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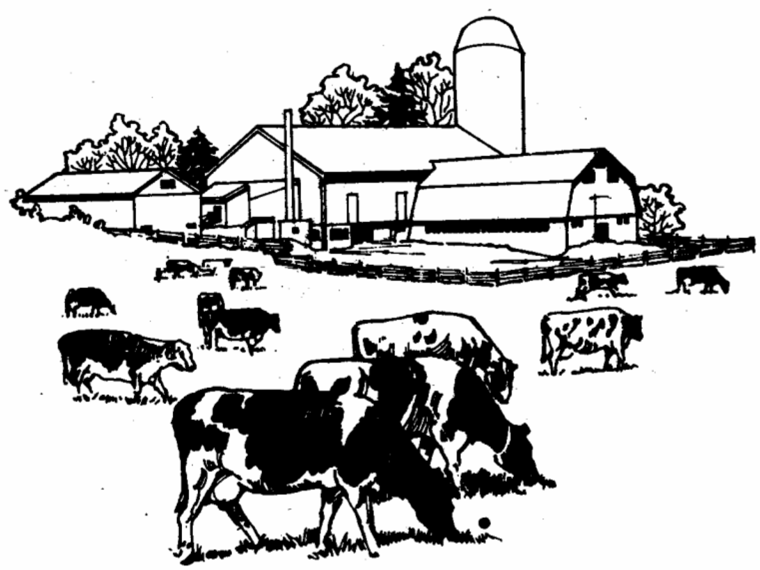
Sharemilking in the Midwest



Sharemilking Considerations for Dairy Producers

by Larry F. Tranel

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Sharemilking in the Midwest

Introduction

Sharemilking is a contractual arrangement between a landlord/lessor/employer and tenant/lessee/employee (hereafter known as OWNER and SHAREMILKER, respectively). Sharemilking combines management, land, labor, cattle and/or machinery in a multi-party dairy enterprise without forming a more formal arrangement such as a limited liability company, partnership or corporation. Sharemilking models from New Zealand and Australia are attracting interest in the Midwest because of their ability to motivate productive dairy enterprises; to support beginning and retiring farmers; and to attract investors. These two countries profit from efficiency of sharemilking arrangements.[i] As one observer put it:

> "Sharemilking is a vital cog to our (New Zealand) dairy industry and it would be very difficult, if not impossible, for young farmers who are not farmers' sons, to achieve farm ownership without the benefit of a few years in this form of occupation. Not only does Sharemilking provide a spring-board (from working for a labor rate or percentage wage) directly into farm ownership, it also allows farm owners to semi-retire gracefully.[ii]

The overall goal of sharemilking is to build career bridges for beginning, mid-career and retiring farmers. Sharemilking arrangements can provide management expertise, economic incentives and a systematic method of asset acquisition for new entrants into the industry. On the other hand, sharemilking can provide established sharemilkers and owners with secure strategies to modify workload, phase-in retirement and exit farming.

Sharemilker Preparation and Career Paths

Dairying has become an increasingly technical and management intensive industry. Successful standards of efficiency continue to rise as do cost levels. Both practice and theory are required if a sharemilker wishes to become a successful manager and/or ultimately attain farm ownership.

Initial education and training can be acquired in Wisconsin through regional technical colleges or through one of the three colleges of agriculture associated with the University of Wisconsin System. The Wisconsin School for Beginning Dairy Farmers, a program associated with the Farm and Industry Shortcourse, UW-Madison, provides an excellent opportunity for persons wanting to engage in grass-based dairying. Following or during training, potential sharemilkers are encouraged to negotiate apprenticeships on successful dairy farms where they will be paid as they receive experience and mentoring in dairy farm management skills.

Apprenticeship experiences with successful dairy farmers as well as networking with other farmers, would prepare a potential sharemilker to begin a sharemilking work experience providing full-time labor to an operation. An initial full-time sharemilker might contract on a 75:25 basis, for example, where the farm owner receives 75% of the proceeds for his/her investment and the sharemilker receives 25% for his/her labor. The actual percentage might increase as managerial skills increase depending upon the contributions of the farm owner and his/her sharemilker. As experience and/or herd equity build, this percentage increases. This is a **major incentive necessary for sharemilking to succeed in the long run**.

