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An Alternative to Leasing: Custom Farming

Burton Pflueger, Extension economist

Custom farming has become a logical and efficient alternative for both landlords and tenants. The new risk environment in agriculture, high machinery replacement costs, and an aging but still interested farm population are several reasons why more people are considering custom farming.

Many landowners think of custom farming as a substitute to farming their land themselves or leasing to a tenant under a typical lease agreement. Potential tenants may find custom farming an alternative to leasing ground while still providing an way to utilize excess machinery capacity or available labor.

Custom farming allows a landowner who wishes to remain classified as a farmer the ability to retain close control of the farm business but not be actively involved in performing day-to-day activities. In this case, the landowner would make all of the farming decisions such as arranging for and purchasing all inputs and also would receive all income from sales.

The custom operator provides the equipment and labor to perform all crop production activities and is paid a basic lump sum fee for his services. (In some cases, the custom operator receives a lump sum as a base and a certain percentage of profits as a bonus.)

As with any type of farming arrangement, custom farming has advantages and disadvantages.

Landlord Advantages and Disadvantages

For a landlord, custom farming could free up management and labor for other enterprises. If those enterprises are ones in which the landlord has more knowledge, custom farming has the potential to increase profitability.

It may be that the quality of the work or the service provided by the custom operator may be higher than what the producer could provide. Hiring custom work can also be a cost-cutting measure, thus increasing profits.

However, landlords should remember that, under a custom farming arrangement, they are still responsible for the cash outlay for seed, fertilizer, and other production inputs plus the payment to the custom operator. Since the returns from the land that is custom farmed are variable, custom farming is often considered to be a higher risk venture than just cash leasing the property.

Landlord disadvantages of custom farming include a loss of control over tasks hired out, a change in the completion timetable of tasks, and the necessity to cash flow for payments to the custom operator.

When hiring custom work, the producer must be willing to relinquish a certain amount of direct control over how and when tasks are completed. If the producer wishes to require the custom operator to perform duties in a certain manner, this should be spelled out in the contract. Once the details of the contract are agreed upon, the producer

should allow the custom operator to do the job without unnecessary interference.

The issue of timeliness is an important one and something that should be addressed within the contract. By the nature of their business, custom operators will focus on completing the work that they were hired to do in a timely and professional manner.

Producers should keep in mind that a custom operator has the ability to complete jobs in a few days that may have taken the producer many hours over the span of a couple of weeks. This may be the primary advantage of custom farming for landowners who have small acreages or limited borrowing capacity. Custom farming allows them to manage their farm without having to invest in a full line of equipment.

Landowner custom farming advantages:

1. Freed-up labor and management for remaining enterprises,
2. Concentrated efforts in fewer enterprises (specialization),
3. Higher quality product(s), and
4. Cuts in input and/or production costs.

Landowner custom farming disadvantages:

1. Different type of control over tasks,
2. Different timetable for task completion, and
3. Need to cash flow production expenses and custom operator payments.

Custom Operator Advantages and Disadvantages

If you are a producer considering becoming a custom operator, it may be one way of expanding your existing operation (diversification). It also can provide an avenue for exiting the production side of the industry. If you have excess machinery capacity (planters, combines, tractors), you may benefit from performing custom work for other producers.

Adding a custom work enterprise to an existing farming business can be a good way to supplement income. Machinery owners can more efficiently use their assets. The increased efficiency results from spreading fixed costs over a larger number of production units.

Custom farming has several other advantages for the custom operator. Little or no additional operating capital is needed. Fuel, lubrication, and repairs are usually the

only added costs. In addition, custom farming offers a fixed return.

The possibility of high repair bills is an important risk. However, price and yield risk from renting additional acreage to more fully utilize the current line of machinery may be greater than the risk of higher repair bills.

The primary disadvantage for the custom operator is that in a good year, he would earn less than if he was in a conventional lease. That is the normal trade-off for reducing risk.

Need for Communication

Although the concept of a custom farming agreement is simple, close communication between operator and owner is essential.

First, an accurate count of the number of acres to be farmed and their location should be agreed upon and recorded. Farm maps and measurements by the Farm Service Agency are helpful. A monitor on the planter can be used to estimate the number of tillable acres.

Second, the field operations to be performed need to be spelled out. This will depend on the equipment and skill of the custom operator. The number and timing of operations can be left somewhat flexible, to adjust for varying weather and pest conditions. The agreement can specify how much freedom the custom operator has to modify the original plan.

