Leasing Arrangements for Colorado's Farms and Ranches

Jeffrey E. Tranel, Jenny Beiermann, Norman Dalsted, and R. Brent Young[1]

August 2016

Land is an expensive resource for agricultural producers. A large capital investment is required to purchase enough land, or land of sufficient quality, to provide the farm family an opportunity to earn a satisfactory living. New and beginning farmers may not be able to afford the of purchase farmland. They may not have enough capital, income may be insufficient to meet debt repayment obligations, they may not have the credentials (including equity) to obtain debt, or the risks may be greater than the possible rewards.

On the other hand, people or institutions owning farmland may be looking for someone to farm it in order to generate returns on their investments. There are retired farmers wanting to retain their investment in the land for security, to provide income during retirement, or other related reasons.

Leasing (renting) is one option for gaining control of farmland. A lease is a business agreement between the tenant farmer and the landowner. It provides the basis for combining the landlord's and the tenant's resources of land, labor, capital, and management to efficiently produce farm commodities. It gives the use of an asset to a lessee for a specific period of time for specific uses at a specified rate. A lease does not transfer title of ownership nor an equity interest in the asset.

Because rented land is so important in farming operations, the rental arrangements between landowners and producers can have significant impacts on the risk and returns of those operations. Thus, it is crucial that producers understand how changing production practices impact rental arrangements and how different rental arrangements affect their operations.

Lease Types

The types of land rental agreements vary widely in each locality and from one region to another, and are often based on long-standing traditions. Landowners and tenants can choose from three primary types of lease agreements for crop production: crop share, fixed-cash, or flexible-cash lease agreements.

Crop Share lease agreements provide for a specified percentage of the harvested crop to go to each the landowner and the tenant. The basic premise is for each party to receive income from the crop in proportion to what each party contributes to production.

In a typical crop share lease agreement, the landowner contributes land and improvements, associated property expenses, and a certain share of the variable costs. The tenant usually contributes machinery, associated equipment

[1] Tranel, Beiermann, and Young are Agricultural and Business Management Economists with Colorado State University Extension and faculty affiliates with the Department of Agricultural and Resource Economics. Dalsted is a Professor and Agricultural and Business Management Economist in Colorado State University's Department of Agricultural and Resource Economics and Extension. Tranel can be contacted at jtranel@colostate.edu.

expenses, and a certain share of the variable costs. If irrigation water is involved, the landowner typically pays any assessment (ownership) fees, provides any pumping equipment, and pays for major pump and well repairs. The tenant usually pays a portion of minor repairs of pump repairs and pumping costs such as diesel fuel, electricity, or natural gas.

Advantages of a crop share lease agreement over other types of agreements include:

1. Less operating monies may be tied up by the tenant due to the landowner sharing some production costs.
2. Management may be shared between an experienced landowner and tenant resulting in more effective and financially rewarding decisions.
3. Crop shares and input purchases may be timed for improved income tax management.
4. Risks of low yields and prices are shared between the two parties. Profits from high yields and/or prices are also shared.
5. The landowner may more easily prove "material participation" for involvement in government programs, estate planning purposes, building social security base, and income tax purposes.

Disadvantages of crop share lease agreements include:

1. Landowner income will vary due to yield and price variations as well as changes in costs of shared production inputs.
2. Accounting for shared expenses must be maintained.
3. The landowner must make decisions about marketing and crop insurance coverage of the landlord's share.
4. The landowner and tenant must discuss and agree to annual cropping practices and management decisions.

Fixed Cash lease agreements provide for the landowner to receive a predetermined cash fee from the tenant irrespective of crop yields or commodity prices. The tenant produces crops on the land and makes general management decisions as if the land were owned by the tenant. The tenant pays all production costs.

Advantages of fixed-cash lease agreement over other types of agreements include:

1. There is little concern about the accurate division of the crop, expenses, and marketing.
2. The landowner has less managerial input, thereby reducing the possibility or likelihood of friction between the landowner and tenant.
3. The landowner has less likelihood of being considered a "participating landlord" when calculating social security payments.
4. The tenant has great freedom in crop production, marketing, and participation in government programs.

Disadvantages of fixed-cash lease agreements include:

1. It may be difficult to determine a cash rental rate acceptable to both parties.
2. Cash rents are likely to be too low in times of high yields and prices and too high when yields and prices are low.
3. The tenant may tend to "mine" the land, thus reducing productivity over time.
4. Cash rents become fixed costs for the tenant.

Flexible Cash lease agreements provide for the landowner to receive a predetermined cash fee from the tenant adjusted for changes in crop yields and/or commodity prices. The tenant produces crops on the land and makes general management decisions as if the land were owned by the tenant. The tenant pays all production costs.

Advantages of a flexible-cash lease agreement over other types of agreements include:

1. The landowner has opportunities to share in the additional income resulting from unexpected increases in extra-ordinary yields and crop prices.

2. The tenant has less risk than with a fixed-cash lease. Rent expense is lower if yields and/or prices are below normal or expected.

