

Beginning Farm Business Arrangements

Introduction

The typical farm operator and his or her business pass through two or more stages during the operator's farming career. The entry (or testing) stage is discussed in this chapter. The alternatives for the longer-run business arrangement are discussed in the following chapter.

Merging the life cycle of a beginning operator (related or unrelated) with the typical life cycle of the established operator must be approached with caution and candor and explored carefully. Each situation is different for at least three reasons:

- 1) Level of achievement and objectives of the established operator
- 2) Beginning operator's ability and timing of his or her entrance into the business relative to the established operator's cycle.
- 3) Treatment and/or expectations of the beginning operator by the established operator.

Each individual farm operation is different and the transfer process needs to account for the unique circumstances on each farm.

The beginning and established operators should first analyze the current situations and then outline the objectives of each. They should then make a preliminary appraisal of the possibilities of working together in a variety of joint business arrangements. If a joint operation is decided upon, then the two (or more) operators should enter a testing stage. The purpose of this testing stage is two-fold; to help the beginning operator decide whether he or she really wants to farm, and to help the parties decide if they can make a joint business arrangement work from both the personal and the business points of view.

Business arrangements adapted to the testing stage normally are in one of two broad categories. The first category includes various types of employer-employee arrangements in which the beginning operator contributes primarily labor and possibly some management.

The second category includes various joint operating agreements that may at times evolve into a more permanent arrangement such as an LLC, a partnership or a corporation. With these latter arrangements, the beginning operator will be supplying some of the personal property as well as labor and management.

Employer-Employee Agreement

An employer-employee agreement is particularly well suited as a beginning agreement when the beginning operator is still deciding whether to continue in farming, or is not yet willing to commit financial resources until it is clear the beginning and established operator can work together.

There are a variety of types of compensation provided in farm employee contracts. They include cash, wage and income share, incentives, bonus payments, fringe benefits, and commodities received for the labor provided. An employment contract may involve more than one of these types of compensation. As with any type of working relationship, the employer/employee agreement should be in writing whether the parties are related or not.

Cash

The basic contract involves only cash. An agreed amount of cash wage is paid periodically. The normal pay period is weekly, biweekly, or monthly. The level of cash payment depends on the skill level of the

employee. Unskilled employees command lower levels of cash wages compared to employees who are capable of skilled labor or supervisory and management responsibilities. The amount of cash paid also depends on other types of compensation provided. Minimum wage laws apply to some farm employment situations.

Wage and Income Share Plan

A variation of the basic cash wage agreement is the wage and income share plan. From a legal standpoint, a wage and income sharing but not loss-sharing plan establishes an employer-employee relationship rather than a partnership. The employee and employer, thus, would avoid some of the liability aspects associated with a general partnership.

Under this plan the established operator typically furnishes the farm, housing for the beginning operator, all farm personal property, and the established operator's own labor and management. The established operator also pays all farm expenses. The beginning operator works on the farm full-time and receives a guaranteed monthly wage and a share of the net farm income. The wage rates should be comparable to current wages for similar services in the area.

Incentives

A variety of incentives can provide a stimulus for employees to excel at their work assignment. When an incentive plan is provided, there should be a predetermined set of performance standards outlined with the associated compensation. These performance standards must be achievable by the employee. Unrealistically high standards provide no incentive for employees and may cause dissatisfaction with the job. The higher the level of performance, the greater the incentive pay. For an incentive plan to succeed, the employer and employee must both be better off financially if an employee excels. The incentive plan must be something that the employee has control over. The plan should be as simple as possible and clearly

understood by both the employer and employee. An example of an incentive plan for a herdsman might be a percent share of increased milk production above the current level. Another example would be to have the milkers lower and maintain a desired somatic cell count (SCC). It is important that the level is achievable. If the SCC is already at a very respectable level, this type of incentive is not appropriate.

Bonus Payments

Bonus payments differ from incentive plans. These can be payments at the end of the year such as "Holiday bonuses." The level may depend on the level of compensation of the employer. Higher income levels may mean greater bonuses. Other common uses of bonuses are to reward length of tenure with the farm or few or no days missed due to illness or other causes. Bonuses are usually not designed to provide added compensation for excelling at the job.

