Leasing Fact Sheets

Learn the many components of a sound farm lease agreement.

Farmers and landowners—and the land—benefit from good farm leases. These fact sheets describe key terms and clauses that make up a sound lease agreement, including tips to develop a written plan, determine rent, and more.

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This information is considerate of New England farmers and landowners. While it may be useful elsewhere, some language and clauses might be different in other regions. It does not address all legal concerns and is not a substitute for legal advice.

Land For Good
PO Box 625, Keene, NH 03431
landforgood.org

Describing The Premises
Leasing Fact Sheet

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Introduction

It may seem obvious that a lease should identify what is being leased, but not all lease agreements do so adequately. The purpose of a good description of the premises is to clearly and thoroughly identify what is being leased so that the parties to the lease—as well as any third party such as an appraiser, a judge, or subsequent owner—can easily identify what's included and understand its condition at the outset of the lease. Providing a clear written description as well as a visual representation of the leasehold will avoid awkward discussions later about exactly which land and infrastructure is included in the lease agreement.

At minimum, the description of the leased premises should include an address and a description of the boundaries. Ideally, a map, annotated satellite image, plot plan, and/or diagram will be attached as an appendix to the lease document. For some agreements, simplicity is fine. Others require a lot more information and detail.

The premises includes everything that is being leased at the time the lease begins. It could include an entire property. But a landowner could be leasing only a portion of his or her property such as a certain field or building. Sometimes *premises* and *property* are used synonymously; the distinction could matter. The premises could include buildings and other structures such as wells and fencing. Leased equipment could be part of the premises (or could be contained in a separate lease). A "whole farm" lease could include a residence, tools, even livestock in the premises. *Note that any new structures or improvements to structures that are not included at the time of signing the lease are not part of the original premises.*

Written Narrative

Strive for an accurate and thorough description of what is being leased. Simple premises, such as a hay field, can be adequately described in a few words ("the southwest corner hayfield at this address"). Every written description should include references to landmarks such as roads, fences, etc. that will clarify where the exact edges of the leasehold lie. More complex properties need more detailed language such as a written description of the land, buildings, animals, equipment, and whatever other features are included in the premises. The written portion could consist of or include a description from the deed. The narrative can be a part of the lease itself or can be included as an attachment that is referenced in the lease.

A legal description of a property and/or reference to the deed is fairly common in a farm lease, and especially important where an option to purchase or right of refusal is included in the lease.

Maps and Photos

Include visual representations. With many farm leases, it helps to include some visual depictions of the leasehold such as assessors' maps, aerial/GIS photos, plot plans, architectural renderings, or hand-drawn sketches. Photos, including detailed close-up pictures of structures can be important and useful both for identifying which structure is being leased and its condition at the beginning of the lease term. Photos that document the condition of equipment that is being leased are also important.

Baseline Conditions

Describe the conditions of the leasehold. The description of the premises at the commencement of the lease serves as the baseline for both parties. This documentation may include a natural resource inventory as well as details on the structures on the premises. These descriptions provide a baseline for monitoring and measuring changes. A description of baseline conditions can include:

- Condition of buildings, fencing, gates, stone walls
- Location of field edges
- Particular trees or other vegetation
- Water resources, including any tests; water lines, irrigation, wells, ponds
- Trails, roads, lanes, culverts, bridges
- Archeological features
- Soil types, quality, and any soil tests

Establishing baseline conditions helps both parties down the road if there is any question about "normal wear and tear" or "failure to maintain." It can help with enforcement and settling disputes, as well as help both parties to plan for repairs. Procedures for monitoring should be clearly set forth in the lease. See Land Use, Management, and Stewardship Plans fact sheet.

A Residence

Consider the options for a leased residence. If the leased premises includes a dwelling, various laws apply. Every state has landlord-tenant statutes; you can find them online. They include a requirement that residential dwellings be habitable, and that repairs are taken care of, for example.

Premises that include a residence can be addressed in two ways in a lease. In a "whole farm lease," the entire premises are included in a single lease document. The advantages include having only one lease, and a single rent payment. A disadvantage is that the one lease could wind up being complex and lengthy.

Some attorneys encourage a separate lease for the residence and its immediate surroundings. The residential lease would conform to that state's legal requirements to address tenants' (and landlords') rights. Often the provisions for maintenance and repairs, for example, are quite different for a residence than they are for farmland.

Separate leases can be very handy in a couple of situations such as if the tenant finds other living quarters nearby but wants to keep leasing the land and farm buildings, or if the tenant wishes to stay in the residence but no longer lease the land and farm buildings.

A disadvantage of having multiple leases is that there are two premises to keep track of. In the case of a house on the farm, the "premises boundaries" between the house and the other leasehold must be clear.

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Introduction

The term of a farm lease means the period of time—or duration—that the lease will be in effect. The word *term* can be confusing because the *terms* of a lease can also mean the provisions and stipulations spelled out in the lease.

Regardless of the type of lease or length of the term, it is important to specifically name the beginning and ending dates of the agreement. Every lease should state whether and how the lease may be extended or renewed. If the lease "runs with the land"—meaning that the lease remains in effect even with a change of landowner—the termination (end) date is still valid, even if the property has changed ownership during the term. See Termination and Default fact sheet and also Lease-To-Own Strategies to Acquire Farmland fact sheet.

In certain circumstances, a month-to-month lease may be adequate. It allows the tenant or landlord to terminate the lease at any time. Month-to-month leases are generally self-renewing, meaning they just keep going, month-to-month.

Length of the Term

Agree on the term. Technically, a lease can be of any duration, subject to pertinent state laws. (Some states set a limit to the length of a farm lease term.) Some leases, such as ground leases with a community organization as the landlord, run 99 years, although this is not common.

The term has implications for both parties to the lease. Will the tenant be motivated to adopt conservation practices? Will the tenant invest in leasehold improvements? Is the lease term sufficient to qualify for farm programs?

There are situations in which a ***short-term lease*** is desirable. Short-term is not a precise time period, but it generally means one or two years. Farmers and landowners might choose to start with a short term as a kind of "trial period." If both parties are happy with the leasing relationship, they could transition to a longer term. Other reasons for a short-term lease include if the future of the property is uncertain, or if a farmer wanted to test the property's fit for his or her operation. A beginning farmer might want to see if farming is a profession that he or she will want to continue. An established farmer may need additional land for a season or two.

One major drawback of a short-term lease is that it does not provide much land security to the farmer. The farmer is less likely to invest in the land and infrastructure, and to make long-range plans. It means less security for the landowner, too; he or she may have to search for a new tenant and establish new relationships. Another relative disadvantage of shorter-term leases is the transaction costs. A year-to-year lease requires annual renegotiation.

Longer-term leases can run five years or longer. Some states limit the length of a farm lease term. Longer-term leases provide more security and stability for both parties; the farmer can invest in the land and the landowner doesn't need search for a new tenant for a

long while. This security for both parties is good, but it comes with a commitment that reaches into the future. The farmer is better able to borrow capital, plant perennials or invest in soil improvement.

Other advantages of a longer-term lease include:

- Covering the term of a farm loan, typically of 5-7 years
- Depreciating improvements (typically over 5-10 years)
- Capturing a return on tenant's investment (property improvements and other farm business investments)

Regardless of the term, a lease of any duration can and should address early termination as well as changes to the lease along the way. See Termination and Default fact sheet. See also this section at Drake University Agricultural Law Center on The Lease Term and Tenure Confidence.

Extension or Renewal

Clearly describe how the lease may continue beyond the initial term. Lease renewal and lease extension may have the same practical effect, and the terms are commonly used interchangeably. But there is a legal difference, and it's advisable to get legal advice on this detail.

At any time during the term of the lease, both parties can agree to extend the lease by changing the end date to a later date. It is a continuation of the original lease, without interruption. All lease provisions would stay the same, with the only difference being that the agreement would extend further into the future. (That said, a good lease will enable the parties to negotiate changes to the lease at any time along the way.)

From a legal perspective, a renewal is a new lease agreement. Technically, a lease is renewed at the expiration of the previous one. In this case, changes can be made in any of the provisions and a new lease term set.

If desired by both parties, an option to renew or extend should be written into the lease. Options to extend or renew give the tenant the ability, prior to the conclusion of the lease term, to continue leasing the premises. An option to renew or extend the lease means that upon the tenant's exercise of the option (choice), the provisions of the agreed-upon option are adopted for the defined term. The terms of the option can include the length of the new term, a change in rent, and other modifications.

If the option rests with the tenant to ask for a renewal, the landlord is obligated to agree under the terms of the option. If there is no option to renew in the agreement, then there is no obligation for either party to renew the lease. Without the tenant's option, the tenant can ask to renew or extend; the landlord may—but does not have to—grant it.

It doesn't make legal sense for a lease to say either party has the option to renew or extend. If the landlord wants to retain the right to not renew, s/he should not grant the tenant the option.

The option typically delineates the timing of notification for renewal or extension, what the rent will be or how it will be negotiated, the number of permissible extensions or renewals, how long each extension will be, and which, if any, of the original terms of the lease will be excluded from the extension.

