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YOUR DAIRY BUYOUT BID: FACTORS TO CONSIDER

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Part IV of Materials Prepared By The National Dairy Herd Buyout Extension Program Committee

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NATIONAL DAIRY HERD BUYOUT EXTENSION PROGRAM COMMITTEE

In November 1985 a group of agricultural economists representing six land-grant universities informally organized the National Dairy Herd Buyout Extension Program Committee.

The milk production termination program, as the buyout program is formally called, became official policy when the President signed the Food Security Act of 1985 on December 21.

The purpose of this ad hoc committee effort is to formulate materials that could be widely used in Cooperative Extension programs designed to help dairy farmers, lenders, and other industry groups to better understand and make decisions relative to the new milk production termination program.

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INTRODUCTION

The "Milk Production Termination Program" was authorized when the President signed the Food Security Act of 1985. To participate in this program, a dairy farmer submits a bid. If the government accepts the bid, the farmer agrees to sell dairy livestock and to refrain from all dairying activities for five years.

Farmers must decide for themselves whether or not to participate in the bidding process for acceptance in the milk production termination program. A major challenge will be deciding what bid to submit. This paper is a general discussion of factors a farmer should consider in preparing the bid. The details of the rules and regulations to be used in administering the program were not known when this paper was written.

When it comes time to analyze individual farm benefits, see the companion worksheets titled, Worksheets for Calculating Breakeven Bids for the Milk Production Termination Program or its equivalent microcomputer program. Other related papers will be available which discuss the detailed rules and regulations of the law, the outlook for the national dairy situation, long-run planning for staying in farming, and the income tax code details which apply.

A. Plan To Get Out Completely

Dairy farmers who would seriously analyze the financial impact of selling out their herd might first accept the idea that they are most likely getting out of the dairy business for good. They should not view this legislation simply as a cost free five year vacation from milking cows. It should be viewed as providing a transition to another type of farming or nonfarm employment. The program is aimed at getting resources (cows, facilities, and people) completely out of the dairy business. Dairy farming is likely to be dramatically different in five years. Retooling could be expensive, both in equipment investments and in learning the technology.

Some dairy farmers will view this program as a golden opportunity. Those about to retire with no family members to take over the farm, and no buyers ready to take over the farm as a complete unit, will likely make a bid. Those facing foreclosure or bankruptcy may find the program an honorable and convenient way out. Those who recently started milking cows and now regret it, may find participation facilitates an occupation change.

B. Getting Your Information Organized

A thorough financial analysis should be done to decide whether or not to make a bid for program participation. If it looks favorable, then a bid has to be determined. The bid is formulated on the hundredweight of milk sold during an historical marketing period. Your first job is to determine your marketing history amounts of milk sold. You will have to establish the size and composition of your herd a) during the period of the marketing history, and b) at the time you submit your bid. This information will be submitted to the government with your bid. The material mentioned below will be only for your own use.

You will want to know how much you earned recently in dairy farming. This means an accrual income summary or income statement for 1985 should be available. In order to see year-to-year fluctuations, you should also examine income statements for 1984 and 1983. A net worth statement, or balance sheet, for the end of each year is also desirable. These should show inventory changes, equity or net worth, and the current debt levels. Cash basis income tax forms will only allow a shallow analysis.

Finally, you need a detailed inventory of what is on the farm. This should show all the items which you would sell if you enter the program. It should have up-to-date estimates of the cash they would bring when sold. The inventory should show the undepreciated value of any capital items, such as cows and machinery, which were purchased. Your most recent depreciation schedule has these; it could be part of the inventory. Livestock should be grouped by age. Because they will be sold for slaughter, weight estimates of each group might be useful. The exception is cattle to be sold for export.

C. Alternative Uses Of Operator Labor And Farm Assets

A bidding strategy most dairy farmers will follow is to bid so as to be at least as well off as they would have been if they kept on dairying. They should make detailed budgets for the next three to five years of what would happen for several alternatives. The first should be if dairying is continued according to the family's long-run plan. A second could be getting out of dairying and into beef. A third alternative could be nonfarm work with the land being rented out. You should think realistically about your own options.

<u>Family Labor</u> - A major decision will be how to use operator and family labor if dairying is stopped. Farmers who could eliminate all the costs associated with the dairy business and get jobs in town making as much as they did on the farm might bid low amounts only considering loss in net worth. Farmers about to retire and who have their retirement income sources all lined up might submit relatively low bids. Farmers with no nonfarm alternatives and only limited markets for other farm products might make relatively high bids in order to remain as well off if they stopped dairying.

An early step in the planning process should be for the operator and family to find out how much they could earn in nonfarm employment. Farmers may find they have several basic skills that are needed by employers. This will help the family confront the issue of whether or not they want to continue farming.

<u>Farm Assets</u> - Farmers will be forced to sell all dairy livestock for slaughter or export if the program is entered. The legislation includes penalties if cattle are not disposed of in those ways. A producer contracting to enter the program will agree not to make available to anyone the milk production capacity of a facility. At the time this paper was written, it was not known how the term "facility" would be defined in the administrative rules. It is likely that any farm machinery, buildings, and land could be used for enterprises other than dairy.

Livestock Alternatives - Beef cow-calf and beef feeders could be handled with few changes to the system. A moderate amount of rebuilding would enable the raising of hogs. A relatively large amount of remodeling would be needed for poultry. Feed handling and manure handling equipment might require changes for alternative livestock. Operators would have to learn management practices and marketing strategies quite different from those used in dairying.

Crop Alternatives - Farmers who raise their own feeds could continue with their same crops, but sell them. This might allow the selling of feed and manure handling equipment. Costs associated with livestock would be avoided. Other crops adapted to the area and which are in demand could be considered, often with only modest changes in field equipment. Corn and small grains are examples. Although some of the buildings might be used, others would probably remain idle. The bid needs to consider the fixed costs associated with idled buildings.

