Improving the Welsh Dairy Supply Chain

Contract Farming

DairyCo

Llywodraeth Cymru
Welsh Government

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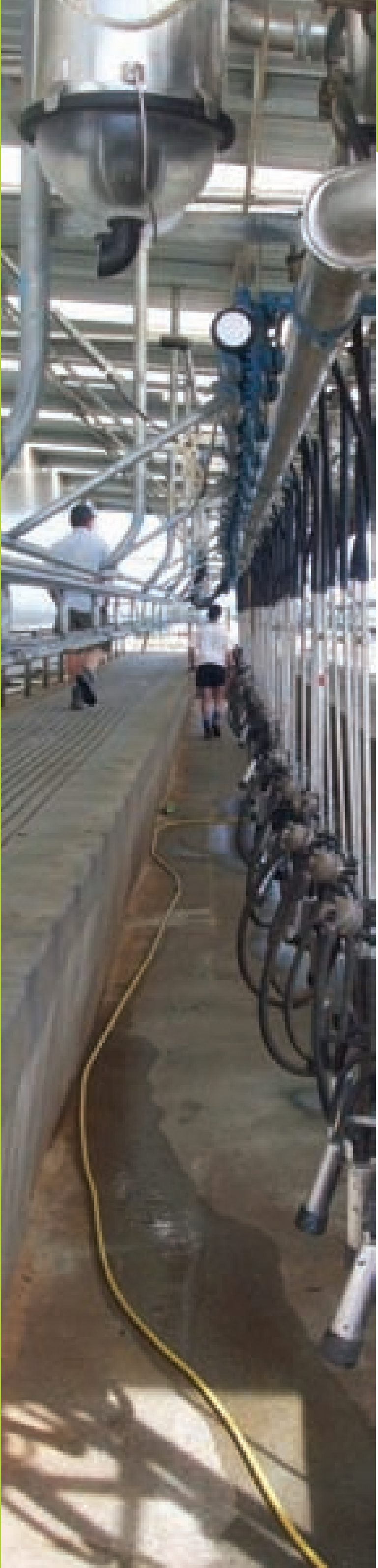


Contents

Introduction to Collaborative Ventures

Put simply, farmer collaboration consists of two or more farm businesses getting together, sharing resources to reduce cost and/or increase profitability. They are relatively common throughout other sectors of UK agriculture, however they are relatively new to dairying.

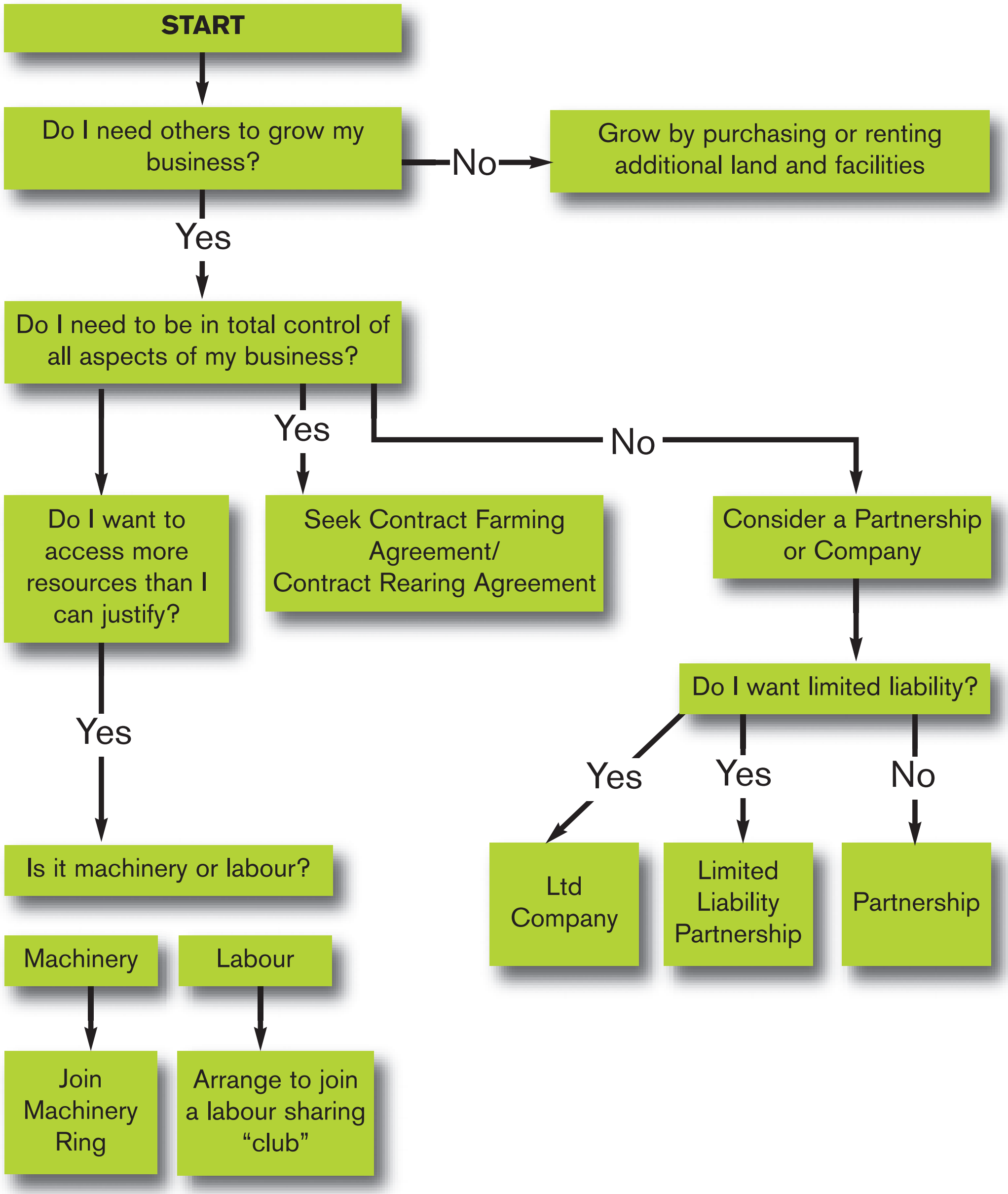
There are a number of reasons for collaboration, these include:

