Two-Generation Farming

Step 2: Selecting a Business Arrangement

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Examining your choices

The following materials contain several different types of business transfer agreements. To successfully transfer your business to the next generation, you must select the proper transfer agreement or series of agreements

Type of operation

The two primary types of business arrangements are the "*spin-off*" and the "*multi-person*" arrangements. Either of these types may be chosen after a brief testing stage during which the younger party works for a wage. The type you choose will depend on the type and size of your business and the goals and interpersonal relationships of each of the parties. You also need to examine the various legal arrangements available.

Spin-off arrangement

With a spin-off arrangement, the younger party develops a separate farming unit after a brief trial period with the parents. At least initially, the two parties may exchange labor and machinery. They may operate part of the business together, such as a joint livestock operation. But the spin-off is primarily an arrangement where the younger party builds equity in machinery and other assets in a separate business. If the parents' unit is quite large, it may be divided to create a separate business for the younger party. At the parents' retirement, the home farming operation may terminate, or it may be taken over by the younger party.

Advantages of the spin-off arrangement are:

- fewer goal conflicts;
- fewer joint decisions;
- the parties can share management, but each is responsible for individual decisions;
- each party preserves an independent nature and pride of ownership;
- the parents' financial security is not jeopardized if the home farm is not large enough to support two families; and,
- exchange of labor or joint ownership of machinery is still possible.

The key to success is the younger person's ability to develop an independent business that will provide adequate income for living and debt servicing.

When the younger party spins-off and establishes a separate farming operation, the two parties often continue to share labor and machinery. The older party usually has sufficient machinery but needs additional labor. Conversely, the younger party often has excess labor but does not have sufficient investment in machinery. So an arrangement is developed when the party's trade labor and machinery with each other.

Multi-person arrangement

With a multi-person arrangement, the younger party enters the business and provides labor, capital, and management in return for a share of the income. To be successful, the parties must be compatible and the business income should be adequate for both families. A key concern is how and when to transfer assets and management to the younger party. This arrangement is often used in farm situations with specialized facilities that would be difficult or impossible to divide — such as a dairy or hog operation.

Advantages of the multi-purpose arrangement are:

- business continuity from one generation to the next;
- the younger party starts in an established business with less risk and more income;
- the young person has a chance to grow into the business without incurring substantial debt;
- both parties are less confined by farm duties; and
- the older party can retire gradually.

When the younger party joins the business, some form of operating agreement is usually developed. The operating agreement allows the younger party to invest in the business, provide managment, and receive a portion of the income from the business. Initially, the younger party may only invest in one enterprise (i.e. hogs, dairy, etc.) while working for a wage on the other enterprises. As the younger party's investment increases, the agreement is changed so his/her share of the income reflects the new investment. If the parties will farm together for several years, a more formal arrangement may be developed, such as a partnership or corporation.

Size of operation

Whether you choose a *spin-off* or *multi-person* arrangement may depend on the size of the parents' operation. Farm families with operations of adequate financial size have a wider array of business arrangements from which to choose.

Multi-person. This approach usually works best when the parent's business is of adequate financial size. Fewer problems arise over the division of income, and everyone is fully employed.

If the business is not large enough but the parents are near retirement, the parties may enter a holding pattern until the parents retire. When the parents retire, the younger party rents the home farm and buys or leases the personal property.

If the business is not large enough and the two parties will farm together for several years, they may develop a multi-person arrangement by expanding the business to meet the income needs of both families. Before doing this, the parents must be sure they are financially strong enough to make such a move and that they do not jeopardize their financial security in retirement years.

Spin-off. Even if the parents' business is of adequate size to support both families, the parties may decide to develop separate farming operations. A typical situation would be a cash grain operation where the parents' business is divided into two separate operations.

A spin-off arrangement is often used when the business is not large enough to support both families. In this situation, the younger party creates and develops a separate business and does not draw resources or income from the parent's business.

Legal arrangements

The major legal alternatives available to you are discussed below. The task is to find the one that best fits your situation.