A major step for beginning sharemilkers is to garner equity in cattle along with experience. Creative financial arrangements and receiving a percentage of the herd growth in the sharemilker's beginning positions are paramount for stepping up the dairy farm career ladder in a reasonable number of years.

Sharemilking positions may only last one to three years if equity progression is successful. After a contract milking experience, one then garners ownership in a herd through equity growth, financing and/or leasing. Sharemilkers should continually aim to better themselves and find positions which "fit" their increasing cow numbers, efficiency standards and workload ability. Also, consider reworking present arrangements based on a new set of contributions.

Locating Sharemilker Positions

As a prospective sharemilker, being selected for a particular position depends on a variety of considerations. Applying for a sharemilker position should be no different than any other job search. Respond to or seek out prospective positions in a professional manner. This begins with a visit and/or letter of application and resume.

Once a potential owner is interested, arrange an on-farm interview consisting of a detailed look at the milking system, housing arrangements, feed storage, calf rearing facilities along with the pasture and cropping system. Consider the income potential based primarily on housing/feeding/milking efficiencies and carrying capacity.

Ask questions to display managerial alertness. Judge the owner's willingness to make periodic changes to improve profits. Contact a previous operator or a neighbor to reference the owner's ability to work with a sharemilker in a fair and mutually beneficial relationship.

Many farms need development work to accommodate additional cows, which can pay handsome dividends to a sharemilker and the owner. Therefore, one should not forget that some sweat equity may be needed for farm improvements. This can be an excellent investment for sharemilkers, as sweat equity often improves relations with the owner.

If not in a pleasant work situation, consider breaking the relationship in a professional manner but realize a reliable character is what one is trying to document. After each sharemilking opportunity, obtain a reference, including work descriptions. To garner experience, consider working on 2-5 farms before attempting to be a sharemilker.

A major obstacle for the sharemilker is obtaining the financing to purchase or lease cattle and/or machinery. Consider providing labor for a percentage of the milk sales initially, begin cattle ownership in year two or three and work with a lender/investor for financing. If the parties are compatible, the owner might assist by leasing the cattle and co-signing the loan for a certain period of time. Or, outright financing from the owner may be an option, but be aware of major problems with any owner financing if the relationship turns sour.

The next step involves consideration of the cash flow feasibility for both the sharemilker and the owner. Most lenders will assist with this "cash flow" analysis but the sharemilker should also assess the profitability (very different from cash flow) of the farm operation (see Appendix A).

Selecting a Sharemilker

From the owner's view, selecting an honest and dependable sharemilker is of great economic value--one that can make or break an operation. Therefore, solicit sharemilkers through agriculture schools, advertisements and especially farmer/agri-business "word-of-mouth".

Learn how the potential sharemilker would manage details of the operation. In these discussions, one can often decide rather quickly the compatibility and management potential. Contact previous employers. If two references had a problem getting along with an individual, it may be more than a slight misunderstanding or personality conflict.

Experience from New Zealand shows that most arbitration cases come from sharemilkers who are managing a herd for the first time on their own.[iii] The sharemilker should not be liable for poor performance due to inexperience unless he/she misrepresented skills beforehand. Owners might consider being more involved in general farm management decisions with first time sharemilkers.

Sharemilking Agreements

Sharemilking can be designed as a share lease arrangement or an employer-employee relationship. A properly signed and executed sharemilking agreement is a legal document that binds the owner and sharemilker to their obligations in the provisions of the agreement. In the interest of both parties, a well designed and fair agreement is an investment to **preclude** misunderstandings.

> *The basis of all good arrangements between a sharefarmer and owner is a mutual trust and an understanding of each other's responsibilities with incentive to develop the total enterprise.*
> *United Dairy Farmers of Victoria, Australia*

Most owners and sharemilkers desire to develop an agreement that is economically sound and equitable to all parties. Thus, an ideal share lease arrangement has two main objectives: 1) attaining the maximum economic efficiency in resource use, and 2) allocating the returns between owner and sharemilker based on their respective contributions.[iv] An economically efficient lease is achieved if the lease arrangement lends itself to letting the whole farm achieve its total profit maximizing potential, while still representing the individual parties to the lease. Optimum farm organization as well as profit-maximizing production practices should be attainable under an economically efficient lease.