- Improving profitability
- Economies of scale and synergies – cost control
- Personal benefits – quality of life
- Allows succession
- Efficient use of capital

It is essential that a budget is always considered before the agreement commences to ensure viability and delivery of all parties' expectations. It is important though that each individual business considering a collaborative venture seeks professional advice from a knowledgeable business and legal advisor. However, there is a shortage of such persons who have adequate knowledge of the subject. Consequently, a farming business could suffer unnecessary delay and cost in the establishment of their agreement, hence the use of checklists and templates provided via the Dairy Development Centre (DDC).

The following information can be used by farming businesses and/or their professional advisors to assist in highlighting potential solutions and provide guidance regarding the points to consider in preparation of the agreed venture being entered into.

This is one booklet in a series and is specific to one type of collaborative venture. To view the Collaborative Ventures report or the other information booklets visit the website www.ddc-wales.co.uk or contact the DDC. For a copy of DairyCo's Joint Venture templates that provide guidance to dairy farmers who are considering a joint venture with other dairy businesses, or bringing others into the business structure, contact DairyCo publications on 02476 478702.


START
Do I need others to grow my business?
No
Grow by purchasing or renting additional land and facilities
Yes
Do I need to be in total control of all aspects of my business?
Yes
No
Do I want to access more resources than I can justify?
Seek Contract Farming Agreement/ Contract Rearing Agreement
Consider a Partnership or Company
Yes
Do I want limited liability?
Yes
Yes
No
Is it machinery or labour?
Ltd Company
Limited Liability Partnership
Partnership
Machinery
Labour
Join Machinery Ring
Arrange to join a labour sharing "club"

Background

Evolved in the 1970s when it was an alternative to three generation succession tenancies. Has been used widely in arable farming businesses in the last 10 years. Relatively new to dairy farming businesses.

What is it?

- A landowner or tenant, either existing or new, employs a third party farmer as a contractor.
- Land ownership/occupation/milk quota – Farmer.
- Management, labour and power to the farm – Contractor.
- The dairy herd and youngstock can be owned by the farmer or the contractor.
- Farming system agreed to by both parties in advance.
- Farmer retains a basic fee and takes a small share of the financial surplus.
- Contractor receives a basic fee to cover his immediate costs and retains the majority share of the financial surplus.

Objectives

- Providing tax efficiency for the landowner.
- Enables a tenant to remain 'on the farm' and living in the house.
- The farmer and the contractor profit from the economy of scale given to the contractor and their business and technical expertise.

Suitability in the Welsh Dairy Industry

- Enables the farmer to retain 'working farmer status' for both trading and capital tax purposes (See Inheritance Tax Section).
- Allows land ownership to remain in hand but introduces new business skills and capital.
- Can be used by farming families to allow smooth succession by providing a mechanism for reward for capital/land/labour and management for each generation.
- For new investors in farms who often do not have the skills/management time to deliver a return.
- For dairy conversions where the farmer does not have the specialist dairy farming skills and knowledge.