Sole proprietorship

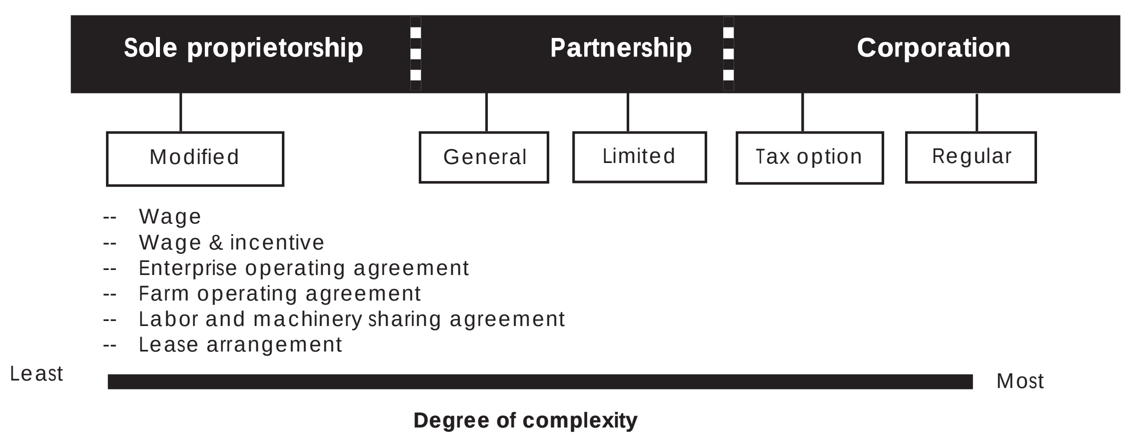
Under a sole proprietorship, the farm is operated by one individual. This legal arrangement continues until the operator quits farming, retires, or dies. Often two or more sole proprietorships are created and linked together with various types of contractual sharing arrangements. Various joint arrangements, such as enterprise and farm operating agreements are examples where two or more proprietorships are used.

Partnership

A partnership is an aggregation of owners. Two or more persons contribute assets to the business and share the management responsibility, profits, and losses. The partnership is not a taxpayer but channels taxable income to the individual partners. A special form of partnership permitted by state law is the limited partnership. A limited partner is an investor and cannot participate in management, but bears no personal risk for the actions of the partnership.

Corporation

The corporation is an artificial entity created under state law. It is a separate business and legal entity, distinct from its owners. There are two types of corporations: (1) the *regular C corporation*, and (2) the *tax-option S corporation*. The regular corporation is a separate taxpayer. The tax-option corporation is a corporation in most respects except that it ordinarily pays no income tax.



Source: *Farm Business Arrangement: Which One For You?*, NCR 50

Wage and incentive agreement

A Wage and Incentive Agreement can be used during the testing stage when the younger party first comes into the business. The testing stage is a period used to determine if the younger party really wants to farm and if all parties can get along.

In a *wage and incentive agreement* the younger party usually has no money invested in the business. He/she receives a wage plus (possibly) housing or other fringe benefits. In addition to the wage, he/she receives compensation through an incentive plan if the business does well. Check requirements for Social Security tax and income tax withholding to see how such income is treated for tax purposes.

Key considerations

Keep the following points in mind in developing an incentive program.

- The incentive is not a substitute for wages, but an addition to a fair and equitable wage.
- It should be large enough to provide a proper incentive. As a rule, it should average 15 to 20 percent of the base wage.
- The incentive should be based on performance levels that are observable, measurable, and controllable by the employee.
- The objective of the incentive is to motivate employees to improve their performance level The incentive payment should be paid promptly and regularly.
- The incentive plan should be reviewed regularly and modified as the employee gains skills or is assigned new duties and responsibilities.

Types of incentives

Labor vs. Management

Incentives may differ depending on whether the employee provides only labor or labor plus management to the operation. With a managerial incentive, the employee has control over much of the day-to-day decisions. Labor incentives can be divided further into skilled or semi-skilled labor.

Physical vs. Economic

Incentives can be based on physical production (bushels of corn or number of pigs), or a share of the income.

Gross vs. Net

Income incentives can be further divided into incentives that are based on gross income or net income. Gross income incentives are usually easier to figure, while net income incentives focus on increasing profits.