Rolling Lease Term and Evergreen Lease

Consider these less-traditional approaches to the term. There are two methods to address lease continuity—a rolling lease or an evergreen lease. These approaches to the lease term give added security and stability to the leasing arrangement. They enable the farmer to think somewhat longer-term, although not with the same guarantees as a long-term lease.

These terms do not have fixed legal definitions, and sometimes they are used interchangeably. So it's important

to focus on the language in the lease rather than the name of the method itself.

Both methods automatically renew the term without any action by the parties to the lease. Generally, an evergreen lease means that the lease automatically renews at the end of the original term for another term of the same length, or on a month-to-month basis. So, a 5-year evergreen lease automatically resets to another 5 years at the end of the term.

A "rolling lease" most commonly means the lease automatically extends during the term for another full term, therefore pushing back the end date of the lease. Thus, the lease is said to have "rolled over" for another full term. For example, at the end of the first year of a three-year lease, the lease rolls over for another three years, therefore pushing forward the end date of the lease.

In either case, the lease would specify the conditions under which these automatic continuations would not occur—for example if either party defaulted. And the lease would need to specify how terminations are enacted.

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Lease-to-Own Strategies for Acquiring Farmland

Leasing Fact Sheet

Introduction

In the farming community, “lease-to-own” refers to certain methods to achieve land ownership. Purchasing a farm with conventional financing is simply not an option (or the best option) for many. “Lease-to-own” can be a more affordable approach to farm ownership.

It’s important to note that “lease-to-own” is not a legal document or principle. Rather, “lease-to-own” refers to strategies to gain ownership of a particular property at a future point via specific legal transactions between the property owner and the buyer.

This fact sheet outlines three ways farmers can achieve lease-to-own objectives, the legal nature of these arrangements, and issues farmers and landowners should consider before adopting them. When exploring or pursuing each of these strategies it’s important to work with an attorney on the legal procedures and language. If an attorney doesn’t draft the documents, his or her review can still alert individuals to potential problems.

Option to Purchase

Generally speaking, an option to purchase gives a buyer (who may also be a tenant) the right to trigger the sale of the property to that buyer-tenant according to specific procedures and within a specific timeframe. A landowner can grant a person the option to purchase a piece of property even if the parties have no lease arrangement. This is often called an option contract.

In a farm lease with an option to purchase clause, an individual (the buyer-tenant) can obligate the landowner (the seller-landlord) into selling by drawing on the option. An option to purchase is generally written into a standard lease agreement, but in some situations, the lease and option to purchase are two separate documents. For example, a tenant and landlord may agree on an option to purchase after the lease has been signed. They don’t necessarily need to sign a new lease if they only need an option to purchase. Leases with an option to purchase included might be called a “lease-to-own” agreement. Legally speaking, however, the document is still a lease with an option to purchase clause included.

Options to purchase come with various contingencies, and there is no single best clause or document. Although there are some overarching legal standards, the parties have wide legal latitude to craft an option that accommodates their unique needs, concerns, and resources. The clause might occupy a couple sentences or several pages. Simplicity is not necessarily a wise objective. Purchasing property is not simple and a simple option to purchase may ignore very important issues.

At a minimum, an option to purchase clause in a lease should contain the following details:

1. **Description of the property subject to the option.** The property included in the option may or may not be the same as the leased premises. Parties should make sure to identify any buildings, equipment or other resources included in the option.

2. **Consideration given for option.** "Consideration" is a legal concept that means both parties gave and received something of value, and consideration makes a contract enforceable. If one party receives something for nothing, they received a gift which may be revoked. If the option to purchase is separate from the lease, it must have its own consideration to be enforceable. If the option to purchase is included in a lease, the recommended legal practice is for tenants to pay an extra one-time fee for the option.

   The option clause should state the fee and that the parties agree it is adequate. The dollar value of the fee is not important so long as something of value is given. It could be nominal. Although additional consideration (in the form of an extra fee) is a best practice, a court would likely find that lease payments under a lease agreement including an option to purchase are consideration enough for the option.

3. **Duration of option period.** The document should describe exactly when the tenant may elect to use the option to purchase. Does the option begin and end on certain dates? Is the option available at any time during the lease?

4. **Terms of the option.** How is the option activated? How does the tenant let the landlord know that she intends to move forward with the purchase?

5. **Price of the property.** The tenant will need to know the purchase price of the property so she can make a decision about purchasing it. This may be as easy as stating a dollar value for the property right in the option to purchase clause or document. However, most parties will not choose this strategy because it is difficult to accurately forecast the value of a specific property. More likely, the price will be determined by an appraisal to be performed at the time that the option is exercised. Or, it could be determined by a formula. Regardless of what method the parties choose, the document should be very clear about how the price is determined.

6. **Timetable for acceptance or rejection of purchase price.** Where the purchase price depends on a formula or appraisal, the tenant might also want the ability to back out of the sale if the purchase price turns out to be unexpectedly high. If so, this right must be specified in the lease. The clause should detail how long the tenant has to make the decision after the price is set. Many tenants also want the purchase subject to the tenant's ability to secure financing. This is what makes it an option to buy the land, rather than an obligation. The right starts as an option but becomes an obligation only after specific conditions are met. Tenants and landlords should pay special attention to these timeframes to ensure everyone has enough time to move the transaction forward as desired.

7. **Whether and how a portion of rent may go to the purchase.** Some options to purchase allow the tenant to assign a portion of each rental payment to the purchase price, if the tenant exercises the option. The option should fully describe the amount, if it's held in escrow, how it applies to the purchase price, and if it's returned should the option not be exercised. Farmers taking

advantage of this opportunity should work with an accountant or bookkeeper to make sure this is handled properly. The portion of rent that goes toward the purchase is considered an equity interest. This would be handled differently from rent by a court of law.

8. **Terms on which property is transferred if option is exercised.** Attorneys often recommend including many or most of the terms for the property sale right in the option to purchase. This makes things easier for the tenant because s/he knows exactly how the process will proceed and can evaluate if it's the right choice. Also the parties might have some incentive to complicate the transfer if the sale isn't in his or her best interest anymore, and including the terms can prevent complications.

A sample "option to purchase" document is available from Freelegalforms.uslegal.com. This example illustrates one way an option to purchase might describe items 1-5 above. (This is a sample, not an endorsement of this specific document.) Although the sample is presented as a stand-alone contract, the same provisions could be incorporated right into a lease. Because the sample is separate from a lease, it doesn't handle allocating a portion of the rent to the purchase price. Farmers and landowners wishing to outline the terms of the property transfer in advance should consult a sample "offer to purchase" agreement tailored to the state in which the farm property is located.

Right of First Refusal

A right of first refusal (ROFR) can be written into a lease agreement, although it can be a stand-alone legal document between a landowner and a prospective purchaser. Generally, a ROFR allows an individual would-be purchaser (in this case, the farmer-tenant) to intervene after a third party has offered to purchase the property. The individual usually has the chance to buy the property on the terms the seller and the third party negotiated. ROFR clauses are highly variable. The seller may not need to find a third party purchaser first. The seller may simply offer the property for sale to the tenant/buyer at a specific price. If the buyer thinks the price is too high or the terms to onerous, the seller may look for a third party who will accept his or her terms.

The ROFR differs from the option to purchase in that the latter is pre-emptive: the buyer can choose to activate the option to purchase. With a right of first refusal, the individual usually has to wait for a third party to elect to buy the property or for the landowner to offer it for sale. Only then can the individual (tenant) step in to become the buyer.

ROFRs and options to purchase are alternatives; a lease should not include both.

Despite their differences, a ROFR contains some of the same elements as an option to purchase. The description of the property, consideration paid for the right, and the term (when it is in effect) of the right should all be listed in detail. A ROFR should also address the following details:

What is the nature of the ROFR? What exactly is the tenant receiving with this right? Is it the right to buy the property on the same exact terms that another third party has already negotiated with the seller? If not, does the seller assemble the terms and then offer it to the tenant? Can the tenant negotiate the terms, and if so, how? Is the seller required to offer the property at an established price or at a price determined by an agreed-upon formula? This section has enormous variation and need for detail depending on what the parties agree upon.

What is the timing of and how does the tenant exercise the ROFR? The parties need to clearly understand how the property owner will notify the tenant that he has decided to

sell and the right is now active. Then, the document should articulate exactly how long the tenant has to decide on the offer or re-negotiate terms as allowed. It may also need to state what the tenant/buyer must tender to exercise her right. For example, does the purchaser have to tender the full purchase price in cash or secure adequate financing by a specific date?

A sample right of first refusal document is available from Freelegalforms.uslegal.com. (This is a sample, not an endorsement of this specific document.) As with the option to purchase, this sample is very brief and doesn't go into detail on how the property will be transferred or any additional terms on the transfer that most buyers want in a real estate transaction. Farmers interested in more detail should consult a sample "offer to purchase" contract for the state in which the farmland is located.

Land Contract (also known as Contract for Deed)

In a land contract the buyer (in this case, the farmer-tenant) makes installment payments to the owner over a period of time. Once the final payment is made, legal title to the land is transferred to the buyer. The buyer (former tenant) now officially owns the land. Land contracts are popular for transferring property between family members. A land contract mimics lease-to-own in many ways, but they are not the same.

