



Ag Business Management

Informing farm families and ag businesses about management issues.

LAND RENTAL AGREEMENTS

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Renting land is an alternative to owning. Renting allows a farmer to increase the size of his or her operation without having to commit (or even have) the money needed to buy the land. For starting farmers, renting is a very good way to enjoy the benefits of a larger operation without taking on large amounts of debt. Renting also provides a farmer with more flexibility to move his or her operation to different geographical areas. For example, a young farmer could initially expand by renting land over a relatively large area and then, as land becomes available closer to the home farm, stop renting land at the farthest points in favor of land closer.

Over half of the cropland in the U.S. is rented. The landowners may be the tenant's parents or siblings, retired farmers, surviving spouses, or off-farm investors. Landowners either manage the rental arrangements themselves or hire a professional farm manager to handle part or all aspects of land management.

The two most common rental agreements for farmland are a cash lease and a crop share lease. Flexible cash rent agreements are available and interest in them is increasing, but they are still not as widely used as a straight cash lease.

Share rental agreements

With a share lease, the owner agrees to share in some of the direct growing costs. Typically, the owner shares in the seed, fertilizer, crop insurance, drying, and transportation costs. With a typical share lease, the tenant pays for fuel, oil, repairs, hired labor, and machinery depreciation) and the owner pays the real estate taxes, general insurance, land loan interest, and so on). Some share owners also share in the costs of weed control; others say that the tenant pays for all weed control and decides whether to use chemical or mechanical weed control. With the improved efficacy of herbicides, the common approach today is to share weed control costs. Usually, the owner takes ownership and control of his or her share of the crop at harvest. In a traditional crop share lease, the tenant and owner are responsible for the storage and marketing of their own share in the crop. Since the owner is receiving the physical crop as the rental payment under a share lease, the owner is assuming some of the risk of the resulting value of the crop and the tenant is relieved of some of the

risk. Thus, the owner can benefit from good weather and good prices more with a share lease but is open to the problems caused by poor weather and poor prices. The tenant loses some of the potential benefit of good weather and good prices but, with a share lease, is able to give some of the risk to the owner.

In a share rent agreement, the tenant farms the land with the owner paying a share of the direct production costs and receiving a share of the physical product. Once the physical yield is divided between tenant and owner after harvest, each is responsible for their own marketing decisions. Since he or she will benefit from good yields, a landowner usually takes a more active management role with a share rent agreement, that is, the landowner may want to help decide which varieties to plant, fertility levels, planting and harvesting schedules, and so on. Compared to a cash rent, the landowner takes on more risk of what the yields and prices will be, so in an average or typical year, the landowner should receive a higher return to land than a typical cash rent. Landowners like share rent if they like to be more involved in the farming operation; they do take on more risk of bad years, but they also have the chance to enjoy good years. Tenants, especially young farmers, may appreciate the decreased risk they face with share rent agreements since some of the price and yield risk is shifted to the land owner. Common shares or percentages in share rent agreements are 50-50 and 60-40 for the tenant and landowner respectively but these shares do vary by locality.

For a share rental agreement to be fair, the tenant's and landowner's shares of production should be equal (or nearly equal) to their shares of all expenses. If production is not shared in the same way as expenses, some inputs may not be applied at economically correct levels. For instance, if a tenant receives 50% of production but is expected to pay for 60% of the fertilizer expenses, the tenant will not realize the full benefit of the crop's response to fertilizer and, thus decide not to apply as much as the landowner may want. In reality, shares usually match well due to gradual adjustments over time. Also, in tight land markets, tenants strive to keep renting the land they currently rent. Thus, they will make sure fertilizers and other production inputs are applied at levels to achieve good production and to keep landowners pleased.

Cash rental agreements

With a cash lease, the tenant pays the owner a fixed amount per year and then owns all of the produced crop to use or sell as the tenant determines. Under a cash lease, the tenant pays all the direct growing costs for that crop (seed, fertilizer, pest control, fuel, crop insurance, transportation, and so on); the land owner pays all the costs associated with owning the land (real estate taxes, land loan interest, general insurance, building depreciation, and so on). With a cash lease, the tenant assumes all the risks of producing and marketing the crop; the owner assumes only the risk of the tenant not paying the specified, fixed rent.