Farm vs. Enterprise

Incentives can be based on the entire farm business or an individual enterprise such as hogs or dairy. Whether an incentive is based on the performance of the whole farm or just one enterprise depends on the employees's responsibilities.

Example

Wages	$14,000
Fringe benefits	
housing	1,500
other	500
Total	$16,000
Incentives	
whole farm	$1,850
livestock	850
	$2,700
Grand total	$18,700

In this example, the employee receives $14,000 in wages plus $2,000 in fringe benefits for a total of $16,000. The employee receives an additional $1,850 whole farm incentive and an $850 livestock incentive for a total of $2,700 in incentives. Total compensation is $18,700.

Examples of Incentive/Bonus Arrangements

Use the following examples of incentive programs only as guides. Adapt them to your situation. Tie them to work responsibilities carried out by the employee over which he/she has some control.

Suggested incentives	TYPE OF EMPLOYEE STATUS		
	Semi-Skilled	**Skilled**	**Supervisory/Management**
Normal incentive should be equal to:	5-10% of cash wages	10-15% of cash wages	15-25% of cash wages
Whole farm (adjust for size and type of farm)	1/2-1% of Gross Farm Receipts		2-4% of net returns after cash operating expenses, or 5-10% of taxable income (Schedule F)
	End of year bonus = $200-$400 per year plus $50 for each year of service	End of year bonus = $300-$600 per year plus $75 for each year of service	End of year bonus = $500-$1,000 per year plus $100 for each year of service
Crop farm	$2-$3/hour tractor driven after 7 p.m. (paid weekly) $3-$4/hour tractor driven after 11 p.m. (paid weekly)	$2-$4/hour tractor or combine driven after 7 p.m. (paid weekly) $3-$5/hour tractor or combine driven after 11 p.m. (paid weekly)	10-15¢/bu. of corn produced over county average or long-term farm average 20-30¢/bu. of soybeans produced over county average or long-term farm average
	¼ -1% of gross crop sales		
Dairy	$3-$5 for each cow detected in heat	<u>Calving interval</u> $150 = 13.5 months $300 = 13 months $500 = 12.5 months	<u>Herd milk production avg.</u> 14,000# = $500/year 16,000# = $1,000/year 18,000# = $2,000/year
Hogs — Farrow to Finish	$1.00-$2.00 for each sow detected in heat	<u>Pigs saved per litter/50 sows</u> 7.5 = $200 8.0 = $400 8.5 = $700 9.0 = $1,000 9.5 = $1,500	<u>Feed conversion farrow to finish/50 sows</u> 425# = $150/year 400# = $300/year 375# = $500/year 350# = $700/year 325# = $1,000/year 300# = $1,500/year
Hogs — Finishing	½-1% of hog sales less cost of feeder pigs $1.00-$2.00 per feeder pig bought and fed out		
Beef	$10-$15 for each feeder detected sick, treated and recovered	<u>Calf crop sold/75-100 head</u> 85% = $300 90% = $600 95% = $1,000 100% = $1,500	Same as other two categories

Source: Farm Business Arrangements: Which One For You? NCR Publication No. 50.

Enterprise operating agreement

An Enterprise Operating Agreement can be a second step in the transition process after a Wage and Incentive Agreement. It also can be used as the initial agreement for a two-generation arrangement.

Provisions

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.

Example

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 example. The older party provides feed that is produced by the cropping enterprise. This is valued at current market price.

Contributions

	Older Party	Younger Party	Total
Machinery/equip.	$7,320		$7,320
Buildings	13,000		13,000
Labor and mgmt.	4,000	$14,000	18,000
Total	$24,320	$14,000	$38,320
Home raised feed	50,400	0	50,400
Total	$74,720	$14,000	$88,720

As shown in the example above, the older party initially contributes $24,320 and the younger party $14,000. After the home-raised feed (for example, corn) is added, the older party's total contribution increases to $74,720.