Sometimes the timeline of a land contract covers a very long period of time, similar to a mortgage—15, 25, or 30 years. A land contract is a way to initially finance a land sale without a traditional bank mortgage. However, often the parties agree on a balloon payment at a particular time—several years down the road—at which time the buyer must pay in full. Ideally the farmer will have established a sufficiently profitable operation at that point to finance a conventional mortgage to cover the balloon payment.

Under this strategy, the buyer agrees to make monthly payments to the seller, generally without an initial down payment. The property is considered "sold" to the buyer in that the buyer holds most of the legal rights and responsibilities of an owner. However, full legal title to the property often does not pass until all or a significant number of monthly installment payments have been made. A land contract can be a good way to receive nearly all the rights and responsibilities of ownership without paying the full purchase price immediately.

A land contract often comes with risk. If the buyer defaults on (misses) a payment, the seller may be able to withhold title to the land because the buyer essentially defaulted or breached the contract. The buyer's equity in the payments made up to the point of default may be lost. Some legislatures and courts have made land contracts more equitable to the buyer. For example, the court system may require a land contract seller to go through the foreclosure process before evicting a defaulting buyer. In other states, sellers must return a portion of the monthly installments, if they exceeded the fair rental value of the property. Some courts may also consider the title to be transferred after a significant number (rather than all) of the payments have been made. These protections apply regardless of whether they are written into the land contract itself.

In many respects, a land contract has the same provisions as a standard farm lease. Land contracts look very similar to leases with an option to purchase provision that allocates a portion of the rent to a future purchase agreement. The parties may interact with each other in the same way: one party pays the other a monthly payment. Yet legally

speaking, the two are different and the distinction matters on several levels. A land contract transfers nearly all the rights and responsibilities of ownership such as the right to mortgage the property, for example. By contrast, a lease transfers a legal right to use the land for a specific purpose. Responsibilities under a land contract may include taxes and assessments, for example; these are usually not the obligation of a tenant. A land contract and a lease may differ with respect to how court procedures are handled following a default.

Whether an agreement is a lease or a land contract is based on the parties' intention. Did the parties intend to transfer the rights of ownership (a land contract), or the right to possess and control the property without ownership (a lease)? The signed documents should reveal the parties' intentions. Did they call the document a lease or a land contract? Do the clauses in the lease show the intent to transfer ownership or just the right to use the land?

Farmers and landowners must make a conscious choice about whether the transaction is a lease or a land contract. The parties should back up that choice with a consistent document. Some parties make the mistake of putting "land contract" at the top of the document but write clauses that transfer only the right of possession, not ownership. A lease with an option to purchase won't be seen as a land contract in court.

USDA Land Contract Guarantee Program. The USDA Farm Service Agency's "Land Contract Guarantee Program" promotes land contract sales by addressing two landowner concerns. Landowners can elect a "Prompt Payment Guarantee" that protects landowners against the risk that the buyer will miss a monthly payment- a situation which might put the landowner's own finances at risk. In the Prompt Payment Guarantee, the federal government through FSA will pay up to three monthly installments plus taxes and insurance if the buyer defaults.

Some landowners/sellers, especially those depending on the land to finance retirement, may be concerned that the land will decline in value. If the buyer defaults and the seller is returned a property with much less value, the individual's retirement financing is threatened. The "Standard Guarantee" program will provide the seller with up to 90% of the outstanding principle if the buyer defaults.

The Land Contract Guarantee Program is restricted to beginning farmers and properties sold for $500,000 or less, among other requirements. Farmers and landowners should contact their local FSA office for more information.

For more information on writing a land contract, including a sample agreement and checklist of issues to consider, see Farm Commons' resource on drafting land contracts.

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Determining The Rent
Leasing Fact Sheet

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Introduction

What rent should I charge? What rent is reasonable to pay? These are among the most common questions from farm landowners and prospective farmer-tenants. Several considerations go into determining the rent for a farm property. Often, and unfortunately, there's no simple answer.

Location, soil quality, infrastructure, supply and demand, and the personal goals of the landowner can influence the rental price for farmland. For many leases, the rental rate is determined on a per-acre per-year schedule. So, up front it's agreed that the farmer will pay a certain amount for the year for a specific number of acres. The crop that's being grown often affects the rental rate – high value crops like vegetables typically have a higher rental rate than pasture or hay land. The rental rate is an opportunity for creativity – bartering with in-kind goods or services is a viable option. Be mindful of tax implications, and consult with a tax accountant. See In-Kind (NoncCash) Farm Rent fact sheet, No Such Thing as "Free Rent" fact sheet, and Tax Aspects of Leasing Farmland fact sheet.

This fact sheet summarizes the more common methods to determine the rent in farm lease agreements. For an excellent, in-depth discussion of farm rent, see How to Determine the Right Farm Rental Rate published by the University of Vermont.

Methods to Determine Rent

The Market Rental Rate: The local market rate can be estimated by talking with area farmers, farm landlords, Extension agents and other farm support personnel. This will give a ballpark figure, but because there are multiple factors that go into the rent, be cautious about "comparables."

USDA County Rental Rate: The National Agricultural Statistical Service (NASS) provides data on average cash rents in many US counties, but not many in New England.

Landowner Fixed or Carrying Costs: One objective of some landowners is to meet (or contribute to) the costs of owning the property. These costs include: depreciation, insurance, repairs, taxes, and interest, know as the "DIRTI 5." By enrolling land in a state's current use tax program, a landowner can reduce yearly tax expenses, thereby reducing his or her carrying costs and increasing the likelihood of charging a rental rate that covers carrying costs each year and is more affordable to the tenant.

Other costs may be absorbed by the landlord, passed on to the tenant in the rental fee, or passed to the tenant directly. These include utilities, water charges, phone, Internet, trash and snow removal, for example.

Resource Capacity: The rental rate can be determined as a function of soil type and condition, size of the parcel, and other varying factors. NRCS soil maps are a

great resource to help determine soil properties and capabilities. Barns and infrastructure often use carrying capacity to determine the rental rate. For example, the number of a head of cattle a barn can house or the number of stalls in the barn is the resource capacity. Finally, square footage, condition of the barn, and type of use can all determine the rental rate.

Costs of Production: A copy of the farmers' business plan can show actual costs of production and projected costs, as well. If the lease includes stewardship provisions that increase the farmers overall costs, then this should be considered in the rental rate.

Social Goals: Some landlords have social motives such as supporting local farming or providing beginning farmers with affordable access to land. They charge less than market rate for rent. These factors may be difficult to measure, so landlords and tenants need to maintain appropriate accounting practices for tax purposes.

Renting farm buildings, equipment, or a residence

Farmers can also rent buildings and equipment. There are no simple formulas for determining the rent on these assets. Most typically, the owner will assess his or her ownership costs through one of several methods. The most common is the "DIRTI-5". This stands for depreciation, insurance, repairs, taxes and interest. Then the owner and the renter can agree on which costs will be covered by which party. For a detailed approach to calculating rent on buildings and equipment, see How to Determine the Right Farm Rental Rate (referenced above) published by The University of Vermont.

Renting a farmer residence can be handled in a couple of ways. Keep in mind that a farm lease is a commercial lease, not a residential lease. Sometimes it makes sense to include the residence in a "whole farm" lease. If included in one "master" lease, the lease should include elements of a conventional residential lease—adhering to state laws and regulations. Farm tenants are due the same rights to safety and habitability as any other tenant. In some cases it makes more sense to write a separate lease for the residence. Most states have websites that detail its requirements. One drawback to the multiple lease approach is having more leases to manage.

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In-Kind (Non-cash) Farm Rent
Leasing Fact Sheet

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Introduction

Cash often isn't the most abundant asset on a farm. Farm products and/or the farmer's labor may substitute for cash in a lease agreement. Landlords may be willing to negotiate rental payments in the form of these alternative assets. Note that "non-cash" or "in-kind" payments are not the same as "no rent." See No Such Thing as "Free Rent" Fact Sheet. One virtue of cash rent is that it has a fixed value, is easily transferred, and is relatively traceable.

In-kind payments are perfectly legal, but they require additional considerations to ensure that the farmer and landlord meet each other's expectations and comply with applicable laws. The greatest concerns with in-kind payments of rent are: 1) that that lease may not describe or treat these exchanges clearly enough; and 2) that they are not properly handled in tax reporting. Non-cash rental payment details must be clear and agreed to in the lease agreement.

Terms for In-Kind Rent

Agree on the terms for in-kind rent. Some landlords and farmers agree on exclusively in-kind payments, while others allow them in certain circumstances, such as if the farmer is experiencing cash flow difficulties. Either is acceptable provided the lease addresses whether the in-kind payments are allowed at any time, at specific times, only under certain circumstance, and at whose request. For example, the farmer could agree to provide up to 10 hours of labor per month at the landlord's request. If in-kind payments are allowed only under specific circumstances, the lease should explain requests and notifications are exchanged.

Describing the Rent

Provide adequate detail in describing in-kind payments. An example helps illustrate why this is important. A landlord and farmer agree that the rent will be paid in the form of a share in the farm's community supported agriculture (CSA) program. What is the monetary value of that share? Since in the CSA model, members share in the risks of production, what happens if crop disease or draught results in a much smaller share? If the farmer offers a hog as rent payment, is the hog live or processed? Is a minimum weight required? Who pays for the processing costs?

