PRINCIPLES OF THE CONTRACT FARMING AGREEMENT

A farming joint venture between two parties, the Farmer (Owner or Tenant) and the Contractor (typically a local farmer).

A Contract Farming agreement is not a partnership; it is a joint venture between two parties. The Farmer is engaging the services of the Contractor and this trading position is preserved where tax, VAT, etc. are concerned. Both parties retain their individual identity as farm businesses in their own right.

The Farmer provides:
- Land
- Buildings or co-operative storage (where available)
- New bank account - 'the No 2'

The Contractor provides:
- Labour
- Machinery
- Management expertise
- Additional storage (where required)
- Regulatory Compliance

The Agreement
The Contract Agreement sets out the terms of engagement, the operation of the Contract, the formula for calculating remuneration to each party and termination procedures covering all eventualities.

Advantages to the Farmer:
- Avoids creation of tenancy or complex partnerships
- Retains occupation of the farm with associated benefits, including both residential and sporting
- Greater stability of returns
- Retains taxation reliefs where applicable
- Release of working capital
- Benefits from Contractor's economies of scale
- Incentivises the Contractor to perform
- Less regulatory compliance work
- Assistance in managing various environmental schemes

Advantages to the Contractor:
- Broadens the farming base area
- Achieves economies of scale
- Cash Flow benefits – quarterly or six-monthly payments enable forward planning
- Opportunity for performance related returns.

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Administration - Role of No 2 (Contract) Account

The Farmer opens a new bank account to simplify administration; the No 2 Account. This is still part of the farm business, but is used to pay all outgoings and receive income applicable to the Contract Farming arrangement (this usually includes environmental payments), as distinct from the Farmer's other business or private costs and income.

It is not essential, but advisory, to have a separate account in order to keep the Contract Farming transactions separate from the Farmer's private affairs and to make the preparation of each farming year's results as simple as possible for the calculation of returns to each party. All financial transactions are undertaken in the Farmer's name and can be identified separately through the use of the No 2 Account.

Costs typically paid through the No 2 Account

All variable / input costs, such as:

- Seeds
- Fertilisers
- Sprays
- Lime
- Pest control
- Agronomy
- Crop drying/cleaning costs
- Haulage
- Other costs relating to crop production.

Certain agreed Fixed Costs:

- Building repairs (for buildings used by the Agreement)
- Building insurance (for buildings used by the Agreement)
- Repairs or improvements (by agreement) to any fixed plant
- Crop insurance
- Water and drainage rates
- Bank charges and interest for the No 2 Account
- Administrative charges for the Agreement
- Various soil nutrient systems

Timing of Commencement

Typically, an Agreement would be for three years and commence at the start of the crop year ie 1st October and run to 30th September of the final year. At the start of the agreement, any land work carried out by the Farmer would be accounted for in the first harvest year accounts.

Remuneration

In reward for their input, the Contractor is remunerated by an agreed formula. This comprises an initial fixed fee (the Contractor's First Charge) on a £/ha basis that contributes only partially to the Contractor's true costs. This is typically paid quarterly or half-yearly in arrears.

The Farmer receives an initial "Farmer's Retention" to his main account (ie transfers from his No 2 to his No 1 account) an amount often to a similar level of the Contractor's First Charge.

Divisible Surplus

Following receipt of the final sales of the harvest year a Divisible Surplus is then calculated. This is the balance of monies 'left in the pot' after accounting for all incomings and outgoings. A pre-agreed formula set out in the Contract will determine the shares that should be allocated to both Farmer and Contractor.

It is necessary to provide the Contractor with remuneration sufficient to cover costs, management time and an element of profit for their endeavours.

The total return to the Farmer will depend on the cropping mix, crop performance, the Contractor's skill and the agreed formula for payment to the Contractor from the Divisible Surplus.

In times of high volatility of returns, the use of two or three tiers of surplus share splits may be appropriate and Brown&Co can advise on a suitable basis for such allocation to ensure that both parties are remunerated fairly for their input to the Agreement.

Taxation

From a tax viewpoint, the Farmer's return would be amalgamated with the balance of his farming activities to calculate the overall trading result.

Most importantly, the Farm Contract provides farming income and for most circumstance retains inherent tax advantages. Once operational, the Farmer's input in overall planning is important. We recommend that minuted formal and minuted quarterly farm meetings are held. In addition, we advise input in the preparation of the annual budget and cashflow projection setting out the annual farming policy, preparation and submission of the annual environmental claims and other routine farm management matters.

Farmer's Position

The Farmer's overall returns under a Contracting Agreement are likely to be comparable or better than under an in-hand farming operation as significant capital is released from investment in machinery, capital required to run the farm, etc. Invariably the Contractor's cost will be less than the farm's existing labour and machinery overheads due to the economies of scale.

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