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 $14,000 but needs to increase his/her contribution by $8,180 to a total of $22,180 in order to make it equal to 25 percent. Conversely, the older party contributes $74,720 but needs to decrease his/her contribution by $8,180 to equal a 75 percent contribution. So, the younger party buys $8,180 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

	Older Party	Younger Party
Actual contributions	$74,720	$14,000
75%-25% contributions	66,540	22,180
Adjustment	$8,180	$-8,180

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 home-raised 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

	Older Party	Younger Party	Total
Sale of hogs	$111,555	$37,185	$148,740
Cash oper. cost	19,800	6,600	26,400
Home raised feed	42,220	8,180	50,400
Net cash income	$49,535	$22,405	$71,940

The younger party's annual income includes income earned from the hog enterprise, in this case $22,405, 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

	Older Party	Younger Party
Net cash income	$49,535	$22,405
Interest on op. cap.		500
Debt payments on		
breeding herd	2,000	1,000
machinery, equip. and buildings	3,000	
Remainder	$44,535	$20,905

As shown above, the younger party's net income from the hog enterprise is $22,405. After deducting $1,500 of principal and interest payments, the younger party has $20,905 to be combined with other income earned on the farm to be used for family living and, possibly, further investment in the business.

Farm business operating agreement

A Farm Business Operating Agreement can be the next step after an Enterprise Operating Agreement. Also, it can be used as an intermediate arrangement between a wage arrangement and a partnership or corporation. This agreement is similar to a partnership and involves the entire operation.

Provisions

Farm business operating agreements are used when both parties contribute labor and management, have capital invested in the crop and livestock programs, 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 what return to pay, based on the contributions of each party.

The costs and expenditures associated with owning assets are paid by the owner of the asset. For example, if the older party provides the land and receives a payment in return (*i.e.* cash rent equivalent or share of the income), then they are responsible for paying the property taxes and debt payments (and other costs) associated with the land.

Example

For example, assume a dairy farm has a 45 dairy cow herd and 360 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 $39,500 worth of resources and the older party provides $110,000. Gross income is divided in the same proportion as the value of the contributions.

Contributions

	Younger Party	**Older Party**
Crop expense		$20,000
Machinery expense	$2,800	7,900
Livestock, feed expense	17,000	17,000
Machinery ownership cost ($100,000 @ 20%)	5,000	15,000
Cattle inventory ($54,000 @ 10%)	2,700	2,700
Equipment investment ($20,000 @ 15%)		3,000
Labor - 24 mo. @ $1,000	12,000	12,000
Land - 360 ac. @ $90.	______	32,400
Total	$39,500	$110,000

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

Older party's contribution	$110,000
Younger party's contribution	39,500
Total contribution	$149,500

Next, compute the percent of the contribution provided by each party. In the example, the older party provides 73 percent and the young person 27 percent of the resources.

Older party's share	$110,000 ÷ $149,500 = 73%
Younger party's share	$ 39,500 ÷ $149,500 = 27%

If the total cash income for the year is $165,000, the older party's share is $120,450 (73 percent) and the younger party's share is $44,550 (27 percent).

Gross cash income

Milk and livestock sales	$140,000
Crop sales and misc.	25,000
Total	$165,000

Older party's share	$165,000 x 73% = $120,450
Younger party's share	$165,000 x 27% = $ 44,550

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 below, the younger party pays $19,800 of livestock and machinery expenses, has an annual machinery and equipment debt payment of $5,000, and needs $18,000 for living expenses. The older party pays $44,900 of expenses, has annual machinery and equipment debt payments of $10,000, pays $5,500 of real estate taxes, and needs $35,000 for living expenses.

Expenditures

	Younger Party	Older Party
Crop expense		$20,000
Machinery expense	$2,800	7,900
Livestock feed expense	17,000	17,000
Machinery debt payment	5,000	7,000
Equipment debt payment		3,000
Land taxes		5,500
Family living	18,000	35,000
Total	$42,800	$95,400

Net cash flow

	Older Party	Younger Party
Cash income (above)	$44,550	$120,450
Cash outflow	42,800	95,400
Net cash flow	$1,750	$25,050

The younger party has $1,750 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. Inventories also can protect one party from receiving undue financial benefits. 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	$165,000
Closing inventory	+23,000
Opening inventory	-19,000
Total returns	$169,000

Labor and machinery sharing agreement

A Labor and Machinery Sharing Agreement is used when the younger party "spins-off" or establishes a separate farming operation. Although each party has a separate farming operation, they share labor and machinery.