In-kind rent payment in the form of services must also be adequately described. For example, if the farmer agrees to "maintain landscaping" as rent, what does that mean? The farmer and landowner may have different ideas of what a "maintained landscape" looks like. How often should the grass be cut? Are edges to be trimmed or shrubs pruned as well? The lease agreement should outline sufficient details so each party knows what is expected in terms of time, effort and end result.

Determining the Value

Quantify the value of the in-kind rent*.* Non-cash rent requires standards or concrete benchmarks, such as 10 trees removed or 20 hours of painting. The value of

24 chickens or landscaping services depends on many factors including the market at the time and the quality of the finished product. Landlords and farmers may be hesitant to assign a specific value to the in-kind payment because it can be difficult to sort through those factors. **For tax purposes, farmer-tenants and landlords must state exact payments made or received and have documentation justifying the basis for the payment.** The IRS and other tax authorities want to see a reasonable connection between the value stated and the product or service provided. Two dozen chickens valued at $2,000 for rent payments may raise eyebrows.

Market value is a good starting point for valuing payments made in the form of farm products, timber, and other physical items. The parties will need to state which market price is to be used. For example, determine whether to assign wholesale or retail value to the goods provided. After that, it may be easiest to use a pre-set value that's reasonably in line with the market value at the farm's location at the time the lease is entered into, plus noting any changes in value for a long-term lease.

Services must also be valued. Some parties assign a per-hour value for labor and then track time spent rendering the service. Others assign a set dollar value to the performance of particular tasks. The rate must address whether the farmer is providing his or her own tools for the task at hand. Farmers may prefer an hourly rate over a flat rate for a service, especially if the amount of work required is variable. The parties should also agree on how to determine when a service has been completed, and to what quality of work. For example, the grass shouldn't exceed 12 inches high or the landscaping must be maintained until the first frost. **These details must be negotiated, agreed to and put in writing as a part of the lease agreement.**

Documenting the Payment

Keep receipts to document rent payments in goods or services. Paying rent monthly by check each month provides a record of the transaction from the bank. Goods and services can be harder to track and document. Tracking payments of in-kind rent by tenants and landlords is critical to preventing disagreements as to whether in-kind rent was paid, and to providing evidence of the transaction if needed by another party. Documentation of in-kind rent payments doesn't need to be formal as long as it is adequately detailed and signed by both parties. The tenant might send an email each time a task is performed or goods are provided and ask the landlord to reply, confirming receipt of the goods or services. This can be done on paper as well, with the landlord signing in acknowledgement of receipt. This simple step creates a valuable documentation trail.

Tax Rules for In-Kind Rent Payment

Learn the rules. In-kind transactions are generally subject to the same tax rules as cash transactions. Income is income, whether it looks like bacon or dollars. Generally speaking, farmers will report the value of the in-kind rent payment as an expense, and landlords will report the value of the in-kind rent payment received as income. However, there are some important exceptions and nuances. See [Tax Aspects of Leasing Farmland Fact Sheet].

There are three key tax aspects of in-kind rent:

1. Farmers who pay rent in the form of crops or livestock may not deduct the in-kind payments as farm expenses on a IRS tax form Schedule F. The costs of producing the crops or livestock are already deductible as a farm

expense. Thus, the tax code does not allow crops or livestock to be deducted as rental payments a second time. If a portion of rent is payable in cash and a portion in crops or livestock, the cash payment is deductible but the crop-share portion is not.

2. Farmers who pay rent in the form of services or non-farm products may be able to deduct the value of the in kind payment as a farm expense on IRS tax form Schedule F. Payments in the form of services or products otherwise deductible are called "barters" and should be documented as such for tax purposes in the business's accounting. According to the IRS, bartering is the exchange of one product or service for another. Barters are taxable exchanges, and the IRS requires reporting of income (revenue over expenses) from such exchanges. Although the

IRS may see some flexibility in strictly casual, informal barters, barters between farm owners, landowners, and customers or suppliers are not the same as an exchange across the fence between neighbors. Income reporting rules apply to barters. Handling barter exchanges appropriately can be tricky, so an accountant or tax accountant is essential.

3. Rental payments are treated as income for the landowner. Landowners who receive rental income from farmers for the lease of their farmland must report the income received regardless of whether payment is made in cash or in kind. The procedure will depend on several factors, including the overall scope and nature of the landowner's activity related to the leased property. If the landowner "materially participates" in the farm operation, the landowner is considered a farmer and will report the income on IRS Schedule F. For more information on material participation, see IRS Publication 225 (2016), Farmer's Tax Guide.

If the landowner does not "materially participate," then the landowner reports elsewhere. See Tax Aspects of Leasing Farmland Fact Sheet. If the landowner rents property as a matter of course, then s/he may have a separate business for tax purposes and report income on a non-farm business return such as Form 1120, 1120S or 1065. If the rental activity is occasional, it may be reported on a schedule attached to a personal return such as a Schedule E. Exactly where the income must be reported is an issue beyond the scope of this fact sheet.

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No Such Thing as "Free Rent"

Leasing Fact Sheet

This fact sheet does not address all legal concerns and is not a substitute for legal advice.

Introduction

Most farmers look for ways to reduce expenses. Land rent can be a hefty expense. So finding a landlord who is happy to have farming tenants on their land for "free" seems like a win-win situation. It looks like a great deal for the farmer. Having the land in agricultural production may be of value to the landowner. Some landlords are willing to forego rental payments altogether because the property tax advantage and/or other benefits are adequate. However, from the farmer's perspective, "free rent" may not be a good deal after all.

Contract or Gift?

In fact, "free rent" isn't a legal term. For a lease to be a valid contract, something of value must be exchanged. One of the oldest legal principles in contract law is that you can't get something for nothing. A contract requires "consideration"--meaning an exchange of value. When you get something for nothing, it's called a gift. A lease agreement without any expectation of payment by the farmer to the landlord may be seen by the courts as a gift, not a legal contract.

Legally, gifts aren't enforceable; therefore a lease that looks like a gift can be revoked at any time. A farmer can't use the courts to force someone to give her a gift simply because they said they would give it to her. Contracts can be enforced by one party against the other in court. If you have a contract with someone, the court may help you get what you were promised.

A court can interpret a lease as either a gift or an enforceable contract. The "lease" between the landlord and farmer is, at its legal essence, simply an agreement that the farmer has a legal right to occupy, use, and control the landlord's property subject to lease terms. The legal rights granted by a lease can be given for free or for a price. In this way, the lease can be seen as a gift or as an enforceable contract.

Whether a lease is a contract or a gift can have tax consequences for both parties. So it's important to establish the precise nature of the agreement.

Farmers who depend on their lease will want it to be viewed by the courts as an enforceable contract rather than a gift. What makes a contract enforceable as opposed to a gift? The exchange of something of value by both parties is a key distinction. Generally, the tenant farmer provides payment (in cash or in-kind) as his or her contribution. The landowner extends the right to use the land. The mutual exchange is called "consideration." All contracts need consideration to be enforceable.

Cash payments aren't the only type of consideration that a farmer might provide. Items, services, and even promises qualify. The value contributed by each party doesn't need to be equal – it just needs to have some value, even if nominal. The bottom line is that some consideration must be specified for the lease to qualify as a contract. See In-Kind (Non-Cash) Farm Rent fact sheet. A lease without consideration is still a lease; it's not an enforceable contract.

Both parties to the lease must agree that consideration was or will be provided, and that the consideration is sufficient. Make sure the lease states how consideration is to been given. Most formal leases have a "boilerplate" clause at the beginning for this purpose. Note that a contract is not necessarily invalid if it doesn't contain a specific statement about consideration, as long as the parties exchange consideration in reality. The statement is a solid piece of evidence that consideration was provided. Without it, the court would consider other evidence that consideration was, in fact, provided.

Here are some contract language examples:

"In exchange for good and valuable consideration, the receipt and sufficiency of which has been acknowledged, the parties agree as follows."

"For the sum of $1 and other good and valuable consideration, the exchange of which is acknowledged…"

"The parties have each provided valuable consideration for this contract, and each party acknowledges that the consideration provided is sufficient."

Consideration is not something to stress over, as long as both parties agree to the nature of the agreement. If parties are providing something of value to each other and it is documented, the requirement under contract law is met. Otherwise a "no rent" agreement is a gift.

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Land Use, Management, and Stewardship Plans

Leasing Fact Sheet

Introduction

What is a land use, management, or stewardship plan? In agricultural leases, land use, management, and stewardship plans guide landlords and tenants toward achieving shared goals related to the natural and built features of the leased property. Plans go by different names and types, and there is no set plan that works for every situation.

A plan should be based on the circumstances of the land, goals of both parties, and type of farm operation. What's important is what is in the plan and the process the parties undertake to develop and implement it.

In some situations, it's adequate for the lease itself to specify, for example, "generally accepted agricultural practices," "sustainable agriculture," or "organic certification." But often it makes good sense for the lease to reference a separate plan, sometimes as an attachment to the lease. A referenced or attached plan is more flexible and easier to change than the lease itself.

Many leases—especially longer-term agreements and those for more complex sites—benefit from a written plan that addresses the overall long-term health and stewardship of the farm property. A plan is a guide that enables the landowner and farmer to work together. It should be seen as a living document that adjusts to and reflects the parties' intentions and relationship.

