Family Farm Series Publications: Farm Management

Farm Leases and Rents

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Leasing or renting land is important in California agriculture. For many farmers, a lease or rental agreement may be the best method to control more land resources. Whether you are leasing or renting depends on the time length of the agreement, local tradition, and other factors. The terms "leasing" and "renting" are used interchangeably in this publication.

Types Of Leases

There are two main types of leases: cash rent and crop-share. The major differences between these two types is how risk is shared between the owner and the lease holder. Other types of leases include livestock-share, labor-share, and flexible-rent leases.

Cash Rent

A cash rent is a fixed payment for the use of land, buildings, and other facilities. The payment is for a specified time period and is set prior to the tenant using the asset. The owner is compensated because he/she expects to earn interest on the investment, pay taxes and insurance, repair buildings and other improvements, and recover depreciation on some assets. In return for paying the owner, the tenant receives all income.

With cash rent, financial risk lies mostly on the tenant. The only risk the owner takes is the tenant not being able to pay the rent. Because it is a fairly stable income, the owner should expect a cash rent lower than the expected return from a share rent agreement. The tenant has all the uncertainty of production and prices; he/she will receive all profits in a good year and all losses in a bad year.

A cash rent agreement will include the amount and terms of payment, the time period, and any restrictions that the owner may place on the use of the land, buildings, or facilities. For land, the time period is usually one year, although an agreement may be multi-year with or without provision to reassess the payment each year. The owner may include restrictions on the maintenance of buildings, fences, canals, etc. Otherwise, the tenant is free to make all operating decisions; the owner usually does not have any management input.

The advantages of a cash rent agreement are:

1. It is simple.
2. The owner is assured of a steady income.
3. The owner does not have to help manage.
4. The tenant has freedom to manage--within the restrictions of the agreement.

The disadvantages of a cash rent agreement are:

1. The owner does not share in very profitable years.
2. An owner may rent to a tenant who exploits the land and improvements, unless restrictions are written into the lease.
3. It is riskier for the tenant; the payment is fixed before production and income is known.
4. A tenant may find the owner slow or reluctant to maintain buildings and facilities unless provisions for maintenance are written into the lease.

A difficulty of the cash rent is determining a fair price. See page 5 of this article for some suggestions.

Crop-Share Lease

With a crop-share lease, the landowner and tenant agree to share the income from the land, but they do not set a specific amount of money. The landowner receives a share of the gross income to compensate for his/her interest on investment, taxes, insurance, maintenance, depreciation, and operating expenses. Usually a crop-share lease calls for shares in gross income equal to shares in total expenses; however, local rates, profit variance, and other factors may have a large impact on the agreed shares.

By receiving a share of income rather than a fixed payment, the landowner takes on more risk than with cash rent. Thus, he/she may seek a higher expected return with a crop-share lease than with a cash rent agreement. Since the tenant shares income risk, he/she does not require an expected return as high as with a cash rent.

When leasing a whole farm, an owner and a tenant may agree to a crop-share lease on the cropland and cash rent on the buildings and facilities. Or, they may set the crop-share lease with the knowledge that the buildings and facilities are included.

The advantages of a crop-share lease are:

1. The uncertainty of production and prices are shared by landowner and tenant.
2. Both parties share in increased income due to new technology and management (e.g., irrigation management, pest scouting).
3. The capital requirements of the tenant are reduced so his/her financial risk is also reduced.
4. A knowledgeable landowner may improve income by participating in operating decisions.

5. The owner has more control over the use of his/her land and other assets.

The disadvantages of a crop-share lease are:

1. The tenant is not totally free to make operating decisions.
2. The tenant has to share during good years as well as bad.
3. If the landowner is not knowledgeable, he/she may lead to unwise operating decisions and decrease income.
4. The landowner may receive a lower return than he/she would have for cash rent in poor income years.

There are difficulties with a crop-share lease. (These are true for all share-rent leases.) The first difficulty is deciding on the equitable share of income. The expenses and share for variable inputs, taxes, insurance, labor, etc. are easy to determine. However, the interest on investment, depreciation, and the cost of new technology (e.g., frost protection) are harder to determine. If a landowner wants a 15 percent return on his money in land, how much should be expected from land price appreciation? If a tenant buys portable heaters for frost protection when frost seldom occurs in the area, how much of that cost should be included?

The process of determining equitable income shares is discussed on page 4.

Other questions that might arise include: Who makes the final decisions when there are disagreements between owner and tenant? How is an equitable payment determined for forage when it is fed to livestock on the farm or ranch? How much should be charged for residences and other buildings used by the tenant? Who should pay for maintenance? Many of these difficulties have to be settled personally between owner and tenant. Then, a fairly standard process can be used to determine shares.