Strengths

- Regulated by a formal contract.
- Flexible agreement where virtually all terms can be negotiated.
- Clearly defined roles and responsibilities.
- Can be structured to be self regulatory.
- Farmer provides working capital facility for the business.
- Farmer has no employment liabilities.
- Allows capital to be released (for other investments/business opportunities/retirement) due to reduced machinery and livestock ownership.
- Brings in specialist skills. Reward depends on ability to deliver a surplus.
- Greater returns compared with renting out the farm but with an increased risk.
- Economies of scales for the contractor could be gained by having more than one agreement.
- A relatively quick way for the contractor to grow a business. Entrepreneurial contractors can use skills to achieve a good income without needing large amounts of capital.

Weaknesses

- Administration hassle and complications.
- Capital investment (land, milk quota etc) has to be carried out by the farmer (age can be a constraint for longevity).
- The volatility of the dairy markets needs to be taken into account when budgeting and agreeing surplus distribution. Provisions and arrangements need to be agreed for years when the dairy market is depressed.

Reasons for success

- Clear and easily understood
- Not a partnership

Reasons for failure

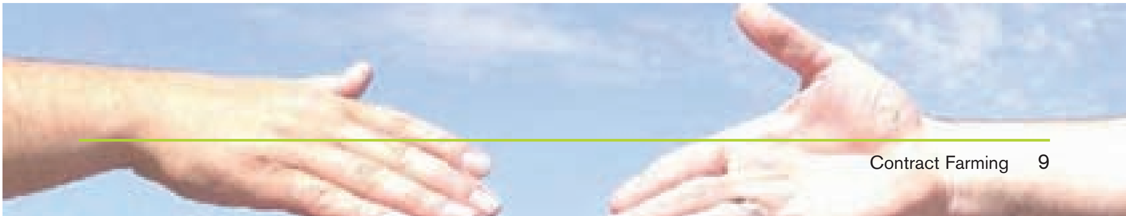
- Farm not delivering sustainable profits
- Poorly established agreements
- Poor administration
- Poor returns to contractor
- Excessive demands from the farmer

Other Points

- **Regulatory Issues**
  Ultimately the farmer is responsible for the farm to meet the requirements of regulations, such as farm assurance and cross compliance. But the farmer can delegate respective duties to the contractor. The specifics of this should be set out in the agreement and then if the contractor fails he/she is in breach of contract and could be liable to fund any shortfall.

- **Insurance**
  The farmer still needs to continue to insure the farm/stock/public liability as per normal. The contractor will need to insure their own machinery and have cover for public liability, employers' liability and professional indemnity insurance against mistakes made on farm that will financially impact the farmer, for example antibiotic contamination of the milk or non-compliances of Single Payment and Environmental Scheme Payments.

- **Contract Rearing on a tenanted holding**
  It is essential that any tenant who is considering establishing a contract farming venture consults their tenancy agreement to ensure they are not in contravention. It may be constructive to inform the landlord if there are any concerns, or at least seek professional advice about the agreement.



Contract - Legal

The establishment of a Contract Farming Agreement will be legally binding upon both the farmer and the contractor once they have signed the documentation under the Law of Contract.

It is essential that such an agreement is documented and signed to protect both parties whilst at the same time providing clarity over areas that could be misunderstood or that cover areas that happen rarely.

A good contract farming agreement which delivers returns for the farmer and leaves the contractor with an adequate surplus will leave both parties happy. However, there may be occasional situations which may result in reference being required to the 'official' document which can provide clarity to the issue and as a result minimise any risk of conflict or confusion.

Inheritance Tax and Agricultural Property Relief

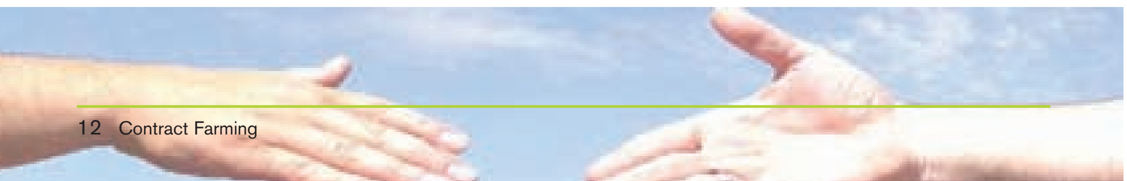
Outsourcing is a common occurrence in many industries but in no other does it generate retention of the tax advantages of maintaining a trading status. It is for this reason that contract farming agreements will come under scrutiny.

