



Farm Business Arrangements and Operating Structures

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Methods to Determine Land Lease Rates

- Crop share equivalent (1/3 : 2/3)
- What others are charging/paying
- Formula that includes average price and/or yield (5-10 years)
- Return on investment (3-3.5% of land value)



Table 2. Crop Share Leases Advantages and Disadvantages

Advantages Compared to cash rents, less operating capital is "tied up" by the tenant because the landlord is sharing costs. Landlord's incomes vary with yield and price variation and changes in shared production input costs. This may be a particularly important concern for retired landlords. Management may be shared between an experienced landlord and tenant, resulting in more effective decisions. Accounting for shared expenses must be maintained. Sales of crops may be timed for tax management. Likewise, purchased inputs may be timed to shift expenses for tax purposes. The need for tenant and landlord to discuss annual cropping practices and to make joint management decisions is greater than with a cash rent arrangement. Risks due to low yields or prices, as well as profits from high yields or prices, are shared between the two parties. As prices or technology change, the lease should be reviewed for fairness. Sharing arrangements may need to be changed. The income received from a crop share agreement by the landlord is eligible for NISA and is considered farming income, which may be important for a landlord who wants to maintain farming status for tax advantages. The results of a tenant's superior management are shared with the landlord.

Disadvantages

Flexible Cash Rent Example

$$\text{Base Rent} \times \frac{\text{Actual Price}}{\text{Base Price}} \times \frac{\text{Actual Yield}}{\text{Base Yield}}$$

- Base rent = 20 to 25% of Crop Insurance Value
- Current Price is calculated 2 times per year (E.g. once on April 1 and once on October 1)
- Base price/yield can be calculated by either using the expected market price/yield, or previous 3 to 5 year average
- Set floors and ceilings for rent (E.g. Up 20% / Down 10%)
- Use a rolling lease whenever possible

The majority of us use risk management strategies such as crop insurance and forward contracting, but how many of us have considered using such things as our land rental agreements to offset risk?

Renting land is becoming a more common alternative for those farmers who are expanding their operations. For most of us who rent land, we pay a flat fee to the landlord every year, regardless of what the yield or price of the crop grown is. Instead, we could look at arrangements that set a base cash rent price, and then have a market component in which our landlords share in some of the yield/price risk and rewards with us.

For example, we could set base cash rent on 20 to 25 percent of Agriculture Financial Services Corporation's (AFSC) production values for crop insurance purposes. In some parts of central Alberta, AFSC values crop production for crop insurance purposes at \$225 per acre. Therefore the base cash rent for the area would be in the range of \$40 to \$56.25 (\$225 x 20 or 25%).

In addition to this the landlord and renter could agree that the renter will also pay an increased payment based on a formula of percentage of price and yield.

The formula for this could look like:

$$\text{Base Rent} \times \frac{\text{Current Price}}{\text{Base Price}} \times \frac{\text{Actual Yield}}{\text{Base Yield}}$$

We calculate the base price and yield by either using the expected market price, or previous 3 to 5 year average.



Flexible Cash Rent - Example

<p>Example 1: Lower than avg. yield</p> <p>Base Rent = \$55 (\$220x25%)</p> <p>Actual Price = \$9 (((\$10+\$8)/2)</p> <p>Base Price = \$10</p> <p>Actual Yield = 30 b/acre</p> <p>Base Yield = 35 b/acre</p> <p>$55 \times (9/10) \times (30/35) = \mathbf{\\$42.42/acre}$</p> <p>Floor of 90% of base rent = \$49.50 (55x.90)</p>	<p>Example 2: Higher than avg. yield</p> <p>Base Rent = \$55 (\$220x25%)</p> <p>Actual Price = \$9 (((\$10+\$8)/2)</p> <p>Base Price = \$10</p> <p>Actual Yield = 50 b/acre</p> <p>Base Yield = 35 b/acre</p> <p>$55 \times (9/10) \times (50/35) = \mathbf{\\$70.71/acre}$</p> <p>Ceiling of 120% of base rent = \$66 (55x1.2)</p>
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40 bushels to the acre would equate to \$66.85/acre



Rolling Lease Concept

- Two to three lease with automatic one year renewal clause
- Pros: Both parties must commit to open communication
- Cons: Price negotiations might occur on annual basis


- Supply is adequate and demand is stable for commodities
- Consumer demand is trumping supply
- Beef and Pork industries downsizing to match current demand
- Grain prices down 10 to 20% from 2008
- Oilseed demand is strong and supply is tightening, making room for some potential price increases
- Feed grain prices are low due to record corn crops and decreasing herd sizes, and abundance of feed wheat
- In general, prices for agricultural commodities forecasted to remain flat. Input costs also looking to remain relatively flat
- Continuing high \$CAD will reduce profitability of some sectors



Rolling Lease – Example

- Tenant / Landlord enter into three year rolling lease agreement starting April 1, 2010 and continuing in full force until April 1, 2013
- Lease is automatically renewed for one additional year (to a maximum of three years) for each year succeeding the commencement date
- Termination of the lease shall be affected only by written notice at least six months prior to the rolling renewal date (but after April 1, 2011)
- Such termination should have no force and effect until three years from the date of notice
- Tenant / Landlord may also include clause that allows for rental rates to be negotiated at specified times (i.e. every two years) using an agreed upon method





Determine how you will earn income
(take cash out of the business)

- Income can be earned through:
 - Labour
 - Management
 - Return on Corporate Capital
 - Capital Redemption
 - Leasing of Personally Owned Assets
 - Share Holder Loans



Corporate Income Tax Rates Combined - Federal and Alberta	
Active Business Income	
January 1, 2010 – December 31, 2010	
\$0 to \$500,000	14.0%
Over \$500,000	28.0%
Investment Income	
January 1, 2010	44.7%



Partnership Planning

In exchange for the assets, Father receives Class “B” Unit of the partnership equal to the fair market value of the transferred property.

- Use a partnership instead of a corporation!


The partnership agreement will provide for two type of partnership interests

- An income/growth interest similar to a common share (Class “A” Units)
- A capital interest – with no income allocation and no increase in value (Class “B” Units)

Incorporation of Partnership Interest



Note: 1) shareholder loans tax paid
 2) Effective tax rate is 14 % not 39%



Issues

- Transactions on 2 separate days
- Price adjustment clauses and elected amount adjustment clauses
- Land in or out of partnership
- Principal Residence in or out of partnership
- Allocation of stub period income
- Negative adjusted cost base

Income is earned by:

1. Labour
2. Management
3. Return on Capital
4. Capital Redemption
5. Lease of Land

Example:

	<u>Dad</u>	<u>Son</u>
Capital	1.0 million	100,000
Return @ 4%	40,000	4,000
Mgmt.	10,000	6,000
Labour	10,000	30,000
	60,000	40,000