Fringe Benefits

There are a variety of fringe benefits provided in farm employment situations. Common types include meals, food, housing, utilities, health insurance, disability insurance, life insurance, employee's half of social security and Medicare payments and retirement or pension payments. The fringe benefits can often amount to nearly half of wages paid. The value of many of the fringe benefits is not taxable to the employee. This makes the after tax income much higher than compensation received in the form of cash. Consequently, the employer can provide more compensation to employees without increasing the employer's cost. The type and dollar value of fringes should be clearly understood by both the employer and employee. It would be desirable to have the fringe benefit dollar values in written form.

Commodities for Labor

Some or all compensation can be provided in the form of commodities rather than cash. The current interpretation is that compensation

paid in commodities is not subject to social security and Medicare taxes. The employee can receive grain, livestock or produce such as milk, eggs or wool as compensation. In order to qualify as exempt from social security and Medicare taxes, these commodities must be in the control of the employee and sold at the employee's discretion. Rent should be paid for storing the commodities if they remain on the employer's farm. The employee must report the fair market value of the commodities for income tax purposes.

Operating Agreements

The testing period may extend long enough or relationships may develop fast enough that the beginning operator begins to contribute personal property to the farm business along with his or her labor and management. On the other hand, a holding pattern may be in order in those cases where the established operator is very close to retirement. Rather than expanding the business or establishing a new business entity, the parties may decide to extend and adapt the testing stage and become involved in some type of joint operating agreement.

In this arrangement the beginning operator may furnish some personal property (for example, livestock and machinery) and some management in addition to labor. He or she normally would not make entire farm decisions, but may make most of the major decisions for one enterprise. The beginning operator may buy into a given enterprise such as the dairy herd, beef cow herd or hog enterprise on a partial or complete basis, either paying the established operator for the use of feed, buildings, and pasture or working out a livestock lease arrangement whereby part of the production is received by the established operator. Any agreement should be put into writing and cover such topics as job responsibilities, contributions, distribution of income, method of settling disputes, and dissolution of the agreement.

The length of the testing period depends on the operators' situation, objectives, and progress toward deciding which future route to follow. Two to three years normally should suffice for the testing period. Delaying the decision to move to the next stage should be viewed critically, particularly if the parties are still in the least involved (wage-type) arrangement. Remember, the purpose of the testing period is to determine whether the beginning operator wants to farm and whether the parties can work together. Once these issues have been resolved, the parties should move out of the testing stage.

In a joint operating agreement (sometimes other similar names are used) two or more sole proprietors combine together to conduct farming activities. These are normally informal oral agreements. However, the agreement should be in written form and last only a few years. It is a transition to some more formal farm business arrangement. Normally these agreements arise when a young family member wants to join in a farm operation with his or her parents. However, unrelated persons can also engage in joint operating agreements.

Under this arrangement each individual is a sole proprietor. The income and expenses of each person is reported on his or her own tax return. These arrangements are not intended to be a partnership or any other form of business arrangement other than sole proprietorships. Normally asset ownership is individual, but in some cases there may be some joint ownership of assets. With primarily individual ownership, it is very easy to form or sever the business organization.

When the joint operating agreement commences, the beginning operator usually owns few if any assets. All, or nearly all, of the assets are provided by the established operator. Most of the management decisions are made by the established operator because he or she has contributed the farm assets to the agreement. Ideally, the beginning

operator gradually becomes more involved with management over time. Both operators contribute labor to the farm operation. If the established operator is beyond contributing labor, then a lease arrangement is the desirable form of business arrangement.

It is important to clarify the work responsibilities and work hours of both operators and other family members. Spouses of one or both of the farm operators may have other employment or other commitments so the work hours of operators and other family members should be agreed upon before entering into the joint operating agreement. Time off each week and any vacation time needs to be clearly agreed upon before commencing the operating agreement. This is one of the common sources of friction between parties in an operating agreement if there is not a clear initial understanding.

Housing is another of the personal aspects that can create major problems within the farm business arrangement. Generally when the beginning operator is not married, he or she is provided housing and meals by the established operator. If the beginning operator is married, an additional house needs to be available. At times a trailer is placed in the yard of the farmstead and members of both operators' families live and work closely together. Living too close can be an additional source of personal conflict. Often it is best to locate the houses as far apart as possible. The established operator may want to move into town if there is only one house on the farm.