To be equitable, the lease must reward the suppliers of the inputs with outputs in the same proportions. If the owner is supplying 50% of the inputs, 50% of the output should accrue to the owner. **Distributive equity contributes to economic efficiency.** In addition, leases should provide the mechanism to respond to changing economic conditions (production costs/levels, asset values, herd size, milk price, etc.) as well as giving the parties to the lease a method of communication and arbitration.

Negotiation plays a large role in determining the farm's ultimate distribution. Factors such as the sharemilker's earning potential, alternative staffing options, overall farm profitability, farm size and efficiency, living accommodations, school district and neighbors impact the sharemilker's and owner's negotiating strengths. Even so, strive toward making it equitable.

Designing a Fair Share Milking Arrangement

Both the owner and sharemilker generally want to do "what's fair" -- often following the custom of the community. Farms, however, are not alike. There is considerable variation in what individual sharemilkers can contribute in labor, management, and capital. Economic and technological changes in agriculture will affect arrangements over time.

Custom can be used as a general guide. However, in developing the details of the arrangement, a fair agreement is more likely to result through an honest evaluation of what each party will contribute to the farm business. **The general principle is that each party should share returns of the farm business in the same proportions that they share the costs.**

There is reason to believe rental practices based on custom fail to fully take into account the difference in the productivity of farms and the contribution made by owners and sharemilkers. In order to determine which percentage allocation is most fair on a particular farm, a contributions worksheet (Appendix A) should be completed.

Thus, arrangements need to be examined periodically to determine if contributions of the two parties are in line with the division of income. This should be done annually, however, more experienced sharemilkers in a 50:50 agreement might negotiate on a 3 year basis.

Determining Contributions

To the extent that contributions are used as a guide to determining a fair arrangement, income should be shared by the owner and sharemilker in about the same proportion as each contributes to the farm business. The values assigned as contributions from various items represent the judgement of the parties involved. They are subject to bargaining and can be difficult to estimate. If they are to be used as a guide for dividing other expenses as well as income, great care must be used to arrive at realistic, accurate values. The fair or appropriate value of all the contributions should be mutually agreed upon **annually or over the length of the contract.**

When the fixed contributions of both the owner and sharemilker have been carefully estimated and agreed upon, the shares are determined. This is accomplished by dividing the total value of fixed contributions of each party by the sum of the fixed contributions of both parties. Variable expenses as well as income can then be shared in that same proportion.

A fair sharemilking arrangement allows for a just compensation to each party for their capital and labor contributions. The prevailing economic conditions can guide what constitutes a reasonable return on investment and a reasonable wage for labor. **A most important incentive for both parties is to realize and share in an increase in herd growth over time.** Cull cows are sold in proportion to the percent of cattle owned but the growth is shared based on the percentage earned. Thus, in a 70:30 agreement in which no cattle are initially owned by the sharemilker, all cull cows initially go to the owner but increases in herd size and heifer inventory accrue to each in the 70:30 share, if agreeable.

Drawing Up an Agreement

An example contract is included in Appendix C. When drawing up an agreement, the following key points should be considered:

Parties to the Agreement

- This should identify the farm owner(s) and sharemilker(s).

Term of Agreement

- When the Agreement will begin and end.
- Extraordinary circumstances due to personal, health, economic or weather factors.
- Length of formal notice required for termination and penalty for early termination.

Provision of Assets and Services by Each Party

- Who provides the land, labor, livestock, machinery and facilities and in what amount?
- Who maintains and repairs which capital items?

Income Sharing

- Define share of the sale of milk, cull cows, calves, payment for rearing calves, and secondary enterprises.
- Method of payment. How is each party to be paid for his/her share of income and how will he/she pay his/her share of costs (consider direct payment from the dairy).