A key reason for farming together is to provide the younger party with access to machinery. However, a *spin-off* arrangement results in two separate operations. This problem can be solved by using a *labor and machinery sharing agreement*. This will facilitate the exchange of labor and machinery between the two parties.

This agreement is used when each party has a separate land base. Each party pays the production expenses, receives the income, and has final management control over his/her individual cropping operation. Livestock programs may be separate or mutually owned and operated.

Each party owns individual items of machinery. However, the younger party usually does not have a complete line of machinery and the older party typically needs additional labor. When both parties combine labor and machinery, they can efficiently operate both farms.

Developing an agreement

To initiate this type of arrangement, the younger party must have access to land. He/she may obtain a rented farm from land the older party previously rented or land that appeared on the rental market. Buying land may be an option.

A contractual agreement is developed whereby the older party pays the younger party for his/her labor and machinery used on the older party's farm and vice versa. To simplify the exchange, the parties will often keep the relationship of the amount of land farmed to the amount of machinery owned approximately equal. For example, if the older party's operation accounts for two-thirds of the total land farmed and they own two-thirds of the machinery, there may be no need for a cash machinery payment. Operating costs can be accounted for separately or ignored in the agreement to simplify bookkeeping. Both parties can provide fuel for machinery used on their own land, and pay for repairs on their own machinery.

If these ratios are not equal, a machinery payment will need to be made. Also, a labor payment may be needed. Two methods for computing the labor and machinery costs on which payments can be based are discussed below.

Based on custom rates

Custom rates are an approximation of the cost of doing various field operations. Costs include labor, fuel, lubrication, repairs, and the cost of machinery ownership (depreciation, return on investment, insurance, and housing). Custom rates may also include a margin for profit. The *Iowa Farm Custom Rate Survey*, Fm-1698, published annually, can provide you with estimates of custom rates.

Adjusting Custom Rates. If the other party does an operation on your farm and provides the labor, fuel, and equipment, you can use the custom rate directly as an estimate of the cost of the operation. If the other party provides everything except the labor and/or fuel, subtract a charge for these items from the custom rate. Do this by either keeping track of the actual amount of labor and fuel used, or estimate them with the publications, *Estimating Field Capacity of Farm Machines, Pm-696*, and *Fuel Requirements for Field Operations, Pm-709*.

Example. The older party owns the planter and tractor and plants the younger party's crop, and a $8.20/acre custom rate is charged. If the younger party provides the fuel and labor, $1.50/acre would be deducted from the rate (.62 gal/acre x 80¢/gal. = 50¢/acre) + ($8/hr. ÷ 8 acre/hr. = $1.00/acre) = $1.50.

Allocating Custom Rates. Custom rates can be divided into their various cost components. For example, the cost of owning the tractor makes up about 27 percent of a tillage custom rate. Another 32 percent consists of fuel and repairs for the tractor for a total of 59 percent. Labor makes up 16 percent.

	Tillage[1]	Planter	Combine
Power Unit			
Ownership	27%	12%	50%
Fuel and lub.	15	9	7
Repairs	17	7	35
Total	59%	28%	92%
Implement			
Ownership	18%	44%	
Repairs	7	13	
Total	25%	57%	
Labor	16%	15%	8%
	100%	100%	100%

[1]Includes chisel plow, tandem disk, field cultivator, rotary hoe, and cultivator.

Example. A typical custom rate for tandem disking is $6.90 per acre. With the table above, the costs can be estimated as follows:

Tractor ownership cost = $1.86 ($6.90 x 27%),
Tractor fuel, lub. & repairs = $2.21 ($6.90 x 32%),
Disk ownership = $1.24 ($6.90 x 18%),
Disk repairs = $ .48 ($6.90 x 7%),
Labor = $1.10 ($6.90 x 16%)

The party receiving the service would pay the other party for only those components received.

Based on actual cost

Depreciation. A popular method of estimating depreciation is to multiply the current market value of the machine by 8 to 10 percent. For example, a $20,000 machine would have an estimated annual depreciation of $2,000. Newer machinery items may justify a higher percent while others may be lower. Income tax depreciation schedules are generally not very useful for estimating actual depreciation.

