'Perfect storm' brewing in agriculture

My heart goes out to the people of the East Coast after Hurricane Sandy ripped through their homes and businesses.

There have been 110 reported deaths and estimated damages of greater than $60 billion.

Most hurricanes revolve around centers of warm air. But, a high-pressure system from Eastern Canada pumped colder, drier air into Sandy.

The mix of warm and cool air provoked especially strong winds.

Meanwhile, a low-pressure system hanging over the Ohio Valley brought additional precipitation into the equation.

Something similar happened in late October 1991. It was known as "the Perfect Storm."

A "perfect storm" describes a rare combination of events which can result in catastrophic destruction in an unusual magnitude.

In my opinion, there has been a "perfect storm" brewing in agriculture for years.

Because the potential loss could involve all of us in one way or another, it is important to understand the elements that could combine to cause significant damage in the areas of farm continuation and estate shrinkage.

Demographics of land owners

Sixty-five percent of real estate in Iowa is owned by people who are 62 years and older.

The folks in this age group are savers. They have accumulated quantities of land and enjoy the purchasing power of economies of scale.

Although this age group can afford to subsidize land purchases that may not independently cash flow, this age group will also distribute their estates in an unprecedented transfer of wealth in the next 12-15 years.

Highest land value in history

The average price of agricultural land is the highest it has been in history.

In the 2012 Iowa Land Value Survey, the average price of high quality farmland was up more than 7 percent in 6 months to $10,045/acre.

There are many contributing factors for this — low interest rates, high commodity prices and the ability for the current land owners to subsidize new land purchases to name a few.

Cash-flow outside of profit range

It is arguable what the average per-acre cost of land acquisition (rent or purchase) should be. It is different for all operations.

Some could afford cash flow payments as much as $500/acre for land acquisition.

For others, it may only be $250/acre or less.

As an example, to finance a land purchase of $4,750/acre over 20 years at 4 percent, the annual acquisition cost per acre would $350 per acre.

Add $30/acre for property tax and $500/acre for input costs and profit margins are thin in the short-run to non-existent in the long-run.

This may seem possible with current commodity prices, but certainly will not consistently cash-flow over the life of a 20-year loan with the inevitability of $4 corn.

It is disheartening for producers to realize their cash flow limit for land acquisition could be more than 50 percent under what the open market currently demands for land sales.

The farm as a legacy asset

Farm families are passionate about keeping the farm together as a unit.

Farming is a way of life. Continuing the legacy is a fundamental desire that a vast majority of families want to achieve even though they may realize they may not have a specific plan to succeed.

French philosopher Rene Descartes believed our existence as human beings is substantiated by our ability to "think."

He once said, "I think therefore I am."

The substantiation of a farmer's existence is the ability to farm.

Few would challenge the genuine passion of a farmer who believes, "I farm therefore I am."

Control is difficult to surrender

It doesn't surprise me most farm families struggle with the issue of control.

For an entire lifetime, a farmer has worked diligently on their farm.

They may have scrimped, saved and sacrificed more than conceivable to get to the position they currently enjoy.

Limited advice from specialists

There is an on-going struggle in rural communities for farm families to seek out specialized advice. In medicine, general practitioners refer health issues to a specialist. This doesn't seem to happen as much in estate planning.

Low interest rates

Interest rates are at an all-time low. The government Applicable Federal Rate (AFR) for a long-term (9 years plus) loan is 2.4 percent. The medium-term (3-9 years) rate is .89 of a percent and a short-term rate (less than 3 years) is .22 of a percent.

This is a good thing as long as your rate is locked in.

Favorable estate and gift tax rates

The Federal Estate and Gift Tax exemption equivalent is currently $5,120,000 per person.

A married couple can pass assets without Federal Estate or Gift Tax of $10,240,000. The exemption has never been higher in our country's tax-history.

This favorable component can change in a hurry.

On Jan. 1, 2013, this exemption equivalent is scheduled to revert back to $1,000,000 without a tax-law change.

Longevity

Our population is living longer.

There are many farm owners who will live into their 80s and 90s and have a farming heir in their 60s and 70s and grandchildren in their 40s and 50s.

This "sandwich" generation will want to own the farm, but may not have an opportunity to own the land during their prime land-acquisition years.

Fair vs. equal

There is an old estate planning saying, "Nothing tests the metal of a family more than a shared inheritance."

This statement has never been more accurate than in a current farm estate trying to decide what a "fair" distribution of their over-inflated estate would look like.

Economies of scale

Unfortunately, there are fewer farmers feeding more people in the world. This has been a long-term trend that will more than likely continue.

Farm operations will need to grow to compete in the future.

The risks associated with this growth make it difficult for survival. There are a small number of producers who have the ability to sustain the economies of scale needed to compete on the current growth curve in agriculture.

Storm on the horizon

Any one of these factors individually could mean serious issues for a farm estate to continue to the next generation.

My concern is there may be a combination of multiple factors all occurring at once which could result in catastrophic destruction in an unusual magnitude — a "perfect storm."

Imagine if 65 percent of Iowa farmland is transitioned at a time when land values are at all-time high and the purchase of the land will only cash flow for a few who have economies of scale, not the immediate family.

What if the estate and gift tax exemption reverts back to $1 million? Few farm estates could withstand a 41-55 percent estate tax and a majority would face the tax at that level of exemption.

What if interest rates take off in the future? We learned the hard way in the '80s what escalating interest rates can do to a family farm.

These issues are micro-economic for individual families and macro-economic for the long-term viability of agriculture.

Sometimes we have sufficient alert when a storm is coming. In this case, my sincere hope is we do not ignore the warning signs and can plan to effectively minimize future damage.

For 20 years, Steve Bohr has been a partner in the farm continuation firm of Farm Financial Strategies Inc. For additional information on farm continuation issues or if you have a question please contact Steve via email at Bohr@FarmEstate.com or by phone at 800-375-4180.