Cost Sharing

- Define which costs are to be shared and the percentage split between the two parties (costs are shared to encourage wise and efficient use of inputs).
- The party who provides an asset is usually responsible for the interest, insurance, depreciation, taxes, repairs and maintenance of that particular input.

Dealing With Disputes

- The failure of either the owner or sharemilker to comply with the agreements set forth in this lease shall make one liable for damages to the other party. In the event an agreement cannot be reached, the matter shall be referred to a committee of three arbitrators, one chosen by the owner, one chosen by the sharemilker, and a third chosen by the two. None of the arbitrators chosen shall be related to either party or have an interest in the questions decided. The decision of this committee shall be in writing and accepted by both parties. The cost of arbitration shall be borne equally.

Taxation of Sharemilking Agreements

- Because of the complexities of the tax system, sharemilkers and farm owners are encouraged to consult Appendix B and seek expert tax advice.

Appendix A. **Sharemilking Arrangement Worksheet**

Budgeting divisions of incomes and expenses are important in developing agreements to which parties are not disillusioned with lower than expected returns. By using the Sharemilking Arrangement Worksheet, scenarios can be developed for individual farms where production variables such as land price, cattle intensity per acre, machinery ownership levels and/or building investment render a more custom-based common lease unfair.

As depicted in Table A1, the aim of the worksheet is to include all the fixed assets on the upper left hand side to establish a current fair market value and charge for each fixed asset. These fixed assets have ownership costs known as the DIRTI 5--depreciation, interest, repairs, taxes and insurance. Actual values for fair market value depreciation (not the tax depreciation allowed) should be used. The interest cost should include either the interest paid on debt of those assets, an opportunity cost (percentage return) which could be earned somewhere else or a weighted average combination of the two. Leased assets have costs equal to the annual lease payment, instead of the DIRTI 5.
Table A1.

Debt Serviceable — SHARE LEASE ARRANGEMENT WORKSHEET — Milk/Cow
Lessor $83,136 — Gary G. Frank and Larry F. Tranel — 14,400
Lessee $47,661 — University of Wisconsin-Extension — Herd Size 180

Fixed Costs Item	Value	Charge	Owner Contribute	% of Total	Sharemilker Contributes	% of Total
LAND	$210,000	8.00%	$16,800	100.0%	$ 0	0.0%
Property Tax	$ 9,000		$ 9,000	100.0%	$ 0	0.0%
Lime Charge	$ 500		$ 500	100.0%	$ 0	0.0%
Insurance	$ 1,500		$ 1,500	100.0%	$ 0	0.0%
BUILDINGS	$130,000					
Depreciation		6.00%	$ 7,800	100.0%	$ 0	0.0%
Interest		8.00%	$10,400	100.0%	$ 0	0.0%
Repair/Tax/Ins.		3.50%	$ 4,550	100.0%	$ 0	0.0%
LIVESTOCK	$216,000					
Interest		8.00%	$ 8,640	50.0%	$ 8,640	50.0%
Insurance		0.50%	$ 540	50.0%	$ 540	50.0%
MACHINERY	$ 25,000					
Interest		8.00%	$ 0	0.0%	$ 2,000	100.0%
Depreciation		12.00%	$ 0	0.0%	$ 3,000	100.0%
Repairs/Insurance		5.00%	$ 0	0.0%	$ 1,250	100.0%
LABOR	$ 44,275		$ 0	0.0%	$44,275	100.0%
MANAGEMENT	$347,040	0.00%	$ 0	50.0%	$ 0	50.0%
(as a percent of the Gross Income calculated below)						
------TOTAL	---		SHARE -----------------------		Share -------------------	
FIXED COSTS	$119,435		$59,730	50.01%	$59,705	49.99%

These fixed asset contributions generally determine the breakdown of variable expenses and incomes. In the above example, the fair market value of the land is estimated at $210,000. The owner's opportunity cost on owning the land is 8%, which is the charge used to determine the owner's annual contribution of $16,800 since the owner owns 100% of the land. Property taxes on the farm are $9,000 which is contributed 100% by the owner. The owner in this example contributes $500 to lime and $1500 to insure the farm annually.