Depreciation per acre (per hour) can be estimated by dividing total depreciation by the total acres covered (hours used). For example, if the older party's machine has $5,000 of depreciation and covers 1,000 acres, the depreciation per acre is $5.00. If 400 of these acres are the younger party's operation, he/she owes $2,000 (400 acres x $5.00) to the older party.

Return on Investment. Money invested in machinery represents a cost. If the machinery is sold, the money can be invested elsewhere to earn a return, or it can be used to reduce debt thereby reducing interest expense. To estimate this cost, multiply the current machinery value by an interest rate (*e.g.*, the current rate on CDs).

Other Costs. Other costs to include are repairs, fuel, lubrication, insurance, and housing. One percent can be added to the depreciation rate to cover insurance and housing. You may want to keep a separate listing of the repairs for each machine or allocate the total repair cost at the end of the year to each machine. Major repairs and overhauls should not be charged as a cost. These increase the value of the machine and show up as higher depreciation and return on investment in subsequent years. Fuel use can be estimated or the actual fuel use can be monitored.

Example. The older party's planter and tractor are used to plant the crops of both parties (800 ac.). The 12-row planter has a current value of $17,000. The 100 horsepower tractor is worth $25,000 and covers 3,000 acres annually. Assuming a 10 percent depreciation rate, 1 percent for insurance and housing, and a 7 percent interest rate, the costs are as follows:

	$/acre
Tractor—$25,000 x 18% ÷ 3000 acres =	$1.50
Planter—$17,000 x 18% ÷ 800 acres =	3.83
Fuel and lub.— .6 gal/acre @ $.80=	.48
Repairs (tractor)— $3,000 ÷ 3,000 acres=	1.00
Repairs (planter)— 600 ÷ 800 acres=	.75
Labor — $9.50/hr. ÷ 11 acres/hr. =	.86
	$8.42

The older party charges the younger party $8.42 per acre for all costs. If the younger party provides the fuel or the labor, these costs would not be included.

Often the younger party provides labor on more acres than he/she receives the use of machinery for. If the value of labor provided is roughly equal to the value of machinery loaned, no actual cash may change hands.

Partnership

A partnership is a flexible form of business organization. A summary of the partnership's applications to farming situations is presented below.

In a *partnership*, both parties have money invested in the business, share management responsibilities, and have some form of sharing of profits and losses.

A partnership is an association of two or more persons to carry on, as co-owners, a business for profit. A partnership may have either a written or oral agreement. In fact, a partnership may be implied without an agreement if the business is conducted like a partnership. The key determinant of whether a partnership exists is if there is a sharing of net income. Although a written partnership agreement is not required, it is recommended. The agreement is the basis for operating the business. Therefore it should be detailed and complete.

Uniform Partnership Act

General partnerships are governed by a code of rules called the Uniform Partnership Act. Alternative and additional rules may be specified in the partnership agreement.

Unless stated to the contrary in the partnership agreement, the Act provides that:

- A partner is entitled to share equally in the profits and must assume an equal share of the losses.
- Each partner has an equal right in management.
- Any differences arising from ordinary matters connected with the business partnership may be decided by a majority of the partners.
- A partner is not entitled to a salary for management services.

Property ownership

A partnership can gain the use of property in three ways:

- Property can be owned in the partnership name. In this case, each of the partners is entitled to an interest in the partnership profits. Generally, property can be transferred into a new partnership in a tax-free exchange without paying income tax on the gain.
- The partnership can lease property from the individual partners or others.
- The individual partners can contribute the use of property to the partnership. The individual partners will often receive an interest in the partnership profits for their contribution of property.

Sharing arrangements

A 50/50 partnership agreement is often the preferred partnership arrangement. It facilitates the transfer of personal property to the younger party while permitting him/her to share in as much of the business profits as possible. Real estate and machinery are often rented or leased to the partnership when it is formed. However, if the younger party owns a portion of the machinery, additional machinery may be given or sold to him/her so that a 50/50 machinery ownership pattern is established with no lease involved. If financially possible, the younger party may then buy a 50 percent interest in any new machinery acquired by the partners or the partnership. He/she also would be permitted to acquire 50 percent of the crop and livestock inventories.

