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Farm Business Operating Agreement

A Farm Business 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) and can be the next step in the **Farm Business Transfer Process** (*AgDM File C4-13*), www.extension.iastate.edu/agdm/wholefarm/pdf/c4-13.pdf). It can be used after an **Enterprise Operating Agreement** (*AgDM File C4-44*), (www.extension.iastate.edu/agdm/wholefarm/pdf/c4-44.pdf). It can also be used as an intermediate arrangement between a **Wage and Incentive Agreement** (*AgDM File C4-42*), (www.extension.iastate.edu/agdm/wholefarm/pdf/c4-42.pdf) and a **Partnership** (*AgDM File C4-46*), (www.extension.iastate.edu/agdm/wholefarm/pdf/c4-46.pdf) or **Corporation** (*AgDM File C4-47*), (www.extension.iastate.edu/agdm/wholefarm/pdf/c4-47.pdf). This agreement is similar to a partnership and involves the entire operation. **Farm Business Operating Agreements** are used when both parties contribute labor and management, invest capital, and share the income generated from the farm business. Often the older party furnishes all the land, although the parties may rent additional land. Many variations of ownership of machinery, feed, and livestock are used. The accounting requirements are simplest if the parties have equal ownership of much of the personal property.

Contributing Resources, Sharing Income

The share of the income received by each party depends on the contributions of each party. The party furnishing the largest share of the resources receives the largest share of the income. The parties involved must decide how to divide the income based on the annual value of the contributions of each party.

The costs and expenditures associated with owning individual assets are paid by the owner of these assets. For example, if the older party owns the land, provides the use of the land to the agreement, and receives a payment in return (i.e. cash rent equivalent or share of the farm income); then he/she is responsible for paying the property taxes, debt payments, and other costs associated with owning the land.

For example, assume a dairy farm has a 45 dairy cow herd and 240 acres of cropland. The younger party furnishes 12 months of labor, pays half of the expenses for the livestock, owns half of the cattle, and owns a $25,000 tractor. The older party furnishes 12 months of labor, pays the other half of the livestock expenses, owns half of the cattle, owns all of the equipment and most of the machinery, and owns the real estate. As shown below, the younger party provides $56,300 worth of resources and the older party provides $196,400. Gross income is divided in the same proportion as the value of the contributions.

Contributions

	Younger Party	Older Party
Crop expense		$60,000
Machinery expense	$2,800	11,200
Dairy expenses	20,000	20,000
Machinery ownership cost ($125,000 @ 20%)	5,000	20,000
Cattle inventory ($90,000 @ 10%)	4,500	4,500
Equipment investment ($90,000 @ 15%)		13,500
Labor - 24 mo. @ $2,000	24,000	24,000
Land - 240 ac. @ $180		43,200
Total	**$56,300**	**$196,400**

First, compute the total contribution by adding together the contributions of both parties.

Don Hofstrand
retired extension specialist

Younger party's contribution	$ 56,300
Older party's contribution	196,400
Total contribution	$252,700

Next, compute the percent of the contribution provided by each party. In the example, the older party provides 78 percent and the young person 22 percent of the resources.

Younger party's share	$56,300 / $252,700 = 22%
Older party's share	$196,400 / $252,700 = 78%

If the total cash income for the year is $250,000, the older party's share is $195,000 (78 percent) and the younger party's share is $55,000 (22 percent).

Gross cash income	
Milk and livestock sales	$150,000
Crop sales and misc.	100,000
Total	**$250,000**
Younger party's share	$250,000 x 22% = $55,000
Older party's share	$250,000 x 78% =$195,000

Individual Cash Flows

Each party's income is used to pay the debt payments and expenses associated with individually owned resources that are contributed to the business. Additional income can be used for family living expenditures and taxes, or additional investment in the business.

As shown in the next example, the younger party pays $22,800 of livestock and machinery expenses, has an annual machinery and equipment debt payment of $5,000, and needs $25,000 for living expenses. The older party pays $91,200 of expenses, has annual machinery and equipment debt payments of $10,000, pays $5,500 of real estate taxes, and needs $45,000 for living expenses.

Expenditures	Younger Party	Older Party
Crop expense		$60,000
Machinery expense	$2,800	11,200
Dairy expense	20,000	20,000
Machinery debt payment	5,000	7,000
Equipment debt payment		3,000
Land taxes		5,500
Family living	25,000	45,000
Total	**$52,800**	**$151,700**

Net cash flow	Younger Party	Older Party
Cash income	$55,000	$195,000
Cash outflow	52,800	151,700
Net cash flow	**$2,200**	**$43,300**

The younger party has $2,200 which can be invested in the business, used to retire debt, or used for additional living expenditures.

Inventory Adjustments

Changes in inventory can be included in the agreement. Although it requires more bookkeeping, inventory adjustments provide a more accurate picture of income. Inventory adjustments can be calculated annually or once during the life of the agreement. Inventory adjustments are computed by adding the year's end or closing inventory to income and subtracting the beginning inventory as a cost.

Sales	$250,000
Closing inventory	+23,000
Opening inventory	-19,000
Total returns	**$254,000**