before going too far, you should **assess the demand** for the service in your market area. Are there enough large farms in your market area to warrant hiring a person to work with transfer plans, or training a member of your staff to do transition consulting part time? Are farms in your area being transferred to the next generation? In some areas a high proportion of the farms are exiting agriculture, or are being purchased by existing farmers, rather than being transferred to the next generation. Since inter-generational transfers occur, by definition, only once per generation, it takes a fairly large number of farms to provide very much consulting business.

You also need to assess the existing consulting services. A few areas have good consultants already in place. In these situations it may be more effective to find a good consultant and try to develop a working relationship or, at least, make him or her familiar with your products. Many areas do not have good transition planning consultants available. In these cases it will be just a matter of assessing the total number of people who might use the service.

Once you have satisfied yourself that there is enough demand, the most critical key to success is to **hire or train good personnel**. Most programs will succeed or fail depending upon the quality of the person involved. The person must be a facilitator. He or she must be able to sit down with a farm family and help them figure out their goals and how they can meet their goals. In most cases it is not a matter of telling them the best thing to do. It is not like telling them how to feed the cows or which fertilizer they should use. It involves helping the family identify what they want to do and the alternatives they can consider, and then working with them to successfully implement the alternative they choose.

The person must relate well to farm clientele. He or she must understand farming and understand and respect farm people. They must be able to talk with and gain the confidence of farm people. They must be a people type of person.

The consultant must be an expert in transition planning. Farmers have received a lot of free consulting in the past, from Cooperative Extension, suppliers, US government etc., so they hate to pay for it. Thus, they are not going to be willing to pay unless they get good quality service. The consultant must know the subject matter and have some suggestions that the farmer views as useful. Experts are made, not born. Thus, it is quite possible for an existing loan officer of other staff person to become a transition planning expert. But, it does take time and effort.

The consultant does not have to be an expert in everything. A farm family usually should have at least three consultants in their advisory group as they do their transition planning: a business and finance consultant, an accountant or bookkeeper and an attorney. While being part of a group reduces the knowledge the bank consultant needs to be an expert, it increases the importance of his or her ability to get along with the other experts. The consultants facultative and people skills are, thus, doubly important. Some might say the expert group is considerably more difficult to work with than farmers.

I would not try to make all loan officers into transition planning consultants. A good transition planning consultant must have a set of skills that many good loan officers do not have. Keeping up to date on all the laws, rules and regulations required to be a good consultant will take considerable time. Most loan officers would be more productive for the bank if they spent that time on loans and business development.

The third key to success is to **target clientele**. Many small or unprofitable farms could use help in their transition planning. However, these people will be less likely to be willing to pay a reasonable consulting fee and they are likely to make only modest use of bank services. Thus, you need to target the large and midsize farms. The large farms are more likely to have larger estates, use larger amounts of money and need a wider array of bank services. The midsize farms are important because they may use considerable amounts of money getting to be larger farms and if you work with them when they are midsize, you will likely have them when they become large farms. The transition process often involves expansion.

You should also target the innovators and early adopters. These people are more likely to take advantage of a new service. If you get them as customers, the others are more likely to follow. Those other farmers learned about the latest machine, the newest feed additive and the most up-to-date fertilizer recommendations from these innovators and early adopters. Make use of that normal information flow to spread the word that "Transition Dan" from your bank is worth having as a consultant for transition planning.

My final key is **"do not expect to make a million dollars the first quarter"**. Rome was not built in a day. Similarly, a strong consulting program and the resulting flow of use of bank services will not occur in a quarter. Regardless of the quality of the person who serves as your consultant, it takes time to become known and trusted. Transition planning deals with the very intimate goals and thoughts of the farmer. He or she is not going to share them with just anyone who drives in the driveway and claims to be an expert. The growth in consulting income will develop gradually as the person becomes known and trusted.

Increase in the use of bank services will occur over a number of years. One of the objectives of the consultant is to tighten the web of bank services around this farm family. Some of the increase in services should occur within a year or so. But, part of the benefits to the bank will occur years in the future. One result may be that you keep a customer who would otherwise go to the competition. Adding a consultant should be viewed more as long run business development.

Summary

The increasing size of farm businesses, the increasing importance of income and estate taxes and the fact that at least a quarter of the commercial farm population is over 60 years of age, all lead to an increasing importance of farm transfer or transition planning in the years to come. Lenders should take advantage of this situation to sell their products. One way to do this is to add transition or inter-generational transfer consulting to their product line. Commercial banks have the advantage of offering a wide array of products that could be used as part of the farm transfer process. Adding a transition consultant could be used to increase fee income, increase the use of bank services and tighten the web of services around the farm family so they are less likely to switch to the competition. When consulting is offered, it should be done right, by first assessing the demand, and then hiring and training good personnel to focus on carefully selected target clientele.