Whilst the existence of a Contract Farming Agreement is unlikely to affect the availability of Agricultural Property Relief on the farmland, it may impact upon the relief available for the farmhouse. Are you occupying your farmhouse for the purpose of agriculture? The question is to be decided in each case and will involve the consideration of aspects such as:

- The degree of financial risk the deceased had
- The deceased's involvement in the day-to-day agricultural activity including the regularity and scope of any meetings with contractor
- The deceased's involvement in decisions relating to the selection of crops, sowing, harvesting, sales and so on.

The following are key points which should be considered for any agreement to withstand scrutiny:

- Farmer must be capable of being seen to be actively in business, for example the business has a bank account, is VAT registered, has a proper recordkeeping system, prepares full annual accounts showing sales and purchases, completes forms for subsidy and collects it.
- Capital must be employed and be at risk to the farmer who should also try to avoid selling all assets off the farm once the agreement commences.
- Invoicing from contractor to farmer must be regular, at least quarterly, and invoices must be paid on the normal commercial terms operated by the contractor.
- Inputs should ideally be invoiced by the merchant direct to the farmer.
- The contractor carries out operations of animal/crop husbandry as an agent for the landowner. The farmer must make all key decisions about cropping/feeding and strategy, obviously the contractor can advise and be involved in this process. The farmer must be involved in the day to day management of the operation and must be able to evidence this by means of minutes of meetings, diaries etc.
- All regulatory documents must be completed by the farmer and retained by the farmer on his premises.
- The farmer cannot have a guaranteed return, he/she must take risk – the contractors bonus or penalty must be defensible. No risk equals fixed return which is a rent.
- The written agreement must be adhered to and the farmers and contractors accounts must reflect this.



- Any arrangements with third parties such as agronomists, consultants etc should be direct with the farmer.
- Does the arrangement look real, does it make commercial sense? If the answer is no, then HMRC is likely to come to the same conclusion.

It is recommended that any farmer with different specific cases should consult further advice from a professional.

VAT

Value Added Tax (VAT) should be added to the invoice from the contractor to the farmer if the contractors business is VAT registered at the prevailing VAT rate.