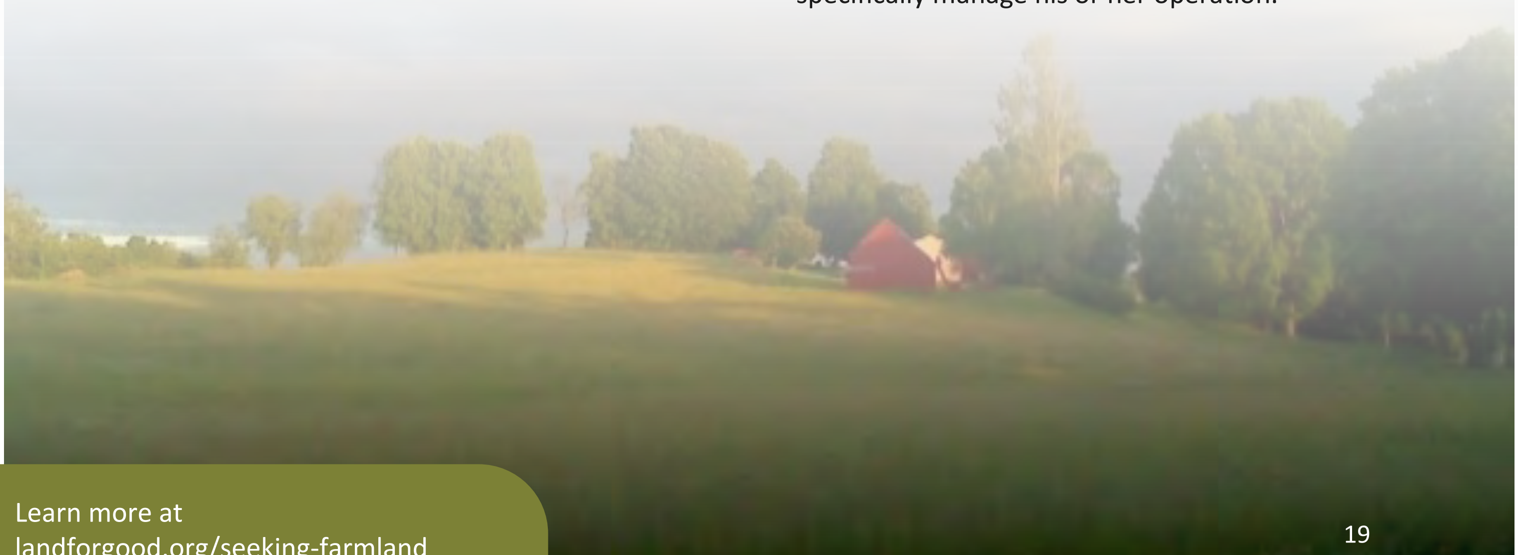
Benefits of a Plan

Learn the benefits of including or referencing a plan document in the lease agreement. Most farmers know the benefits of farm planning—from budgeting to crop rotations to equipment maintenance. As a tenant, a farmer is responsible for the leasehold itself. A plan for managing the premises is a valuable tool for both the farmer and the landlord. It can be a way of stating shared goals about the site, and communicate how both parties view stewardship. Additional benefits include:

- Explicit statements of agreement about the scope and specifics of practices and activities on the premises
- Guidelines for managing the site's resources and for accomplishing landowner and farmer site-related objectives over time
- Establishing baseline conditions
- Providing a context for the landowner and farmer to explain concerns and aspirations
- Helping third parties such as lenders, certifiers, easement holders, and the public understand and gain confidence in the farm's use and management.

Developing a Plan

Develop a well-thought-out plan that meets the interests of both parties. A land use plan is not a detailed prescription for how a farmer should specifically manage his or her operation.



A well-thought-out plan might start with general principles: overall stewardship goals such as "maintaining and enhancing the long-term health of the site's soil and vegetation" or "preserving the historic and cultural legacy of the property." Goals articulate ways to address the principles. Practices include activities a farmer implements on the farm to accomplish the goals. A land management plan may not (and usually should not) get to the detail level of practices.

There are two basic approaches to farm plans in the context of a leasehold. The first is where the farmer prepares and is responsible for the plan. The landlord is informed about it and may be entitled to review it. At minimum, the farmer should make sure the landlord is apprised of the farmer's basic approach and any problems or pending or proposed repairs, improvements or significant changes in the operation.

The other approach is a plan developed and overseen by both parties. Landlord and farming tenant work on the plan together. They agree on who is going to be responsible for what repair or improvement during what time period. The jointly identify site challenges such as the spread of an invasive plant, or areas of erosion. This does not mean the landlord has a say in the tenant's daily farming decisions. A plan should not "micro-manage" the farmer by specifying specific activities, although if there are certain required or prohibited practices, these should be included.

Often, establishing baseline conditions—documenting the condition of all elements of the leased premises at the commencement of the lease term—is sensible, if not required. A baseline conditions component could include narrative descriptions, data, photos, and/or inventories. For example, photos showing the barn gutters in poor condition at the start of the lease will avoid different recollections later and make it easier to agree on their repair as part of a site management plan.

A land management plan needs to harmonize with the lease itself. The plan should not require or permit something that conflicts with the lease terms. It should reflect the realities of the lease. For example, a farmer cannot be expected to significantly improve soil fertility with a one-year term. Farmers with longer lease terms are more likely to invest in the land and to see a return on that investment. Also, tenants and landowners need to understand and account for any financial impacts of a land use, management or stewardship plan.

What's in a Plan?

Decide what to include in a plan and at what level of detail. Typical areas to address include:

- Soil management: conservation and quality
- Water management: access, quality, conservation, wetlands and waterbodies, drainage and flood control
- Wildlife and wildlife habitat
- Vegetation, including management of invasive species, field edges and buffer zones
- Forest resources
- Waste and nutrient management
- Built features and infrastructure: structures, stone walls, roads and farm lanes, fencing
- Historic and cultural features: aesthetics, views, archeological sites
- Recreation: hiking, hunting, fishing, etc.

Some plans will get rather specific about which fields may be cultivated, or what types of animals are allowed, if this is not already specified in the lease itself. For example, a landlord may prohibit hogs. A plan might set goals for barn repair or for clearing certain parcels.

Type of Plans

Determine the type of plan that makes sense for your situation. Most plans fall within three categories:

1. Management systems are overall frameworks that guide farm operations. Examples include ecological agriculture, biodynamic agriculture, permaculture, and integrated pest management (IPM).
2. Certification Programs are specific, measurable, and observable standards that usually require record keeping systems. Organic certification is a prominent example.
3. Farm Planning Tools include a National Resource Conservation Service (NRCS) Conservation Plan, whole farm planning, and Holistic Management. One of the simplest ways to address resource management is with an NRCS Conservation Plan. In many cases an NRCS staff person or an accredited third party will come to the farm and prepare a plan at no charge. The benefits of a Conservation Plan include eligibility for cost sharing for conservation improvements, payments for providing environmental benefits, technical assistance, and low- or no-interest loans, rental payments.

Depending on the type of plan, it should address the following questions:

- What are the farmer's and landowner's goals and objectives regarding land use and stewardship? Are the parties on the same page and if not, how can they get there?
- What level of detail is needed and acceptable to both parties?
- How will monitoring and enforcement take place and by whom?
- What is the process for changing or updating the plan?

Monitoring and Enforcement

Agree on the role of each party in monitoring and enforcement. These can be tricky aspects of the landlord-tenant relationship, but they don't have to be contentious. The best practice is to avoid conflict by proactively communicating about the plan. Meet regularly, if only by phone or email. Walk the site annually. Bring problems to the immediate attention of the other party. Regular meetings between the landowner and the farmer are one of the most effective methods to review the past year, plan for the coming season, identify any areas of concern, and reaffirm shared objectives.

One challenge is if the landowner is not familiar with farming and is therefore not able to judge whether a plan is being implemented as agreed. Sometimes a third party is brought in to monitor and report back to the landowner. On the other hand, farming tenants don't want a landlord (for example a retired farmer) second-guessing each site management decision or activity.

Depending on whether and how a plan is referenced in the lease, a violation of the plan may trigger default. Before getting to that point, the parties should engage in good-faith dialogue about the situation.