The owner also contributes 100% of the buildings which has an estimated fair market value of $130,000. Depreciation on buildings is estimated at 6% or $7,800; interest on buildings is charged at 8% or $10,400; and repairs, taxes and insurance on buildings total 3.5% or $4,550 annually. Livestock is valued at $216,000 and each party contributes one-half. An 8% interest charge equates to an $8,640 contribution to each. Insurance on livestock is estimated at .05% or $540 for each party.

The sharemilker supplies the $25,000 worth of machinery on this farm. Interest at 8% or $2,000; depreciation at 12% or $3,000; and repairs and insurance at 5% or $1,250 are the annual contributions by the sharemilker for his/her machinery. Labor is supplied 100% by the sharemilker and is valued at $44,275 (husband and wife team). Management is included with labor in the example. Management is often contributed as a separate percent charge of gross income and divided on percentages based on each party's management contribution.

The total fixed costs in this example farm equal $119,435 annually. The owner contributes $59,730 or 50.01% of the total. The sharemilker contributes $59,705 or 49.99%. Thus, this example based on fixed asset contributions would suggest a 50:50 sharemilking arrangement meaning that since the owner contributes 50% of the assets, he/she should receive 50% of the incomes. The same is true for the sharemilker. As asset and investment levels or the mix of ownership changes, so too would the contribution percentages.

Table A2 contains the variable costs which are usually shared. The value of each cost equals the annual sum accrued in a typical year. The total variable costs in the left column are the annual sum of these variable costs for the whole farm.

Table A2.	FARM	OWNER		SHAREMILKER	
Vet and Med	$ 4,576	$ 2,288	50.0%	$ 2,288	50.0%
Farm Supplies	$ 3,700	$ 1,850	50.0%	$ 1,850	50.0%
Breeding Fees	$ 250	$ 125	50.0	$ 125	50.0%
Purchased Feeds	$104,218	$52,109	50.0%	$52,109	50.0%
Crop Expenses	$ 6,500	$ 3,250	50.0%	$ 3,250	50.0%
Fuel/Oil/Gas	$ 544	$ 272	50.0%	$ 272	50.0%
Utilities	$ 4,984	$ 2,492	50.0%	$ 2,492	50.0%
Labor Hired	$ 5,000	$ 0	0.0%	$ 5,000	100.0%
Rent/Lease/Hire	$ 10,224	$ 5,112	50.0%	$ 5,112	50.0%
Other Expenses	$ 14,593	$ 7,297	50.0%	$ 7,297	50.0%
-------TOTAL		SHARE		SHARE	
Variable Costs	$154,589	$74,795	48.38%	$79,795	51.62%
-------TOTAL		SHARE		SHARE	
CONTRIBUTIONS	$274,024	$134,525	49.1%	$139,500	50.9%

The variable expenses (except labor hired) in this example are shared on a 50:50 basis. If the fixed asset would be contributed on a 70:30 basis by the owner and sharemilker respectively, the variable expenses would then be split on this same level. The total variable expenses on the 50:50 example equal $154,589. The difference in the contributions is the hired labor which is the responsibility of the sharemilker. This hired labor might be included as a fixed asset contribution rather than a variable expense increasing the contribution of the sharemilker before a percentage breakdown is calculated.

The total contributions amount for the farm is the sum of the total fixed and variable costs. The total contributions for the farm are $274,024 annually with the owner supplying $134,525 or 49.1% and the sharemilker supplying $139,500 or 50.9%. Due to the hired labor of $5,000, the sharemilker in this example actually contributes about $5,000 of additional value to the operation. The incomes to the farm are generally rounded which customarily would mean a 50:50 split of income. Technically, this farm would more accurately divide income on a 49:51 basis to be precisely equitable.

Table A3 contains the incomes from the farm in total dollar value for each income type and the total gross incomes of the farm. The bottom left side of Table A3 depicts the net return over variable costs for the total farm followed by the net return over cash costs excluding interest and labor (exc IL); net return over cash costs excluding labor (exc L);
net return over cash costs followed by the net return over total costs.

Table A3.