Disadvantages of a flexible-cash lease agreement include:

1. Flexible-cash rent increases risk for both the landowner and tenant.
2. The tenant foregoes some benefits from higher yields due to the tenant's production and marketing skills.
3. Flexible-cash rents are more difficult to calculate than are other types of rent.

Key Areas of Decision Making

There are certain key areas in developing a farm lease that should be given very careful consideration by both parties. The answers to these questions will depend on the intent of the parties in the leasing arrangement and the bargaining position of each.

Timing A lease agreement should clearly state the beginning and end dates of the lease, the length of time the lease will be in effect, and how the lease may be renewed. "Verbal" farm leases in the State of Colorado begin on the first day of March and end on the last day of the following February. Written leases typically extend for three to ten years with automatic renewals.

Sharing Costs There are many variations in how the costs for custom application of fertilizer and pesticides are divided. A common question pertains to the landlord's responsibility in sharing herbicide costs for weed control as a partial or complete substitute for cultivation or other tillage methods. Many landlords agree to furnish some portion of the cost of these materials under a crop-share lease. Some landowners believe that where no-till or minimum tillage practices are used they should not have to pay their full share of the cost of herbicides. Therefore, it is advisable to discuss these items in advance and state in the lease whether or not the landlord will share in any of these costs.

Who pays for harvesting costs is another common issue? If the tenant has his own equipment, it is typical for the tenant to pay all harvesting costs. In those cases when the crop is harvested by a "custom harvester", there may be some division of harvesting costs – especially under crop share lease agreements.

Costs associated with harvesting, drying, transporting and storing crops may be shared under a share lease. When storage and drying facilities are part of the rental unit, the landlord often furnishes the dryer and storage facilities. The fuel and power costs for drying are normally shared in the same proportion as the crop is divided. In some cases the tenant is paid extra for delivering the owner's share of the crop from farm storage to an elevator or processor.

Removing Stover/Stubble There is likely to be some residual vegetation (stover, stubble, etc.) after harvesting. This vegetation can be used as pasture forage, removed for livestock feed or bedding, or left standing for ground cover. Tenants and landowners should specify in the written lease the arrangement and amount of stover which can be removed and whether the landlord receives a portion of the income.

Maintaining Fertility Farm owners often worry about whether a tenant will maintain or improve the level of fertility on the farm. Regular soil testing can establish whether additional nutrients are needed. While tenants should be discouraged from "mining the soil," applying additional fertilizer when levels are already testing high or very high not only wastes money but also contributes to nutrient run-off and downstream pollution.

Applying lime (or other additives) to soils contributes to productivity. Since such applications usually last for several years, their cost is usually the responsibility of the landowner, and is reflected in the rental rate of the land.

Long-term crop-share tenants may divide the costs of lime, however.

Controlling Weeds and Maintaining Buildings Many landowners place a high value on controlling weeds along fence rows, in ditches, and around building sites. Indeed, cutting or spraying weeds classified as noxious is required by law. Maintaining the appearance and functionality of farm buildings and fences is often a high priority for landowners, as well. Even if some buildings provide no substantial benefits to the tenant, he/she may be able to provide labor and machinery for keeping the area in good repair at a considerable savings to the landlord. Owners should generally pay for materials and supplies, especially if the tenant is providing labor. While such practices may have little economic payoff for a tenant, they can contribute to a longer and more harmonious leasing agreement, and often require a minimal amount of time and cost.

Participating in Government Programs Most crop producers participate in some of the commodity programs offered by the U.S. Department of Agriculture. They are usually designed to reduce price or production risk for major grain crops. New farm legislation requires landowners and tenants to make decisions about program participation.

Under a cash rent lease the farm program benefits usually are paid to the tenant, because that is the person bearing the risk. With a flexible cash lease, the commodity program payment can be included in the gross revenue used to determine the rental rate each year. Under a crop-share lease the owner and tenant usually share in the program benefits in the same proportion as they share the crop. If there is a cost to participate in the program, the owner and tenant must carefully analyze the potential benefits to each party. Government program decisions can affect the rental value of a farm for several years.

Conservation programs may offer short-term payments for following certain practices, as well as long-term benefits in the form of reduced erosion, increased fertility, and cleaner water. If the incentive payments to do not completely offset any extra costs or reduced income to the tenant for following the conservation practices, he or she may be reluctant to participate. If the lease has only a short duration, such as one year, the long-term benefits of the practices do not offer much incentive to the tenant. The landowner may have to reduce the cash rent to offset the tenant's short-term loss of net income.

Setting the Length of Lease Many farm leases are in effect for only one year at a time. Multi-year leases provide owners and operators with an incentive to invest in long-term improvements to the land and maintain soil fertility and conservation structures. They also avoid the uncertainty of building new relationships frequently. While some states limit the length of a lease contract, leases can be routinely renewed if both parties agree.

Economic Considerations There are several important economic factors to consider when developing a farm lease agreement.

- Does the lease provide a business framework for the most profitable long-term operation of the farm?
- Does the agreement encourage the use of the most profitable levels of capital, labor, and management in the farm business, as well as adoption of new technology?
- Are the returns shared between the landlord and tenant in an equitable manner when the value of the contributions made by each party is considered?
- Is the level of cash rent to be paid consistent with the current land market and the productivity of this particular tract of land?
- Is the farming unit large enough to achieve an efficient level of operation and provide a satisfactory return to both landlord and tenant? A larger tract of

land may be more attractive to potential renters than a small tract.