Livestock-Share Lease

A livestock-share lease is similar to the crop-share lease. The difference is the income to be shared is from livestock instead of crops. The terms of livestock-share leases vary more in content than crop-share leases because the resources in buildings and other facilities vary more than land within one area.

The usual terms in a livestock-share lease are for the owner to furnish the land and facilities, the tenant to furnish the labor and most equipment, and for them to share in the investment in the animals. Operating expenses may or may not be shared.

The livestock-share lease is advantageous to the low equity (perhaps new) producer who can use the facilities of a neighbor. The tenant can increase his/her income without large capital requirements.

It is also advantageous to an owner who wishes to retire from direct livestock labor, but still utilize past investments in buildings and equipment. It is a way to share management and perhaps bring new people into the business.

Difficulties with livestock-share leases are the same as those discussed in the previous section on crop-share leases.

Labor-Share Lease

This type of lease is often used by the beginning or low-equity producer. The tenant supplies his/her labor, management, and little or no capital and equipment. (The amount of capital and equipment supplied by the tenant depends on his/her equity and experience.) The labor-share lease can be used for crops or livestock.

The labor-share lease is especially useful for a beginning producer. The tenant is more than a hired worker--he/she participates in management decisions. The tenant encounters more income risk than a hired worker, but also expects a higher return.

The difficulties and process for determining equitable shares are the same as for other share-rent leases.

Flexible-Rent Lease

Sometimes owners and tenants combine cash rent and share-rent leases. These leases are almost as varied as the people who write them. The process for deciding on flexible-rent leases is similar to the process for cash rent or crop-share leases, except for the combination of components. A few approaches used are:

1. Select a fixed amount of the crop (e.g., 30 cwt of rice) and the market price on a certain day to determine the cash payment.
2. Select a lower fixed payment and a lower crop-share percentage and use both to determine the total payment.
3. Determine the payment based on a formula involving yields, price, and cost indices from the U.S. Dept. of Agriculture or the state reporting service.

These are just three variants. There are variations within the variations. The options on flexible-rent leases are up to the owner and tenant. The basic guideline is that the resulting lease needs to be legal, fair, understood, and written.

Determining The Share Rent

In many instances, the owner and tenant accept the local, traditional shares as the shares in their own lease agreement. This may be a mistake for both sides. In an equitable, long-term agreement, neither side wishes to be at a disadvantage or to put the other at a disadvantage. By reviewing the lease agreement periodically, the shares can be evaluated for fairness and adjusted if necessary.

An equitable rent, as usually defined, is one where owner and tenant share the gross income in the same proportion as they contribute to the cost of production. To establish the fair shares:

1. Determine the contributions made by each party.
2. Assign appropriate values to these contributions.
3. Calculate the total monetary contributions by the owner and tenant.
4. Establish the share of the total costs contributed by the owner and tenant.

Examples of determining the equitable shares in a crop-share lease for chili peppers and zinnia seed are shown in Tables 1 and 2. Individual items, such as seed, labor, interest, depreciation, etc. are listed and specified as owner's, tenant's, or shared expenses. (These are examples; they should not be used to estimate rents in these or other counties.)

In the examples, the operating costs are divided between owner and tenant, the fixed costs of investment and overhead are allocated to owner and tenant, and the share of expenses is determined. An enterprise budget is the best source of the information needed for share rent determination. In the chili pepper example, the owner is estimating a 20 percent contribution to total costs, so the owner's equitable share of the gross receipts is 20 percent. Other conditions may cause the share to be changed.

A basic premise of these examples is that the costs listed are accurate and fair. The cost of many of these items, such as fertilizer and insecticides, can be calculated easily. Other items may be harder to calculate (e.g., the amount of fuel used, the cost to harvest). Still other items involve some arbitrary assumptions, such as the amount of interest on land investment that should be allocated to farming. Both owner and tenant should decide appropriate values of these contributions. Agreement may not be found, but each will have a base for bargaining for the final shares.

This process may yield a share rent that is different from the prevalent rents in the area. This could be due to differences in land quality and micro-climates that cause differences in cultural practices and in land values. Or, in a specific year, the land rent market may be strong or soft, causing the rent to move up or down.

Operating expenses may be shared between owner and tenant. To prevent distortions between their points of view, the owner and tenant should share these operating costs in the same proportion as the gross receipts are shared. If the share rent is 25 percent and the owner is going to pay for part of the fertilizer, he/she should pay for 25 percent of the fertilizer.