The established operator receives the largest portion of the income from this arrangement because he or she is contributing the majority of the resources in the form of capital, management and labor. The percentage of income each party receives can be estimated by using UW-Extension "*Multi-Person Operating Agreement Worksheet*" A2664.

Proceeds from the sale of assets owned by each party belong to the owner of the asset when sold. For example, when a dairy cow is sold, the owner of the cow receives all of the cull cow income. By contrast, income from milk sales or corn sales would be divided between the operators according to their share of ownership.

Each party pays fixed expenses associated with the ownership of his or her assets. This includes property taxes, insurance, interest, depreciation, and sometimes repairs. At times repairs should be split between the two operators. Operating expenses are split between the two operators. These expenses are shared in the same percentage as income is shared. It is almost impossible for the beginning operator to suffer losses in this agreement because he or she pays only a small portion of the operating expenses and little or no fixed costs. Thus the major risk is on the established operator.

At times the beginning operator may receive farm assets in addition to cash income. For example, by receiving a portion of the heifer calves at birth, the beginning operator begins to acquire ownership of assets. This is very desirable if the established operator needs cash to service debt for other needs, and the beginning operator has minimal cash needs.

It is desirable for the net income of each party to be equitable, but it also must be adequate for each party to keep each satisfied. In most cases, the beginning operator gets a break by receiving more than his or her share of the net income. It is one way the established operator can help the beginning operator get established into farming. If the agreement was totally equitable, the beginning operator might not ever be able to get established in the farming operation. Formulating the share each receives must be based in part on the financial needs of both parties. Each must receive adequate income to meet all cash obligations including paying farm expenses, making necessary capital investments,

servicing loans and having adequate family living expenses. This all needs to be based on the debt load, living expenses and income generated by the farm business. Also, the agreement must change over time as the beginning operator acquires a greater share of the ownership.

A complete inventory should be taken just prior to the beginning of an operating agreement. Physical quantities and financial values should be recorded. There are several alternative ways to handle the financial obligation of feed and supplies. Quite often the established operator does not sell feed and supplies to the beginning operator just prior to starting the joint operating agreement. Such a direct approach is often avoided because the feed and supplies remain on the farm and the parties prefer to defer the income tax liability that such a sale/purchase creates. At times there is a gifting of a share of the feed and supplies equivalent to the share of income to be received by the beginning operator. Another alternative is for the established operator to receive the beginning operator's share of the income until that income equals the value of the beginning operator's share of supplies. At that point all future income is split. A third common practice is for the established operator to contribute the use of the feed and supplies for the duration of the agreement. Upon termination of the operating agreement the established operator receives cash or commodities of equivalent value to his or her original contribution.

There are two common forms of joint operating agreements. They are enterprise agreements and total farm operating agreements.

Enterprise Agreements

With an enterprise agreement, the beginning operator receives all or nearly all of his or her income from this single enterprise. If it is a dairy enterprise agreement, then milk sales are divided according to the percentage agreed upon in the operating agreement. Calf sales

are also divided if newborn calves are to be shared. Proceeds from cull cow sales belong solely to the individual that owns the cow. Most proceeds from cull cow sales are paid to the established operator because he or she owns all or most of the cows.

Operating expenses for the dairy enterprise are split. This usually includes such expenses as purchased feed, breeding cost, veterinary and medical cost and dairy supplies. The established operator pays the fixed costs for the dairy enterprise such as building repairs, insurance and taxes on property, and interest on loans for real estate, machinery and dairy cows.

With an enterprise agreement, all income and expenses for other enterprises on the farm belong to the established operator. It should be clear what income items and what expense items are to be shared and what items belong solely to the established operator.

In an enterprise agreement, the beginning operator sometimes contributes all or most of his or her management to this enterprise. Often the beginning operator is expected to contribute labor to all enterprises on the farm even though he or she receives no compensation from nor has any voice in the management of these other enterprises. This can result in a conflict of interest between the operators as the beginning operator might want to spend more time with the enterprise from which his or her income is generated. The fairness of the beginning operator working with the other enterprises varies with the degree of the break he or she may receive from the established operator.

Total Farm Operating Agreements

Under this arrangement, income and operating expenses are split for all or almost all enterprises on the farm. Income from the sale of individually owned assets belongs solely to the owner of the asset. Operating expenses for the farm are split. Fixed costs of assets are paid solely by the owner of the asset. Repair

costs are often an exception and are divided between both operators. The rationale for splitting repair costs is that it makes the beginning operator more careful in operating equipment, if he or she must pay a portion of repair costs.