Legal Considerations Several federal and state laws affect lease terms. Such legal considerations promote an efficient business, ensure that lease provisions are carried out as intended, and protect the interests of each party.

Self-employment Income A "materially participating" landowner must report farm income as self-employment income rather than as passive investment income. As such, it is subject to the normal self-employment tax rate. On the other hand, paying some self-employment tax may increase future Social Security benefits. A cash rent lease rarely qualifies a landowner as a material participant, but a crop-share lease may do so. An owner must be in the trade or business of farming in order to deduct certain expenses such as interest on operating capital or applications of fertilizer and lime.

Estate Tax Valuation Many farm properties can qualify for "special use valuation" when they go through probate, which often results in a valuation below current market value. This can be advantageous for estates large enough to trigger federal estate taxes. However, one requirement for special use valuation is that the decedent or a family member must have materially participated in the business five out of eight years prior to death and a qualified heir must materially participate for ten years after the death of the decedent.

Communication Good communication between tenants and landowners is essential for building a successful leasing relationship. Landowners are concerned about the use and care of their farm. Nonresident owners cannot observe conditions first hand. Some spouses or children who have not been heavily involved in the management of the property may feel unsure about how to proceed with decisions.

Provide Reports Tenants can borrow a technique from professional farm managers who provide their clients with written reports on a regular basis. Obviously, a report is more important with a crop-share lease than a cash lease. It may be beneficial for a tenant with a cash lease to develop an abbreviated form of reporting, especially for landowners who have a strong interest in the productivity of the farm. Sending pictures to a landowner who is not close enough to observe crop conditions regularly is a very effective communication tool.

The accounting of expenses should be kept current, especially under crop share lease agreements. Some input suppliers will invoice each party individually. However, informing the owner beforehand that he/she will be receiving a bill, and its purpose, is recommended. Tenants renting from several owners may purchase supplies in volume and prorate the bill to each of the owners. In this situation a copy of the original invoice should be included. Explain each item on the bill, as names of farm inputs change frequently. The owner may not be familiar with commercial product terms for seed, herbicides and insecticides, but nonetheless may have to categorize the expenses for income tax reporting.

Crop insurance policies and some USDA programs require information about historical crop yields before a farm can be enrolled. Landowners need to have this information each year for making future decisions about participation in such programs.

Written Lease Written leases make the lease terms more definite and leave less chance for disagreement and misunderstanding. People tend to selectively recall only those portions of conversations that reinforce their point of view. It protects not only the original parties, but also assignees and heirs in case either party should die, or the farm is sold.

A written lease encourages both parties to consider all aspects of the lease before the lease period begins. Decisions are made before the problems occur. In subsequent years, it provides a basis for changing provisions when conditions change. Written leases also provide documentation in case of a tax audit or for settling an estate. Lease agreements that cover more than one crop year are required to be in writing, and leases written for five years or more must be notarized and recorded at the county recorder's office by the tenant.

The document should meet at least the following minimum requirements:

- It should contain an accurate legal description of the property.
- It should specify a definite period for which the lease is to run.
- It should state how the lease may be terminated and what process is invoked in case of default by either party.
- It should state the kind and amount of rent, and time and method of payment (cash lease).
- It should state any specific uses and limits to use.
- It should specify how production, USDA payments, and input costs are to be shared (crop-share lease).

Oil, gas, and mineral exploration and other uses of the sub-surface typically impact use of the land. A written lease should specify the conditions regarding exploration, who and when they may access the property, changes to the lease when such occurs, and other related impacts to both the landowner and tenant.

Termination of a Farm Lease A farm lease automatically continues from year to year unless either party gives a notice of termination. Each state has specific laws regarding the termination of leases. The process for terminating the lease should be consistent with state law and be included in any written lease agreement. In order to terminate a verbal lease within the State of Colorado, the landowner or tenant must notify the other in writing (1) describing the property and (2) specifying the time when the lease will terminate. The termination notice must be signed by the party (or his/her agent) giving notice.

Summary

Leasing is one option for gaining control of farmland. A lease is a business agreement which provides the basis for combining the landlord's and the tenant's resources of land, labor, capital, and management to efficiently produce farm commodities. It gives the use of an asset to a lessee for a specific period of time at a specified rate.

The type of lease put into effect will impact the level of risk, amount of capital needed for crop production, management, marketing needed, productivity of the land, etc. for both the landowner and tenant. Additionally, the type of lease will impact the landowner's income tax liabilities, contributions to and/or benefits from Social Security, and estate planning.

Labeling a document as a lease does not necessarily mean it is a lease according to the Internal Revenue Service (IRS). Questions concerning the IRS treatment of a lease should be addressed by your tax management professional. Also, the legalities of the lease should be addressed by professional legal counsel.

Additional information about crop, pasture, and building lease agreements are available from Colorado State University (www.coopext.colostate.edu/ABM/).