

# **Enterprise Operating Agreement**

n Enterprise Operating Agreement is one of your farm business choices Examining your Farm Business Choices (AgDM File C4-41), (www.extension.iastate.edu/agdm/wholefarm/pdf/c4-41.pdf). It can be a second step in the Farm Business Transfer Process (AgDM File C4-13), (www.extension.iastate.edu/agdm/wholefarm/pdf/c4-13.pdf) after a Wage and Incentive Agreement (AgDM File C4-42), (www.extension.iastate.edu/agdm/wholefarm/pdf/c4-42.pdf). It can also be used as the initial agreement in the transfer process.

In an Enterprise Operating Agreement, the younger party has capital invested in the personal property, operating capital, or livestock of one specific enterprise. Often that enterprise is a livestock enterprise. The younger party also has a portion of the management responsibility for that enterprise. For his/her contribution of capital, labor, and management to the enterprise, the younger party receives a portion of the income from the enterprise.

The parties share the income from the enterprise in the same ratio as they contribute capital, labor, and other resources to the enterprise. As an alternative, the younger party may pay the older party for the feed, use of the facilities, equipment, or pasture, and retain all of the net income from the enterprise.

On the rest of the farming operation the younger party has no capital invested, little or no management responsibility, and receives a wage for labor provided. In addition, the business may provide the younger party with housing and other fringe benefits.

For example, assume the parties are developing an agreement for a hog enterprise. The agreement is for the older party to receive 75 percent and the younger party to receive 25 percent of the gross

income. Also, many of the cash operating expenses of the hog enterprise are shared in the same ratio. The breeding herd is owned 75-25 percent by the two parties. The older party provides the machinery, equipment, and housing for the hog enterprise. Each party provides a portion of the labor and management with the younger party providing the most.

### **Contribution of Resources**

The value of the resources contributed by each party must be determined. This includes machinery, equipment, buildings, labor, and management. The value of the fixed assets includes a return on current value plus depreciation. The breeding herd is not included here because this contribution is made in the same ratio as income is divided (75-25 percent).

Home-raised feed also is listed as a contribution in this situation. The older party provides feed that is produced by the cropping enterprise of his/her farming operation. This is valued at current market price.

Contributions			
	Younger Party	Older Party	Total
Machinery/equip.		\$13,000	\$13,000
Buildings		18,000	18,000
Labor and mgmt.	<u>\$18,000</u>	4,000	22,000
Total	\$18,000	\$35,000	\$53,000
Home-raised feed	<u>0</u>	<u>70,400</u>	<u>70,400</u>
Total	\$18,000	\$105,400	\$123,400

As shown in the example above, the older party initially contributes \$35,000 and the younger party \$18,000. After the home-raised feed (for example, corn) is added, the older party's total contribution increases to \$105,400.

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## **Contribution Adjustment**

To be equitable, the value of the resources contributed by each party should be in the same ratio as the division of gross income (in this example, 75-25 percent). If the older party's contribution does not meet the required percentage, an adjustment can be made by him/ her buying home-raised feed from the older party and contributing it to the enterprise. In this example, the younger party only contributes \$18,000 but needs to increase his/her contribution by \$12,850 to a total of \$30,850 in order to make it equal to 25 percent. Conversely, the older party contributes \$105,400 but needs to decrease his/ her contribution by \$12,850 to equal a 75 percent contribution. So, the younger party buys \$12,850 of home-raised feed from the older party and contributes the feed to the hog enterprise. Now the resources are contributed in the same ratio as the division of gross income.

Adjustment		
	Younger Party	Older Party
Actual contributions	\$18,000	\$105,400
75%-25% contributions	<u>30,850</u>	<u>92,550</u>
Adjustment	-\$12,850	\$12,850

### **Income Sharing**

The income from the sale of market hogs and cull sows is divided 75-25 percent between the two parties. To determine the amount of income each party will receive from the hog enterprise, the cash operating costs (split 75-25) and value of homeraised feed are subtracted from gross income. The value of home-raised feed must be deducted because it is a cost to the hog enterprise and income to the crop enterprise.

None of the costs (such as depreciation or real estate taxes) associated with any of the resources (such as machinery, equipment) contributed to the hog enterprise are deducted here. These costs are borne by the party owning the resource.

However, minor repairs may be deducted here if an allowance for repairs was not included in determining the value of the contribution.

Net cash income					
	Younger Party	Older Party	Total		
Sale of hogs	\$37,185	\$111,555	\$148,740		
Cash oper. cost	6,600	19,800	26,400		
Home-raised feed	<u>12,850</u>	<u>57,550</u>	<u>70,400</u>		
Net cash income	\$17,735	\$34,205	\$51,940		

The younger party's annual income includes income earned from the hog enterprise, in this case \$17,735, plus wages earned from work on the other enterprises of the farm and any fringe benefits.

#### Cash Flow

Each party's cash flow from the hog enterprise consists of the net cash income less cash costs and debt payments associated with the ownership of the contributed resources. The remaining cash flow can be used for family living, replacing capital assets, or investing in the business.

Cash flow		
	Younger Party	Older Party
Net cash income	\$17,735	\$34,205
Interest on op. cap.	<u>500</u>	
Debt payments		<u>3,000</u>
Remainder	\$17,235	\$31,205

As shown above, the younger party's net income from the hog enterprise is \$17,735. After deducting \$500 of interest payments, the younger party has \$17,235 to be combined with other income earned on the farm to be used for family living and possibly, further investment in the business. See *AgDM File C4-16* for additional information and examples of **Dividing Business** Income (<a href="www.extension.iastate.edu/agdm/wholefarm/pdf/c4-16.pdf">www.extension.iastate.edu/agdm/wholefarm/pdf/c4-16.pdf</a>).

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