INCOMES		OWNER		SHAREMILKER	
Milk Sales	$311,040	$155,520	50.0%	$155,520	50.0%
Cull Cow Sales	$ 25,200	$ 12,600	50.0%	$ 12,600	50.0%
Calf Sales	$ 10,800	$ 5,400	50.0%	$ 5,400	50.0%
Gvt.Prg.Income	$ 0	$ 0	50.0%	$ 0	50.0%
Crop Sales	$ 0	$ 0	50.0%	$ 0	50.0%
Other Income	$ 0	$ 0	50.0%	$ 0	50.0%
------TOTAL		SHARE		SHARE	
Gross Incomes	$347,040	$173,520	50.0%	$173,520	50.0%
NET RETURN OVER					
Variable Costs	$192,451	$ 98,726	51.3%	$ 93,726	48.7%
Cash Costs exc IL	$175,071	$ 83,136	47.5%	$ 91,936	52.2%
Cash Costs exc L	$128,591	$ 47,296	36.8%	$ 81,296	63.2%
Cash Costs	$ 84,316	$ 47,296	56.1%	$ 37,021	43.9%
Total Costs	$ 73,016	$ 38,996	53.4%	$ 34,021	46.6%

The owner of the cows generally would obtain cull cow and calf sales. However, in a 70:30 split where the owner also owns 100% of the cattle, the owner would garner 100% of the cull cows and calf sales. Herd inventory growth over time, though, might build on the 70:30 basis which is an important, but negotiable, incentive for the sharemilker.

Figuring the total cost picture on the farm is the first step in determining a fair lease arrangement (Tables A1 and A2). Once this cost picture has been determined, this would then be divided between the owner and sharemilker (Table A3). Based on the value and charge columns of the worksheet, the user inputs the percent of the total the sharemilker(s) contributes to the operation. The owner's contribution is automatically calculated as are the owner's and sharemilker's contribution in dollar value for each income or expense item. Aside each total is the share in dollar value and percentage of the owner and sharemilker.

The Sharemilking Arrangement Worksheet is also available in a computer spreadsheet form. This includes an input form (A3670-W) where the various blanks can be filled in so an individual with access to the spreadsheet can run the program. This SHARE MILK program can be obtained through the UW-Extension Office at 222 N. Iowa St. Dodgeville WI 53533 (608) 935-3354.

Appendix B. **Classifying Sharemilking Arrangements for Tax Reporting**[v]

Tax consequences vary depending upon the formation of the operating agreement. A sharemilking arrangement is, in effect, either a farm lease or employer-employee arrangement. Due to the ability of an owner to fully deduct benefits such as health insurance, housing, SEP's, etc. and the ability of the employee to receive these benefits tax free provides an ample reason to consider an employer-employee relationship versus a lessor-lessee relationship. Tax laws change, however, so refer to current information.

The 1995 ***Farmers Tax Guide*** briefly addresses farm leases on page 16 by stating -- "The rent you receive for the use of your farmland is generally rental income, not farm income, and is reported on Form 4835 and Schedule E. However, if you materially participate in the farming operations on the land, the rent may be considered farm income rather than rental income and is reported on Schedule F and subject to self-employment taxes (SE)."
Sharemilkers would report income and expenses on Schedule F. The classification of share leases involves the determination of two completely different tests of material participation.

Test No. 1. Material participation for purposes of the self-employment (SE) tax. This test determines whether the landlord reports the activity on Schedule F (Farm Income and Expenses) or on Form 4835 (Farm Rental Income and Expenses). The

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i. Conversation with Ken Lewis, Dairy Farm Consultant, New Zealand during travels to New Zealand in 1994.

ii. Sharemilking: How Sharemilking Agreements Can Benefit Both Parties, Ralph du Faur, Farm Books, New Zealand, 1993. p.7.

iii. Sharemilking: How Sharemilking Arrangements Can Benefit Both Parties, Ralph du Faur, Farm Books, New Zealand, 1993.

iv. <u>Livestock Share Lease</u>, UW-Extension Publication A2851, Leslie F. Huber, Robert A. Luening, and Arnon R. Allen

v. Harris, Daughtrey and Bock. Agriculture Issues and Form Preparation, Fall 1995.