If the older party is able and the parties agree, the younger party may receive a larger share of the profits, thus building equity more rapidly. However, the Internal Revenue Service may consider the inequitable sharing of income to be an unreasonable distribution and consider it a gift for tax purposes. Also, the question of equity with non-farming children may be a concern.

A farm family may wish to start with a share arrangement that is less than a 50/50 arrangement. Profits may be shared according to each partner's relative contributions of land, machinery, labor, and management. For example, the older party may receive 75 percent of the profits and the younger party 25 percent. A one-third and two-thirds share agreement also may be considered.

Transferring property

Partnership shares can be transferred from the older to the younger party, although not quite as easily or conveniently as corporate stock. Transfer of partnership shares to minors poses special problems.

Dissolution

A partnership is a fragile arrangement. Dissolution of a partnership occurs when the stated term of the partnership is completed, or when a partner or partners decide to dissolve the partnership. Dissolution by law may occur at the death, departure, or bankruptcy of a partner unless there is a provision in the agreement for continuation.

Because the younger party is likely to be concerned with gaining equity in and eventual control of the business, he/she is in a vulnerable position. However, dissolution of the partnership may not lead to a winding-up of the business. When the partnership is dissolved the partners can:

- terminate the partnership;
- form a new partnership; or
- change the form of business organization.

Buy and sell agreements

Partnerships may include buy-and-sell agreements where a deceased partner's partnership interest is purchased by the surviving partners. This agreement permits the business to continue and reduces financial problems at the death of a partner. A buy-and-sell agreement may be funded with life insurance.

Income taxes

Generally the partnership pays no income taxes. The partnership files a Form 1065 information return. Income, losses, capital gains, etc. pass through the partnership to the individual partners. The partners report their individual share of income, losses, etc. on their individual income tax returns.

Employee benefits

The partners in a partnership are not employees for purposes of participating in employee benefits. However, partners can participate in benefits available to self-employed persons.

Limited liability

Partners of a general partnership have unlimited liability for the obligations of the partnership. If a general partnership incurs obligations, these obligations can be satisfied first out of partnership assets. If the partnership does not have sufficient assets, the partnership obligation can be satisfied out of the individually owned assets of the partners. Insurance is usually carried to cover liability based on negligence. The other liability is contractual liability.

Limited partnership

The limited partnership is a variation of the general partnership. A limited partnership has one or more limited partners. Limited partners have limited liability and cannot participate in management. A limited partnership must have at least one general partner who participates in management and has unlimited liability. Limited partnerships may be structured so that the farming family members are general partners and the off-farm partners are limited partners. In some situations, the limited partnership is used to hold the land, which is then rented to a general partnership, sole proprietorship, or corporation.

Corporation

The corporation is a separate legal entity, making it a more complex form of business organization. Below is a summary of the major provisions of the corporation.

A *corporation* is a separate business entity created under state law. It is separate from its owners (shareholders). A major characteristic of the corporation is this distinction between the business and its owners.

Corporations can be *publicly owned* or *closely held*. Major U.S. corporations are publicly owned. Their stock is widely owned and traded. Closely held corporations are owned by a small group of shareholders. Outsiders cannot generally buy into these corporations. Farm corporations are usually closely held corporations.

Corporation taxation

The *regular C corporation* creates a separate taxing unit. This permits a splitting of income between the corporation (retained earnings) and the individuals (salaries, rents, interest). The corporation as a new taxpayer offers more favorable tax rates for income retained in the corporation than for individual taxable incomes above about $30,000.

To take advantage of these features, the after-tax earnings of the corporation must be retained in the corporation and reinvested. Otherwise, the earnings will be subject to double taxation (corporate and individual levels) if distributed as dividends, or to an accumulated earnings tax if retained within the corporation beyond the reasonable needs of the business. Thus, the corporation is often recommended where there is a growing business in which retained earnings can be reinvested for an acceptable business purpose.

A *tax option* or *S corporation* is similar to a regular C corporation except that it pays no income tax. Net income, capital gains, and other items pass through to the individual stockholders and are taxed at the personal level.