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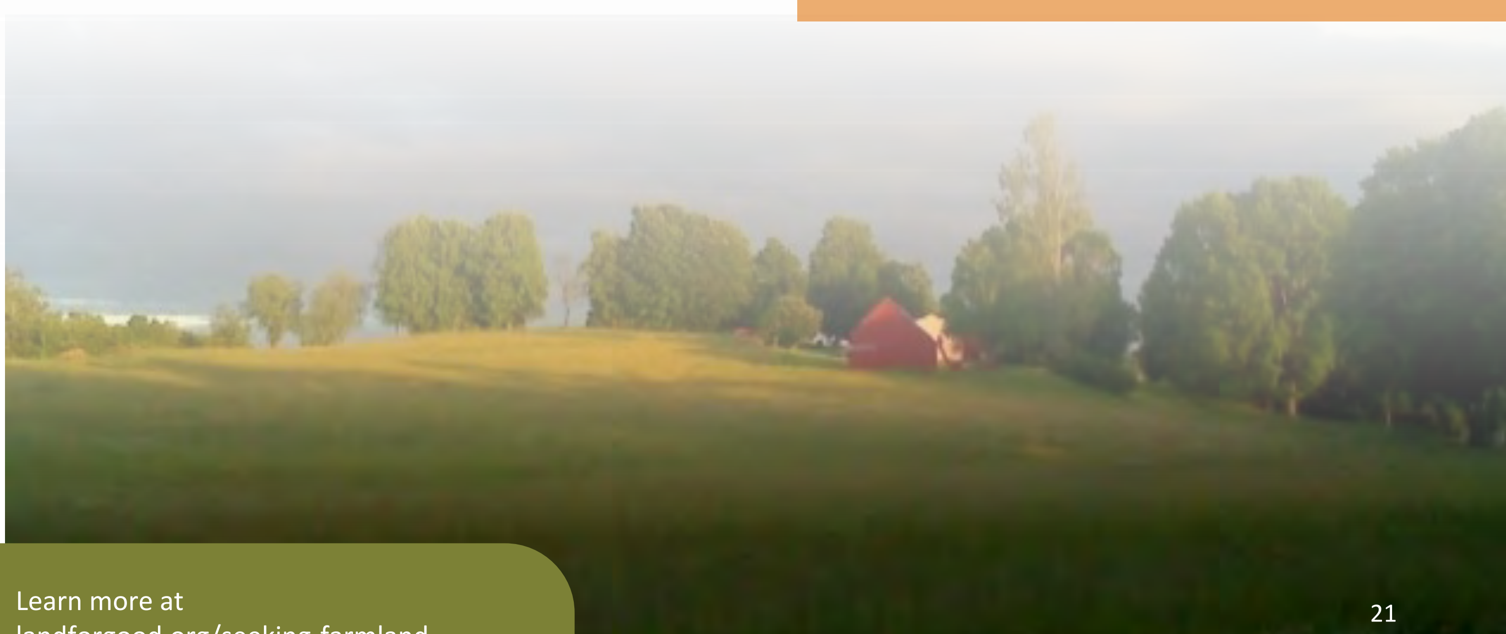

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Introduction

Farmer-tenants and landlords worry. What happens if someone is injured on the leased premises? What if the property is damaged? Liability and property loss ("casualty") are significant concerns for both parties. They can be addressed via several strategies, including through specific lease language and requirements.

While a certain amount of risk is inherent in owning property and in farming it, both parties can—and should—take steps to mitigate risk. Parties should assess risks, identify strategies to mitigate them and develop an action plan. General risk mitigation approaches include *avoidance, limitation,* and *transfer*. Avoidance means just that: don't engage in a risky endeavor. Limitation means reducing your exposure to the risk(s). Transfer means shifting the burden of the risk(s) to another. In the case of a farm lease, responsible practices and diligent maintenance will go a long way toward avoiding and limiting adverse occurrences. Transferring risk is mainly done through the use of insurance.

The rules governing a landowner's and tenant's responsibilities to each other and to third parties are complex and vary from state to state. Generally, the law imposes liability on the party who occupies or controls the use or maintenance of the property. In a lease situation, the tenant is usually in control of the premises. In some cases, however, landowners have some of the burden of liability, particularly as it relates to the maintenance and safety of buildings and infrastructure. In reality, both landlord and tenant need to exercise reasonable care towards preventing injuries and accidents on the property, though their roles and responsibilities in this will be different.

A "casualty" is damage or destruction of property resulting from a sudden, unusual, identifiable event. Examples include accidental fire, storms, earthquakes, lightening, vandalism and flood (unless expressly excluded). Generally, landlords bears responsibility for insuring their property against property loss, except for instances where the loss is caused by the negligence of the tenant. To address this, the tenant also typically needs property loss insurance that will cover the landowner's property in cases where the tenant is responsible for the damages. Further, it is the responsibility of the tenant to insure the tenant's personal and business property which is not part of the leasehold. Tenant's personal property insurance would not typically be required by the landlord in a farm lease.

Addressing Insurance in a Lease

A strong lease will have a section on liability and insurance that spells out the insurance requirements of each party. What is covered by each party and the level of coverage are important issues to be addressed in the lease and the insurance policies themselves. When shopping for policies, both parties will want the insurance agent to specify the coverage and make sure it's reflected in the written policy so that it's clear to a third party such as a court. Each party's questions should be addressed. Is direct marketing at the farm stand covered in the tenant's liability policy? What about agri-tourism activities or food processing? What about a residence?

In the case of a casualty loss insurance, similar guidelines apply. The lease should state the type of insurance required by each party, what is being covered and the level of the coverage. Will the policy cover wind damage? Does it cover full replacement?

Tenant's Insurance

Typically, the lease will require the tenant to show proof of his or her liability insurance including what is covered, and the level of coverage. It is recommended that the tenant name the property owner as additional insured. In doing so, the farmer is essentially sharing his or her insurance with the landowner.

Usually, the landowner carries casualty insurance on fixed buildings and infrastructure, but the tenant may be required to carry fire-legal liability insurance in case of damage to a farm property caused by the tenant. The lease should specify what happens if property damage prevents the tenant from carrying on the business. And it should state whether the landlord is required to use the insurance proceeds to repair or rebuild infrastructure essential to the farming operation.

Liability insurance is a business necessity for all farm operations. At the time of the publication of this document, a common level of commercial liability coverage is $1 million per occurrence and $2 million aggregate. For insurance purposes, farming is defined as the production of crops and livestock. Depending on what is included in the policy, a farmer might need to purchase additional insurance for such things as public events or animal processing or even pick-your-own or a roadside stand, which are not directly considered farming.

Generally, tenants will want to insure their business property for casualty loss. Tenants might also want to insure their personal property such as home furnishings in a residence that is part of the leased premises. Tenant's (also known as renter's) insurance provides protection against loss, damage or theft of personal items.

If the farmer is leasing equipment from the property owner, the tenant might want—or be required to—obtain coverage for "hired or borrowed equipment." This provides coverage for damage to the equipment itself, and is not related to liability. It's relatively inexpensive, and not standard on a farm policy.

Landlord’s Insurance

Standard homeowner’s liability insurance will not cover commercial farming activities on the landowner’s property. That’s why requiring the tenant to hold his or her own insurance, naming the landowner as additional insured is a best practice. Some agents recommend that property owners maintain their own farm liability coverage in addition to being named on the tenant’s policy. Landowners could add a farm endorsement to their standard homeowner’s policy. Or they could replace their homeowner’s policy with a farm liability policy, which would be particularly appropriate if they were going to participate in the farming operation in some way. Or a landowner could obtain a commercial liability policy which covers lessor’s risks.

As with liability insurance, a standard homeowner policy will not cover loss to a property on which commercial activity is taking place. The landowner could change from a homeowner to a farm owner policy. Alternatively, the landlord can require the tenant to carry property loss on his or her policy, naming the landowner as additional insured and “loss payee” on the farm policy.

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Tax Aspects of Leasing Farmland
Leasing Fact Sheet

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Introduction

Leasing plays a role in the life cycle of many farm businesses. Farmers lease land from other farmers and from non-farmers. For tax purposes, farmer-tenants and farm landlords—whether or not they farm—must account for their rent expenses or rent payments received.

Most farmers will use a Schedule F to report farm business income or loss, which is then carried over onto the farmer's individual income tax form such as the Form 1040. Other schedules are used to report other forms of business or personal income.

Non-farming individuals, trusts, businesses and organizations may be involved in farm leases as well. For example, a nonprofit conservation organization may acquire and lease farmland to a farmer. Farmers transitioning out of active farming may rent land to another farmer. Each of these situations may affect the tax reporting procedures of leasing farmland. This fact sheet explores some of the most common scenarios and the tax rules that accompany them.

Note: This sheet is not an exhaustive exploration of this topic. Farmers and landowners are strongly encouraged to work with an accountant and tax preparer with farm. Farmers should avoid jumping to conclusions about farm business deductions and Schedule F earnings.

Farmers Leasing Farmland from Others

Understand the basic tax rules that guide farmers renting land. Here are some guideposts:

Rent paid in cash for the use of property in a farming business is allowable as a farm business expense. This is fairly straightforward, but a few subtleties apply. The IRS will scrutinize rent payments that seem unreasonably high within the context of the farm operation and location. Also, only rental for property used in a farming business is deductible. If the rent is for personal or non-farm business use, the expense is not deductible to the farm business. For example, a farmer leases property with cropland, a residence and a machine shop used for a tool fabrication business. The portion of the fair value of the rent for the land would be a business expense. Non-farm expenses may be deductible elsewhere and farmers may have other opportunities to account for business use of their personal residence from a tax perspective.

Rent paid in the form of crops or livestock is not deductible as a farm business expense. The costs of producing the crops or livestock are already deductible as a farm expense. The tax code does not allow crops or livestock to be deducted as rental payments a second time. If a portion of rent is payable in cash and a portion in crops or livestock, the cash payment may be deducted while the non-cash portion is not deductible. See In-Kind (Non-Cash) Farm Rent fact sheet.