Landlord - The farmer could sell all equipment and facilities consistent with the contract rules and keep only the land, and perhaps some storage buildings. These would be rented out to some other farmer in the community, or perhaps one could place land in the Conservation Acreage Reserve, another government program provided for in the 1985 Act. Like the milk termination provisions, the rules for entering the Conservation Acreage Reserve are not known. There would be land taxes, insurance, and any debt servicing to be considered as cash costs for these alternatives.

Each of the alternatives could be combined with either retirement, or part-time, or full-time nonfarm employment by the operator, spouse, or both. You should determine the most likely alternative(s) for the use of resources if your bid is accepted. Each alternative plan will result in different amounts of annual net income earned from the resources and, therefore, affect the bid. You may want to consider several alternative plans for resource use, with each of these plans evaluated separately.

Once an alternative has been selected, the details should be specified to help in estimating the receipts and expenses likely to occur during the contract period. The plan selected will also affect the assets to be sold, the amount of income to be received from the assets, the amount of debt paydown from the sale, plus any interest and principal payments on the remaining debt.

D. Calculating Asset Values If Sold

Make a net worth statement built with market values at the end of 1985. Or, create a detailed inventory list of those assets, such as cows, feeds, and machinery which you would sell. All dairy livestock will have to be sold for slaughter or exported. The net worth statement probably has the livestock valued for dairy purposes. The slaughter price will probably be your local price for low grade (cutter, canner) beef. You will have to estimate the weight of your animals to get the total sales value. This total will have to be reduced by a marketing fee which might be 4 to 12 percent of the total value.

For the other assets, such as feed and nondairy machinery, review the net worth statement values and change if necessary. You want a good estimate of the cash they would bring when sold. Depreciation schedule "book" values may have no relationship to current market values. There may have been some overvaluation of feed inventories at the end of 1985. Markets for these items may be soft if a substantial number of farmers in an area decide to sell. Selling costs, such as auctioneer fees, might run 5 to 15 percent of the total value.

Before you make a bid, consider whether it might be better to sell assets in a normal sale rather than one tied to the program. In a normal sale, the dairy cattle could be sold for dairy purposes rather than for beef. The farm could also be sold as a dairy farm. It is possible that the net result could be superior to joining the program.

E. Consider The Lenders

If you borrow money, it is likely that all your assets, including cows and feeds, are tied up as collateral for the loans. They might be in the form of mortgages, chattel mortgages, security agreements, or contracts. Before collateral can be legally sold, the lender must release them. Lenders will probably insist that proceeds be assigned first to loan repayments. If the loans are not completely repaid, you should find out whether or not the government buyout payments will meet the adjusted loan servicing schedules. If not, will alternative jobs make up the difference?

You may have to sell more than just your cows to pay off debts. You may also need to negotiate with your lenders to leave enough money to cover estimated income tax payments. Lender requirements may create a minimum bid you can make.

F. Income Tax Implications

All of your livestock and feeds probably have a zero adjusted cost basis. This means any proceeds from their sale will be taxable gain. For livestock on your farm over 24 months, this will be long-term capital gain. Only 40 percent of long-term capital gains are included in taxable income according to 1985 tax rules. Younger animals will be short-term capital gain and, hence, fully taxable. Gains from feed sales will be fully taxable at ordinary income rates.

Machinery sales may produce gains or losses, based on the age. Older items have likely been fully depreciated. Any cash proceeds received will probably be taxed at ordinary rates due to depreciation recapture rules.

New machinery might sell for less than the adjusted cost basis on the depreciation schedule. This would be treated as a capital loss and would offset some of the capital gains being reported that year. Newer machinery items, if sold, may also cause an investment credit adjustment. This could be either a reduction in credit carryover or cash recapture the year of the sale.

The year of the sale, the individual person may lose their status as a farmer under the tax laws. This means quarterly estimates will have to be filed and paid. Buyout payments will probably be treated as ordinary farm income and, hence, taxable for social security as regular income.

The tax bite will reduce the money available for debt repayment and other uses. This reduction may force bids to be higher than if tax considerations were ignored. This section has covered federal IRS rules. Similar provisions may also exist in your state tax laws.

G. Planning For Re-entry To Dairy Farming

Farmers might plan to get back into milk production after the contract period (probably three to five years) is over. At the least, this would mean purchasing a herd of cows with replacements. The existing dairy herd would be sold at lower beef prices; the re-entry herd would be bought at higher dairy purpose prices. If you wish to get back into the business at no extra cost, the bid will have to be increased to cover this price difference.

Although interest could be earned on the sale of proceeds during the contract period, income taxes will have reduced the total to invest at the time of sellout.

You would have startup costs of buildings and equipment. We believe some milking equipment would have to be replaced. Barns might have to be renovated. Health certification would have to be re-established.

SUMMARY

This paper has discussed, in general terms, the items to consider in preparing your bid to enter the whole herd buyout program. To make a sound economic estimate, you need to establish your base hundredweight of sales. We suggest you prepare a summary of your farm financial accounts for 1983, 1984, and 1985. It will be easier if they are in the form of income and net worth statements. You need a detailed inventory of your dairy animals and equipment, including their adjusted cost basis plus an estimate of the cash they will bring when you sell them.

Besides past performance, you need to have a good estimate of what you would do with your barns, machinery, and land if only the livestock is sold. What can you earn in nondairy farm enterprises? Or, if you sell everything, what can you earn off the farm?

Even if you have other income opportunities, can you live in the future with the sellout provisions your lender may require? Finally, don't forget the cash drain which will be caused by income tax payments.