Determining The Cash Rent

The same information is needed to determine cash rent as is needed for determining share rent. The first step is to determine the equitable share rent. This serves as an estimate of the maximum cash rent from the tenant's viewpoint. For example, in the chili pepper example, the equitable share rent is 20 percent. Expected production is 4,550 pounds per acre. Thus, the expected value of 20 percent of 4,550 pounds is the maximum cash rent the tenant should consider--barring other land market considerations.

This is the maximum value because the tenant is assuming all of the price and production risk. With a share rent, this risk is shared. With a cash rent, the tenant should expect a higher return for taking more risk, and the owner should expect a lower return for not having as much risk.

As with the share rent, local land rent market conditions may have an effect on the final cash rent decision. In a strong market, the owner holds a larger bargaining position and may raise the cash rent. A tenant may wish to hold onto land even though cash rent is high. However, the tenant cannot pay cash rents that cause expenses to exceed expected cash income.

Share Rent Determination for Chili Peppers in Monterey Co. (based on cost study by S. Mendivil and E. Yeary)

Expense item	Total Cost	Owner's Share	Tenant's Share
Operating costs:			
Fuel/repairs	$70.73	---	$70.73
Labor	$552.84	---	$552.84
Cover crop (1/3 to peppers)	$40.00	---	$40.00
Listing/fertilizer	$62.00	---	$62.00
Herbicide	$64.00	---	$64.00
Fumigation (1/3 to peppers)	$13.63	---	$13.63
Seed/fertilizer	$44.00	---	$44.00
Water/power	$112.00	---	$112.00
Fertilizer	$73.25	---	$73.25
Insecticide	$36.50	---	$36.50
Harvest	$728.00	---	$728.00
Overhead and fixed costs:			
Business costs	$160.34	$32.07	$128.27
Taxes	$30.00	$25.00	$5.00
Depreciation	$78.80	$33.00	$45.80
Interest	$436.37	$402.00	$34.37
Total Costs:	$2,502.46	$492.07	$2,010.39
Percent Shares	100%	20%	80%

Share Rent Determination for Zinnia seed in Santa Clara Co. (based on sample costs by N. Garrison & L. Horel

Expense item	Total Cost	Owner's Share	Tenant's Share
Operating costs:			
Fertilizer	$25.00	---	$25.00
Furrow custom	$8.00	---	$8.00
Herbicide/application	$13.00	---	$13.00
Seed	$20.00	---	$20.00
Thinning/hoeing	$100.00	---	$100.00
Sulfur/application	$27.00	---	$27.00
Machinery costs	$51.82	---	$51.82
Irrigation power	$53.25	---	$53.25
Labor	$87.95	---	$87.95
Interest on Operating Caiptal	$12.14	---	$12.14
Custom harvest	$100.00	---	$100.00
Overhead and fized costs:			
Taxes	$54.26	$40.00	$14.26
Interest	$264.56	$233.00	$31.56
Depreciation	$54.75	$14.00	$40.75
Management	$300.00	---	$300.00
Total Costs:	$1,171.73	$287.00	$884.73
Percent Shares	100%	24%	76%

A Leasing Checklist

Any time two or more parties join together in a business arrangement, dissatisfaction or disagreement is possible. Some problems can be avoided by planning ahead. Key points to consider in leasing arrangements are:

1. Make sure there is economic gain for both owner and tenant. Without a profit, somebody will be unhappy and the arrangement will likely fall apart after a year or two.

2. Put the lease in writing! A written lease protects the heirs if one of the original parties dies. In case of a dispute, a written lease prevents many legal problems by forcing all parties to consider explicitly the terms they are agreeing to.
3. Make sure the lease provides for legal protection for both parties. Neither owner nor tenant wants the agreement construed as a partnership.
4. Make sure all parties have agreed on the contribution each is to make to the leasing arrangement.
5. Keep accurate and complete records and have all parties agree on who should keep them.
6. Decide which party has responsibility for which jobs or enterprises.
7. Agree on a means for sharing expenses and production. Try to share the production income equitably; misunderstandings will be reduced.
8. Agree on the responsibility for maintaining buildings, facilities, and soil fertility.
9. Discuss and decide who will be the "topman" when it comes to finalizing decisions on how differences in opinion will be resolved.
10. Decide when a settlement of business earnings or rent will be made.
11. Decide how the lease holder is to be compensated for improvements if he/she breaks the lease before the asset is depreciated out.
12. If desired, decide when and how the lease can be automatically renewed and how the rent can be renegotiated or recalculated.