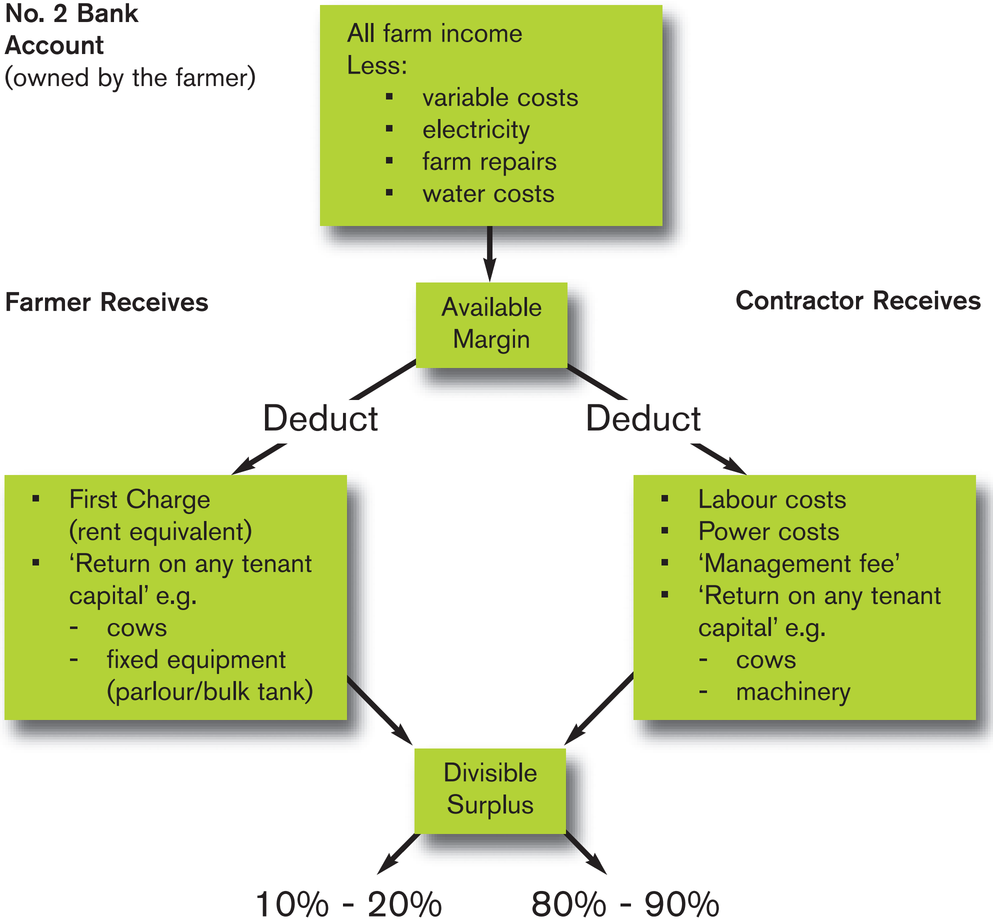
Herd Basis Election

Should the farmer be selling the herd before commencing with the agreement he/she may be in a position to benefit from the sale of his dairy herd with Herd Basis Election and tax relief.

It is recommended that any farmer wishing to sell his dairy herd should consult his accountant for the correct timing and actions to be advised.

If the farmer wished to sell his dairy herd to the contractor this could be achieved on an annual basis from the contractor's earnings and this could still be achieved in a very tax efficient way.

Operational Chart



Key Points

- Farmer retains farming benefits but moves day to day responsibility to the Contractor.
- Cows can either be shared ownership between farmer and contractor or be owned entirely by one of the other.
- Split of Divisible Surplus should always be very high in favour of the Contractor to reward success and high performance.
- All farm income includes Single Payment and Environmental Scheme Payments to ensure the farmer is taking 'risk' to qualify for all farmer status tax benefits.

Farmer provides:	land, buildings (300 cow dairy herd and youngstock) milk quota dairy facilities
Contractor provides:	know-how expertise labour machinery

The farmer is 58 years old, financially secure, with 400 acres of land and two daughters that are not interested in farming. The farmer wishes to farm in a collaborative venture with the eventual opportunity of the contractor probably taking on the whole of the farm via a Partnership or Tenancy. The farm previously employed staff.

The farmer and contractor have little knowledge of each other at the beginning of the agreement so they each ring-fence their own capital. The business is going very well with the farmer providing all the bank facilities to operate the venture and the contractor receiving a payment for his:

- know how
- labour
- power costs

The farmer takes a return that is close to the rent equivalent and the cost of his own time input (which is on a reducing basis). Each party receives a return on capital for their investment.

At the year end the surplus is allocated in proportions agreed in the contract, in this case 80:20.

This business is operating successfully because:

1. The overall business trading surplus is sufficient
2. Mindsets and vision are similar and discussed regularly
3. Communication is excellent
4. The participants are in business to make money working together
5. They enjoy working together.

Heads of Terms

Please find below the minimum requirements that should be included in an agreement.

CONTRACT FARMING AGREEMENT

1. Farmer Details

1.1 Name of Farmer ______________________________

1.2 Trading Title of Farmers Business ______________________________

	Please tick
Sole Trader	☐
Partnership	☐
Limited Liability Partnership	☐
Company	☐

1.3 Address of Farmer ______________________________

____

____

2. Contractor Details

2.1 Name of Contractor ______________________________

2.2 Trading Title of Contractor's Business ______________________________

2.3 Address of Contractor ______________________________

____

____

____

3. Farm Details

3.1 Address of Farm to be contract farmed (if different to 1.3 above)

____

____

____

3.2 Farmable area of land to be contract farmed ____________________

3.3 Please provide field schedule on separate sheet

4. Agreement Length

4.1 Date of commencement of agreement ____________________

4.2 Year end of agreement ____________________

4.3 Length of agreement and/or termination date ____________________

4.4 Will compensation be available to the contractor for early determination? ______

If so how much and at what interval ____________________

____

5. Farming Details

5.1 Farming System – please provide a brief description ____________________

____

____

5.2 Single Farm Payment – please provide schedule of entitlements to be made available and copy of most recent SFP application form.

5.3 Is the farm in an Environmental Scheme? ☐ Yes ☐ No

Are the payments to be included in the contract farming account?

☐ Yes ☐ No

5.4 Will the contractor provide any: Please tick if yes

☐ Fixed equipment ☐ Capital ☐ Animals ☐ Improvements

If yes please specify: ______________________________

____

6. Payment Details

6.1 Provide outline budget

	£/ha	£/ac
Gross Output:		
Variable Costs:		
Gross Margin:		
Hirer/Rearers First Charge:		
Farmers First Charge:		
Divisible Surplus:		

6.2 What rate will divisible surplus be divided between parties?

☐ 90 : 10 ☐ 80 : 20 Other – please state ______________

7. Other Information

7.1 Name of Farmers Bank ______________________________