In a cash rent agreement or cash lease, the tenant farms the land and pays the landowner a fixed cash rent. The landowner does not pay any production costs and does not receive any physical crop to market. Compared to the share rent, the tenant with a cash rent agreement has more freedom to make production decisions. The tenant makes all crop marketing decisions. With a cash lease, the landowner does not participate in management decisions except perhaps in setting guidelines for crop rotations, fertility levels, erosion control and other concerns related to maintaining soil and environmental quality; these guidelines are usually written into the rental agreement. The landowner

has less risk with cash rent; they do not have an immediate or direct worry about what the yield and price will be in the rental year. The only risk a landowner may have with a cash lease is the risk of the tenant not being able to pay the rent. Because they have less risk, the landowner should expect to receive less net return to land with a cash rent agreement than with a share rent agreement. Landowners who do not want the worry of making marketing decisions or the risk of a bad year may want a cash lease. Tenants who want more freedom in production decisions and who can take on the additional risk may appreciate a cash lease over a share rent agreement. Typical cash rents vary geographically and by soil quality.

Historically, the timing of cash rent payments has been half in the spring and half in the fall. However, some landowners, and perhaps an increasing number of them, are requiring payment of the entire rent in the spring to avoid the need to file a landlord's lien with the county in order to have protection in the case the tenant were to default. Having to make the full payment in the spring increases the cash flow needs and financing requirements of the tenant since the tenant cannot delay half of the cash rent until after harvest time and the chance to sell some of the crop to pay rent.

Flexible cash rental agreements

Flexible or variable cash rents are also available for landowners and tenants. With these leases, the final cash rent is determined after harvest the current year's yield and/or price are known. Landowners may enjoy this type of lease because they do not have to market their own crop but they can enjoy the higher returns in good years. Tenants may enjoy this type of lease because they can shift some risk to the landowner and maintain control over more of the production decisions. A tenant who wants all the grain for livestock but also wants to decrease his or her risk may want to consider a flexible cash lease. Some common variations of the flexible cash lease are described below.

Base rent multiplied by the ratio of current year's price to a stated base price. The tenant and landowner specify the base rent and base price in the lease using typical or expected prices, yields and costs. The lease also specifies how the current year's price is to be determined. This could be done by choosing a certain period (September 15 to November 15, for example) and calculating the average price at a specific location, the local elevator, for example. Say the tenant and landowner agree that the base rent will be \$90 per acre and the base price will be \$2.00 for corn. If the current year price turns out to be \$2.15, the rent is increased to \$96.75 per acre ($96.75 = 90 * 2.15/2.00$). The procedure could be modified slightly to account for a typical crop rotation by specifying the base rent and base prices for both corn and soybean and determining the annual rent based on the average of the corn and soybean price ratios. In a multiple year lease, the rules the base rent and base price would remain the same, but the annual cash rent would vary due to the current year's price varying.

Base rent with stated adjustments for price changes. Rather than changing the annual rent for any change in the current year's price, this form of the flexible cash lease describes how the base rent will be adjusted if prices move out of a specified range. Perhaps the rent changes are made only when the price moves above a specified price. This form of flexibility results in less change in the annual rent than the first alternative. Some tenants and landowners may prefer to have more stability in their cash flows.

Fixed amount of commodity. The lease defines the rent in terms of physical yield, say number of bushels or tons, and also defines a procedure for determining the current year's price. The rent for each year is the set physical yield multiplied by the current year's price. In a multiple year

lease, the number of bushels would remain the same, but the annual cash rent could vary as the current year's price varies.

Base rent multiplied by the ratio of current year's price to a base price and by the current year's yield to a base yield. This variation in flexibility is similar to the first option described except the yield is also included. As in the earlier example, say the tenant and landowner agree that the base rent will be \$90 per acre and the base price will be \$2.00 for corn plus the also agree that the base yield for corn will be 150 bushels per acre. If the current year price turns out to be \$2.15 but the actual yield is 145, the rent is increased to \$93.52 per acre ($96.75 = 90 * 2.15 / 2.00 * 145 / 150$). This annual rent is lower than the earlier example because the actual current year's yield is lower than the base yield.

Stated percentage of the current crop's value. This variation is very similar to a share rent agreement except a pricing procedure is specified rather than the landowner taking physical possession of the crop.

Minimum base rent plus a percentage of increased value. With this variation, the tenant agrees to pay a fixed, minimum base rent plus a specified percentage of an increase in value based on the current year's yield and price. Two similar but slightly different methods for determining the flexible portion in this lease are (1) as a percentage of the yield above a base yield with the price chosen on a certain day or period and (2) as a percentage of the current year's crop value over a specified base. In the first option, the bonus or variable portion is based on the actual yield exceeding a base and then valued using the current year's price. With this option, the variable portion will be positive if the yield is high and the price is low. If the yield is below the base and current prices are quite high, the landowner will not receive a higher payment even though farm income may be higher. With the second option, the bonus or variable portion of the rent is based on each year's combination of yields and prices. Thus, if low yields and high prices happen in the same year, the total value could still exceed the specified base value and the landowner still receive a positive variable rent payment.