Employee benefits for owners

Since the corporation is a separate legal entity, the owners/operators of the corporation can become employees of the corporation. They become eligible for a wider range of fringe benefits than under self-employed status. Employee retirement plans may be established by the corporation. Employees can receive tax-free medical benefits from the corporation. Employees may receive tax-free meals and lodging if required to live and eat meals on the premises as a condition of employment. Also, the corporation may provide group term life insurance. The cost of these benefits is a tax deductible expense for the corporation.

Estate planning

A desirable estate planning feature of the corporation is the ease of property transfer while maintaining control of the business. With a corporation, transferring property involves transferring shares of stock rather than property items. As little as one share of stock can be sold or given away at a time, making an interest in the business easily transferrable.

Often parents want to transfer part of their property to the farming children or other heirs without giving up control over the business. With a corporation, parents can transfer a substantial amount of the business ownership in the form of corporate stock. As long as they retain 51 percent or more of the common stock, they retain control of the business.

Financial structure

An important decision at formation is how to financially structure the corporation. In addition to common stock, the corporation may issue nonvoting stock or preferred stock (some restrictions exist for tax-option corporations). These stocks may be used to give special or preferential dividend rights to shareholders. A person could be issued bonds or notes to make them a creditor rather than an owner of the corporation although the issuance of debt securities as part of a tax-free exchange is discouraged. For example, if the corporation is also capitalized with preferred stock or bonds, and these go to the parents or off-farm heirs, the amount of common stock the farming children need to gain control of the business is reduced.

Business continuity

A key feature of the corporation is business continuity. A corporation can be established to continue forever — or until it is dissolved by the owners or by operation of law. So the life of the corporation may transcend the life of individual members and is not disrupted by the death or withdrawal of a family member. This aspect of the corporation allows for a smoother transfer of the business from one generation to the next. However, this is no guarantee of success. The remaining corporate members must have the managerial skills to operate the business.

Limited liability

As a general rule, the liability of the shareholders is limited to their investment in the corporation. Limited liability becomes an important issue when the owner-operators have personal investments outside the business. However, there is no absolute guarantee of limited liability. Even the corporate shareholder may be subject to liability greater than his/her investment (or commitment to invest) if the shareholder assumes personal liability for debt obligations. This frequently occurs in farming when shareholders are asked to co-sign the corporation's loan agreements. Adequate liability and property insurance should be carried to protect the business capital. The liability issue should be checked carefully with your attorney.

Minority stockholders

The interests of majority stockholders may be different from those of minority stockholders. For example, the majority stockholders also may be employees of the corporation. They may want to distribute the corporate income as salaries rather than dividends. The majority stockholders may vote against the interests of minority stockholders leaving them with little or no cash return on their investments. In addition, there may be little or no market for the stock of a closely-held corporation. Minority stockholders may be *locked in* unless their rights are specified in the articles of incorporation and by-laws, and buy-sell agreements are used to protect their investment.

Corporation control

Two key issues that arise at corporate formation are:
- what property should be put into the corporation; and
- what type of capital structure should be used?

If all the farm property is put into the corporation and the owners all receive common stock in return, the farming child must gain control of 51 percent of the total business assets to control the business.

An alternative would be to keep certain property out of the corporation. For example, the production side of the business could be incorporated with the land not included. This would reduce the amount of common stock the farming child would need to gain control. However, leaving the land out may not meet the estate planning objectives. So, holding the land in a limited partnership or trust may be used. Also, the production side of the business tends to be a heavy user of capital. Leaving the land out eliminates a very important source of collateral for borrowing.

Another alternative would be to place all the assets into the corporation, but use a capital structure that also includes preferred stock or debentures or both. This would reduce the amount of common stock needed to gain control of the business, while guaranteeing returns to minority stockholders.

Disadvantages

Generally, it costs more to set up and maintain a corporation. There also are some possible adverse tax consequences in the formation, operation, and dissolution of the corporation. At formation, a tax-free exchange is usually possible. Since the exchange of assets is normally tax free at formation, termination holds the potential for a large capital gains tax. Also, more formal record keeping is required of a corporation.

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Prepared by Don Hofstrand, ISU Extension farm management field specialist. Reviewed by William Edwards, Extension economist and Neil Harl, Charles F. Curtiss distinguished professor of agriculture and professor of economics, ISU. Edited by Elaine Edwards, Extension communications specialist.

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