Payments under a land contract are not deductible as a farm expense. A land contract is a sale arrangement that looks a lot like a farmland lease but is quite different from a legal perspective. See Lease-to-Own Strategies to Acquiring Farmland fact sheet. Under a land contract, a farmer purchases the land with monthly installment payments. Under a land contract, monthly payments made towards the principle are not deductible. Rather, the purchase price of the land is depreciated as a capital expenditure. The portion of the monthly payment allocated to interest is deductible as a farm business expense.

Rent payments made under a "lease-to-own" agreement require closer scrutiny. A purchase option clause has to be clear how the lease payment is handled. If it's entirely rent, and if it's for the farming business, it may be deductible as explained above. If a portion of the rent payment is allocated to the down payment or purchase of the property, the portion of the lease payment is not deductible as a rent expense.

Rent is deductible in the year to which it applies. Pre-paying rent doesn't necessarily work the same way as pre-paying for other farm expenses. Even where other prepaid farm expenses may be deducted in the year the payment was made, the IRS' position on prepaid rent is that it should be deducted in the year to which the rental payment applies.

Farmers Receiving Farmland Rental Income

Determine the tax consequences for farmers who rent land to others. Farmers who rent farmland to others need to know if the rental payments received are considered farm business income or another kind of income. The answer depends in part on whether the farmer "materially participates" in the farm operation.

To the IRS, a person materially participates if she or he has an arrangement with the tenant for participation and meets one or more of the following tests:

- **Test 1:** You do at least three of the following.
    1. Pay, using cash or credit, at least half the direct costs of producing the crop or livestock.
    2. Furnish at least half the tools, equipment, and livestock used in the production activities.
    3. Advise or consult with your tenant.
    4. Inspect the production activities periodically.

- **Test 2:** You regularly and frequently make, or take an important part in making, management decisions substantially contributing to or affecting the success of the enterprise.

- **Test 3:** You work 100 hours or more spread over a period of 5 weeks or more in activities connected with agricultural production.

- **Test 4:** You do things that, considered in their totality, show you are materially and significantly involved in the production of the farm commodities.

If a farmer materially participates in the farm operation to which farmland is leased, the rental income is considered farm income, reported through Schedule F. If a farmer does not materially participate in the farm operation to which farmland is leased, the rental income is not considered farm income reported through Schedule F. It is reported elsewhere.

Farmers who do not materially participate in the tenant's operation still need to report rental income received. Generally, non-participating farmland owners who receive rent in the form of crops or livestock will report income and expenses on IRS Form 4835: Farm Rental Income and Expenses. Non-participating farmland owners receiving cash

rent for farmland may report it on Schedule E: Supplemental Income and Loss, which is commonly used to report real estate rental income. There are exceptions to these general rules and farmer landlords must do further research to make sure they use the right form.

The facts above about farmland rental income and material participation relate to farmland rental income only. Where farmers rent out their buildings, the income is not farm income reported through Schedule F. It is reported elsewhere. If farmer-landlords rent out land containing both farmland and buildings, the farmer-landlord should allocate the rental payment between the value of the land separately as to the buildings. Generally, rental income received from non-farmland is reported on Schedule E: Supplemental Income and Loss. Exceptions to this general rule exist.

Non-Farming Landowners Who Receive Rent from Farmland

Determine the tax consequences to non-farming landowners who rent land to farmers. Landowners who receive rental income from farmers for the lease of their farmland must report that income. The procedure will depend on several factors including the overall scope and nature of the landowner's rental activity. If the landowner is materially participating (see above) in the tenant's activities, the landowner is considered a farmer and will report the rental income on a Schedule F. If the landowner does not materially participate, then he or she reports the income elsewhere. If the landowner rents property as a matter of course, then he or she may have a separate business for tax purposes and report income on a non-farm business return such a Form 1120, 1120S or 1065. If the rental activity is occasional, it may be reported on a schedule attached to a personal return such as a Schedule E. Exactly where the income must be reported is a topic for the landowner's tax advisor.

Organizations as Farm Landlords

Learn what factors come into play if the entity renting the land is a nonprofit organization. The organization will need to consider whether the income is related or unrelated to the nonprofit purpose for which the organization was formed. This determination is a legal one, and the organization's Form 1023 may need to be consulted to determine the organization's exempt purpose. Many farmland-leasing organizations are organized for educational purposes. Unless renting farmland is directly and exclusively related to the organization's educational purpose, the income is deemed unrelated. Unrelated income is taxable, even if the organization is otherwise tax exempt. Some organizations are fine with paying taxes on unrelated income as it's still a valuable revenue stream.

If the organization spends significant time or earns significant revenue in relation to the unrelated income, more serious problems can develop. First, if the organization is seen as competing with regular businesses in the rental market it can threaten an organization's status as a tax-exempt organization. Second, significant unrelated business income can threaten the organization's status as a charitable nonprofit itself, even if the organization is not competing with regular businesses and is paying taxes as obligated. Nonprofit organizations should seek legal advice if farmland rental is or might become a part of their operations.

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Maintenance, Repairs & Improvements
Leasing Fact Sheet

Introduction

Addressing maintenance, repairs, and improvements in a farm lease can be challenging. The lease should specify which party is responsible for what maintenance, repairs, and improvements of the premises, and any infrastructure that is subsequently placed upon the premises. Lease language should describe the process for decisions and approvals. Maintenance, repairs, and improvements should be discussed at minimum annually and as needed. In general, an annual walk around with a checklist for expected expenditures for both parties can minimize problems and ambiguity.

The Difference Between Maintenance, Repairs & Improvements

Learn what each term means. Maintenance refers to the general upkeep of the premises and fixtures in a clean, serviceable and safe condition. This includes actions that prevent damage or undue wear. A repair is an expenditure that keeps property in its ordinary, efficient operating condition or restores the property to the original operating condition after it has been damaged or broken.

An Improvement substantially improves the value of a property or significantly extends its useful life. Some improvements adapt the property to a new or different use. Others are in the category of major (or capital) repair. Some improvements are substantial fixes (e.g., a new roof) or alterations to existing features; others are additions (e.g., a new shed).

The Internal Revenue Service provides these criteria for an improvement:

- Creating an addition, physical enlargement or expansion
- Creating an increase in capacity, productivity or efficiency
- Rebuilding property after the end of its economic useful life
- Replacing a major component or structural part of the property
- Adapting property to a new or different use
- Fixing a defect or design flaw

Income tax laws should be carefully considered. The tenant may deduct expenses for repairs and semi-permanent structures (such as high tunnels) on his or her income taxes. Real property improvements add to the landowner's tax basis and should be depreciated by the landowner.

Tenant and Landlord Responsibilities

Be clear in the lease about who is responsible for what. In practice and common law, the tenant is responsible for routine maintenance and minor repairs needed to avoid

deterioration of the facilities. These may include painting, replacing windows, fixing plumbing and wiring, replacing belts and other machinery parts, repairing heaters and feeders, mending fences, and clearing culverts.

The landowner is usually responsible for major repairs (see above), including new, permanent improvements. These include structural components such as construction of barns and fencing, exterior siding, roofing, water supply systems, waste treatment systems, and heating and ventilating systems, for example. That said, repairs can be handled in whatever way suits both parties.

Capital Improvements

Understand how to address capital improvements. In common law, at the end of the lease all permanent structures belong to the landowner regardless of who paid for the improvements. However, a lease may provide otherwise. A lease may name the tenant as the owner and permit him to remove (at his own expense) or sell the structure back to the landowner or to a new tenant at the end of his lease. In some situations, the landowner may be willing to pay for new construction because of the value it brings to the property. The tenant may be willing to pay for an improvement if the lease term is long enough to depreciate it or recoup the investment over time.

A lease provision that allows the tenant to build equity in an improvement she paid for increases the likelihood that the tenant will invest in the land and structures. In considering reimbursement for improvements, it’s important to discuss—and put in writing—any improvements that are needed, the costs of required improvements, and what will be contributed by each party. Typically, unless otherwise stated, the tenant is responsible for maintaining any new improvements, regardless of who owns them.

It’s more complicated when the improvement is to the soil or other natural features of the leased premises. In the last few years more attention has been paid to “ecosystem services”—benefits to the environment from agriculture. These include carbon sequestration, biodiversity, water quality, soil quality and conservation, and pollination. But these services lack markets, so it’s difficult for a landowner or tenant to assign a monetary value to them. Additionally, practices that improve soil quality also increase the productivity--and therefore the profitability--of land for future farmers.

While improving the environmental quality of the land is generally valued by both parties, there are no set formulas for how these contributions are valued or how they might be appropriately reflected in the lease. Some landowners give a credit, discount or reimbursement to their tenants for soil improvement or similar expenses. Here again, a longer-term lease helps the farmer realize a return from his stewardship practices.

Maintenance, Repairs & Improvements in Farm Lease

While the typical division of responsibilities is described above, there are no absolute rules. Some landlords and farmers devise their own formulas for sharing these responsibilities and costs. In any case, the lease should specify who is responsible for what.

The lease should state a process for how new improvements will be approved, what improvements the landowner will allow and who owns them. For example, there should be clear guidance on whether the improvement is a permanent fixture or whether it may or must be removed by the tenant at the end of the lease. Farm tenants should only make capital improvements with consent of the landowner. The tenant should describe the

improvement, its location and construction methods. These transactions should be in writing.