The operator may have the added responsibility to monitor weeds and insects throughout the summer and to suggest actions to combat them.

The type and amount of pesticides to apply also will vary. The owner generally has the final word, although the responsibility can be delegated to the custom operator. If the custom operator is responsible for purchasing supplies and having them delivered, additional compensation, such as a percentage markup over the cost of these supplies or payment for time and mileage expended, can be agreed upon.

Time of harvesting should be a mutual decision between owner and operator. The moisture level of the crop must be checked closely. If the custom operator also has his own crops to harvest, varieties with different maturities can avoid harvesting bottlenecks.

Some contracts call for the custom operator to take charge of drying and handling grain into storage, as well. Even if this is done with the owner's equipment, the operator can be paid a fixed rate per bushel for managing the dryer and the storage facilities.

Contracts

In all cases it is advisable to prepare a written contract. It doesn't need to be an elaborate legal document but one that simply discusses and provides records of important points. It can avoid misunderstandings later and provide evidence of the nature of the agreement for income and estate tax purposes. For further clarification, the contract can specify that the operator is an independent contractor, not an employee or tenant of the owner. As with any farming agreement, legal counsel should be consulted for advice and assistance.

Determining payments

Setting the payment rate may be the most difficult part of writing an agreement. South Dakota custom rate information can be found in publication http://www.nass.usda.gov/Statistics_by_State/South_Dakota/Publications/Miscellaneous_Reports/Pub/custom-rates2004.pdf which reports average rates charged for custom farming and individual machine operations. Professional farm management firms also may be able to provide information about custom rates.

Other Considerations

Most custom operators inspect the land to be farmed before agreeing to a contract, checking field shape and size, terraces, ditches and waterways, rocks, drainage problems, weed infestations, and access to storage facilities.

Custom operators should talk to their insurance agents about obtaining insurance coverage or bonding against damage to machinery or property while doing custom work.

Operators should be realistic about how many acres they agree to farm. Timeliness is important for customer satisfaction. Leaving several extra days for emergencies reduces the risks in late planting or harvesting.

Custom operators need to know their own machinery and labor costs. It may be that the operator will not always be able to charge enough to cover all costs if others are willing and able to do the job for less. Over time, howev-

er, making the extra effort to do high-quality work and to communicate regularly with the landowner will probably have more influence than price on the demand for the services of a custom operator.

Types of Custom Farming Agreements

There are many variations to custom farming agreements. Three general categories of arrangements are outlined here.

Custom hiring agreement

The landowner (farmer) makes all the farming decisions, arranges for and pays for the purchase of all inputs, and receives all the income from grain sales. The landowner and the custom operator agree to have one or more custom operators perform the machine operations. The landowner agrees to pay a custom fee to the custom operator upon the completion of each machine operation.

Joint farming venture agreement

Both parties are considered to be farmers. The landowner supplies land to the joint venture and the other party supplies machinery, machinery operating costs, and labor. The two parties then share the crop sales on a percentage basis and also share the input costs (seed, fertilizer, chemicals, crop insurance, property taxes) on the same basis. Both parties benefit from crop insurance coverage and revenue insurance indemnities.

Farming partnership agreement

This is much the same as the joint venture, except that a partnership is established with more defined rules to govern the relationship. Some custom farm agreements have been drafted in a manner that gives the same financial results and exposure to risk as a crop share lease.

It is always advisable to consult a lawyer, accountant, and/or farm management specialist before entering into any custom farming agreement. Also advisable is to review custom farming agreements that were entered into several years ago to determine if they are in tune with current requirements.

Putting the Agreement into Writing

It is to the advantage of both landlords and tenants to put the terms of a custom farming agreement into writing. A

written agreement enhances understanding and communication between all parties, serves as a reminder of the terms originally agreed upon, and provides a valuable guide for the heirs if either the landowner or tenant dies.

Consulting with an attorney is good business practice when contractual arrangements are being considered. A sample custom farming agreement form can be found elsewhere in this publication series.

Adapted for South Dakota from Custom Farming: An Alternative to Leasing, William M. Edwards and Darnell Smith, ISU Extension Publication, ISU Extension, No. FM 1823, March, 2003, as well as from information at <http://www.dollarfarms.net/custom.htm> and http://www.agr.gov.sk.ca/DOCS/Econ_Farm_Man/Business/busarr3.asp?firstPick=Economics%20and%20Farm%20Management&secondPick=Business%20Arrangements&pick=&child=1

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