The established operator normally contributes most, if not all, of management for the farm operation. This needs to be gradually shared with the beginning operator. It may be useful to split management responsibilities by enterprises or in some other manner. Splitting management responsibilities may result in less conflict between operators as compared to all decisions being made jointly. It also allows for greater specialization in management.

Labor is contributed by both operators. They may jointly work together or split labor responsibilities. The normal pattern is for both parties to work together at times and separately at other times.

The established operator provides all or nearly all of the assets when the operating agreement commences. Over time, the beginning operator should acquire more asset ownership. It is usually best to first acquire personal property because these assets generate a higher cash return than real estate.

Leasing Considerations

Leasing is an excellent alternative in the transition stage for farm operators with limited capital. A lease payment is made for the use of an asset instead of paying interest and principal payments associated with ownership. This allows a farm producer to use limited capital in the most effective way. Leases can be for a short time or multiple years. Leases can apply to farm real estate, farm buildings, machinery, and/or livestock.

Real Estate Leases

Farm real estate is the most common farm asset that is leased. Agricultural leases generally begin March 1 of one year, ending at the end of February the following year. However, the parties can agree to any starting and ending date. Leases for more than a year must be in writing to be enforceable. Many leases continue year after year as both the lessor and lessee want to continue the lease arrangement. Either party can terminate an year-to-year farm lease by giving a 90-day written notice prior to the end of the current year.

Written leases are recommended because they provide each party with the same language and help insure the same understanding of their contract. This can help avoid conflicts and also serve as a base for subsequent agreements. There are three types of farm real estate leases: cash; crop share and livestock share.

Cash Leases for Real Estate. Under a cash lease, the lessee pays the lessor cash for the use of land and/or buildings. The lessor pays all the fixed costs (property taxes, interest, insurance on buildings, repairs on buildings and fences). The lessee receives all of the income from farm sales. The lessee pays all operating expenses. The lessee owns all personal property used on the farm.

This type of lease gives the lessee more management authority and a minimum of joint decisions. The lessee benefits from excellent crop yields by not sharing any of the crops produced. The lessee is obligated to pay the cash rent whether or not prices or production are adequate; thus there is greater risk to the lessee with a cash lease compared to share arrangements.

Crop Share for Real Estate. In a crop share lease, the lessor and lessee share the crops produced on the farm. In a typical crop share lease, each party receives one-half of the crop production. In this arrangement, the lessor

owns the real estate and pays all fixed costs associated with the real estate. The lessee owns all crop machinery and pays the fixed costs associated with the machinery. The lessee also provides all of the labor for the crop operation. Direct variable costs for the crops (fertilizer, seed, fuel, etc.) are split 50/50. The lessee owns all the livestock and the lessee receives all livestock income and pays all livestock expenses. Other share percentages may be used where contributions differ. Under this kind of agreement, decision-making is shared with the lessor. Risk of crop yields and crop prices is also shared between the lessee and the lessor.

Livestock Share for Real Estate. A livestock share lease involves both crop and livestock enterprises. In a typical lease, the lessor owns the real estate and half of the livestock. The lessee owns all of the machinery and the remaining half of the livestock. The lessee provides all the labor for the entire farm operation. All farm income is split equally between the lessor and lessee. Fixed costs for the real estate are paid entirely by the lessor. The lessee pays fixed cost for machinery and any hired labor. All direct variable livestock and crop expenses are split equally.

The rights and duties of both the lessor and lessee must be specified in the lease. These include cropping program restrictions, conservation practices, compliance with FSA programs, care of buildings, and rights reserved to the lessor.

Every lease situation is different and every lease term can be negotiated. Careful crafting of the lease agreement can avoid misunderstanding and conflict during the lease term. Both the lessor and lessee need to know exactly what expenses they are obligated to pay and which party receives each of the various income items. For example, the lessor may pay half of the custom-hired cropping expenses such as baling or chopping if the lessee does not own

that particular type of equipment. Barn cleaners or silo unloaders may be owned by either party and the expenses associated with them must be stated in the lease. Expenses can be shared in a manner different from the typical lease if both the lessor and lessee feel alternative terms make sense and are fair to both parties.