If the tenant wants to build a temporary structure such as a high tunnel/hoophouse at her own expense, an approval process is still important. In these cases, it's important to specify what happens to the structure at the end of the lease. Must it be removed? If not, will the landlord buy it, and according to what formula?

Regarding maintenance, repairs and improvements, the lease should include at minimum:

- Who is responsible for maintenance and routine repairs
- A process for determining and approving what's needed
- Guidelines for scheduling and monitoring maintenance and repairs
- Treatment of capital repairs and improvements including the process for requesting and approving; who contributes to the costs; and who owns the improvement and its disposition (what happens to it at the end of the lease term).

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Termination and Default
Leasing Fact Sheet

This fact sheet does not address all legal concerns and is not a substitute for legal advice.

Introduction

Termination and default are important concepts in any lease agreement. In a farm lease, the word termination can refer to two events. One is when the lease has come to its intended end date; it has concluded or expired. The other is when the lease stops before its end date according to terms spelled out in the lease. Default is the failure of a party to abide by or carry out their lease obligations or for violating a provision in the lease. Either party can default, although more common events of default fall on the farmer-tenant.

As explained below, a lease should allow for either party to "remedy" or "cure" the default before actions to terminate are triggered. It should also include a clause on dispute resolution wherein a process is set forth to address a case of default. The parties will be held to that process before going to court.

Termination, the End of the Lease

Be clear about the terms for termination. A lease should have clear language about the tenant's exit when a lease terminates because it has "run its course"—that is, reached the end of the term (its end date). It should specify at minimum the manner in which the property is to be vacated by the tenant, the condition in which the property is to be left (including what must or may be taken or left behind), and the time period for vacating the property. A lease will automatically terminate at the end of the lease term unless the parties agree to renew or extend the lease. See The Term Fact Sheet.

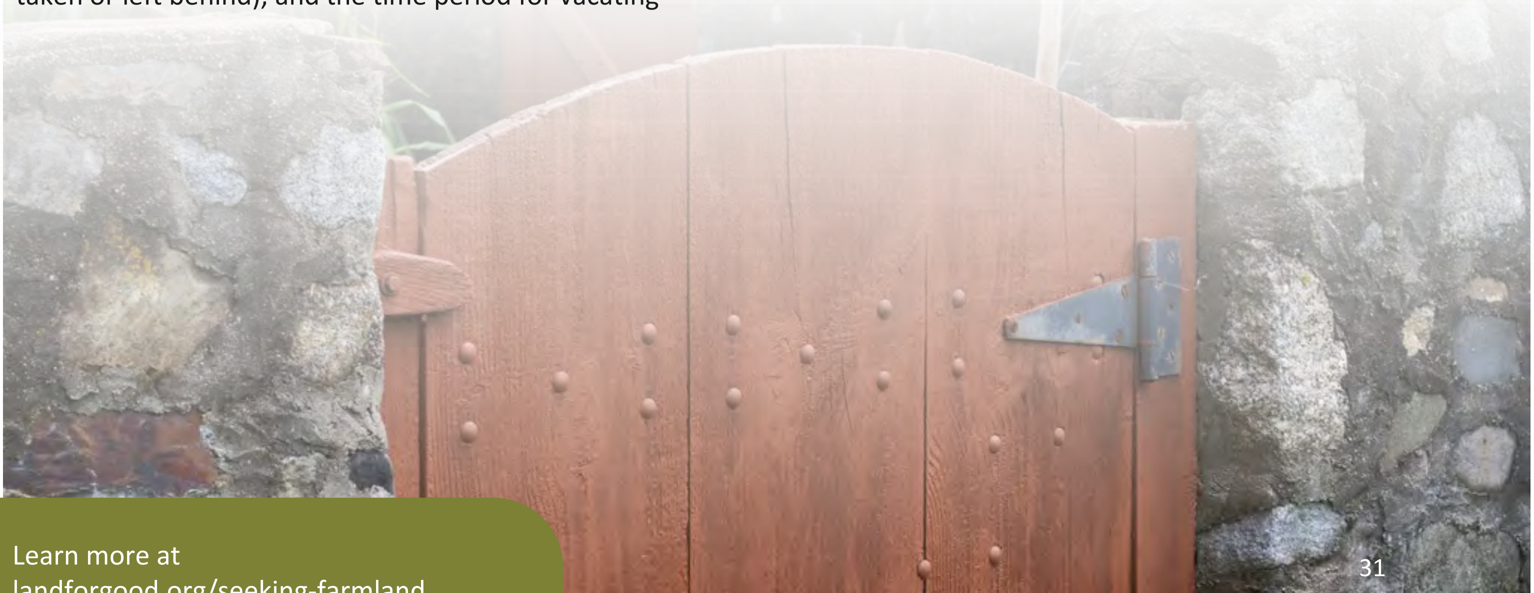
The lease should also specify the procedure for notifying the other party. How much lead time is reasonable to let a landlord know the farmer is leaving? What's a reasonable notice for a tenant to prepare to vacate the leasehold? In any case, the notice should be in writing.

Default by Either Party

Understand what constitutes default and how it is handled in the lease. The parties should be sure of their ability and intention to perform as agreed in order to avoid default. Default is coupled with termination because most leases will specify that if one party defaults, the other party has the right to terminate following a fair process.

It's critical to specify in the lease what constitutes default. Examples of tenant's default include failure to: pay the rent; manage the fields as promised; or perform maintenance tasks on rented infrastructure. For the landlord, default might be failure to: provide adequate access to the leased property; abide by the agreed upon inspection/visitation parameters; or perform the agreed-upon capital improvements.

A lease should include provisions for communicating about default and steps to remedy or fix it in order to avoid premature termination of the lease and other



unpleasant consequences. Usually, it is agreed that the "wronged" party will notify the defaulting party in writing of the default and give a stated period of time to remedy or cure the problem. If the defaulting party does not remedy the problem the "wronged" party may terminate the lease. For example, the landlord emails the tenant to inform her that the rent is overdue, and that per the lease, she has 30 days to pay past rent plus specified interest. If the tenant does not respond in that timeframe, the landlord may take action such as eviction.

A good lease will recognize that some circumstances are beyond the tenant's control and should not necessarily be treated as default. For example, if there's a hurricane that delays the tenant's promised repairs to a building.

Early Termination for Reasons Other than Default

Be clear about how early termination by either party is addressed in the lease. A lease could terminate before the end of the term for several reasons. Neither party can simply terminate the lease early without consequence unless explicitly provided for in the lease. A lease could say that either party may terminate with, for example, a six month written notice to the other party. However, this essentially gives the tenant six months of security, regardless of the actual lease term. (And it gives the landlord only six months to find a new tenant.) This would not be a preferred approach in most cases. Regardless of whether the parties agree to end the lease early, they are still responsible for all actions and breaches that may have occurred before the date of termination.

It may be considered a breach of the lease if one party wants to terminate early. If one party breaches the lease by terminating prematurely, the other party may sue for breach of contract. A court could require the remainder of the lease be honored, either by performance (completion of the lease), or by financial compensation (payment to the non-breaching party).

a. Early termination by the tenant

There are several reasons a tenant might want or need to terminate before the end of the term. A farm lease should be explicit as to what is a "legally protected reason." It should state the conditions under which a tenant can terminate before the end of the lease term. The tenant may want to terminate early to move to another location or because of a change in careers. If a farmer chooses to terminate a lease early, and the lease does not explicitly allow this without penalty, the farmer may be liable to the landowner for the remainder of the rent owed on the lease. However, the landowner is required to make attempts to reduce his or her losses. In any case, the tenant is still obligated to do whatever the lease says about termination. For example, removing personal property, or planting a cover crop.

Many leases address what happens if the property is rendered totally or partially unusable due to fire or a natural disaster. Often the tenant has the option to terminate under such circumstances. Again, the lease should address this possibility and describe what constitutes "unusable" and how it is determined.

b. Early termination by the landlord

Suppose the landlord wants to sell the property and prefers not to have farming activities while it is on the market. Or the owner wants to use the property for other purposes. Unless the lease allows the landowner to terminate for any reason, or for these particular reasons (for example), the landowner cannot simply terminate the lease. Some leases will say that default by the tenant is the only acceptable reason for early termination by the landlord.

As stated above, unless explicitly allowed, a landowner's early termination would be considered a breach of contract. If the landowner chooses to terminate the lease early without the agreement of the farmer, he may be liable for the financial losses suffered by the farmer. If the farmer has invested in improvements to the land or has planted crops awaiting harvest, the landowner may be liable for the financial investments and the actual losses suffered by the farmer. At minimum the landlord usually owes the tenant the right to harvest standing crops.

Crops in the Ground

What happens when there are crops growing and the lease terminates due to any of the reasons above? The best way to address this is to make sure the lease allows the farmer "reasonable time" to harvest the crops, including allowing him or her to come back on the property to do so. Reasonable time depends on the crop, weather conditions and opportunity, among other factors. In common law, the "Doctrine of Emblements" guarantees the farmer's right to harvest annual crops.

This doctrine does not equally apply to perennial crops. So it's critical for the lease to specify the rights and obligations around perennial plantings and termination. Will the departing farmer be compensated for remaining perennial trees and plants? Can perennial plantings be removed?

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