The livestock share for real estate requires the greatest shared management responsibilities of any of the leases. The livestock share lease shifts more of the risks in the livestock share lease to the lessor however, the return to the lessee is less as livestock income is also shared.

Farm Building Leases

Farm building leases are an alternative to purchasing or constructing the building. Alternatives include leasing from a building company or leasing unused farm buildings from a neighbor.

Leases with building companies are usually multiple year leases. Generally, a purchase option is included at the end of the lease period with a rather small payment to secure ownership. The lessor uses the lease in hopes the lessee selects the purchase option. It is expensive for the lessor to tear down the structure at the end of the lease period if the purchase option is not elected.

Leasing unused buildings from neighbors is normally much cheaper than constructing new buildings. Initial costs to update a dairy barn when the building has not been used for many years could be costly for a lessee. Estimates should be obtained prior to entering into a lease agreement. Lessees should also be cautious about entering into agreements that impose all repair costs on the lessee. To help avoid future conflicts, the obligations of both parties should be clearly stated in a written lease.

Livestock Leases

Leasing of dairy cows or other breeding livestock is available from a leasing company or from a retiring farmer. Lease payments to a leasing company are based on the number of cows leased per month. Quality of the cows is not always specified in the lease and the leasing company has the right to exchange cows at any time during the lease period. Usually, the best cows are removed from the herd and replaced with another cow. Death losses are borne by the lessor up to some limit, then the lessee must pay for additional losses. Generally, the lessor gets all offspring. Feed and operating costs are the responsibility of the lessee. Fixed costs of ownership should be compared to the lease payment to determine which alternative is cheaper. As a general rule, a farm producer would be better off financially owning the dairy herd and leasing other assets if there is limited capital. The return for a livestock investment is normally greater than for machinery or real estate.

Sometimes a herd of dairy cows can be leased from a retiring farmer. Leasing the dairy cows is attractive to the retiring farmer for two reasons. First, a lease allows the retiring farmer to spread out the capital gains over several years as compared to a herd dispersal sale. Second, the retiring farmer benefits by having the herd that they spent a lifetime building remain intact and in not having to experience the trauma of a dispersal auction.

For a young person wanting to get into the dairy business, it is possible to lease the cows, the dairy buildings, and the equipment. A typical agreement allows ownership of all future dairy heifers to go to the lessee, which allows the beginning operator to build ownership in a dairy herd over time. Cull cow income belongs to the retired farmer and is spread over several years, which may reduce the total income taxes on the gain. After approximately five years, the young person would own the dairy herd. This alternative may be very attractive to both parties

financially. The largest potential problem is personal conflicts between the two parties. The retired farmer may provide unwanted advice to the young person or be present for nearly all the milking. The ability of the parties to work out areas of personal conflict is crucial to a successful lease. Farmers must carefully assess their personal relationship qualities in addition to the economics of leasing.

Advantages of a Total Farm Operating Arrangement

- 1) Provides a way to transfer assets through the business arrangement
- 2) Beginning operator has no or little debt when beginning farming
- 3) Established operator can assess the likelihood of a successful joint farming operation and the ability of all parties to get along before the transfer of major amounts of assets
- 4) Beginning operator begins to acquire ownership of farm assets
- 5) Management transfers can begin with this type of farm business arrangement

Disadvantages of a Total Farm Operating Arrangement

- 1) Beginning operator may not become involved in management
- 2) Ownership transfer may be slow
- 3) Beginning operator may have inadequate funds

Advantages of a Leasing Arrangement

- 1) Lessee can acquire the use of resources with less capital investment
- 2) Lessor has a stream of income to pay for retirement
- 3) Lessor does not have to recognize gain from sale of the asset
- 4) Lessee can deduct the full lease payment as a business expense

Disadvantages of a Leasing Arrangement

- 1) Lessor must report the lease payments as ordinary income
- 2) Lessee does not build equity in the leased asset
- 3) Lessee can lose the use of the asset at the end of the lease

Exercise

SWOT Analysis I

For Case Farm Study #1 complete a SWOT Analysis. When completing the SWOT analysis consider the type of business arrangement, transfer of farm assets and debts, and the transfer of management and labor resources.

Internal

(those factors the family has control over)

Strengths:

Weaknesses:

External

(those factors that are outside the control of the family)

Opportunities:

Threats: