Colorado State University Extension
Agriculture & Business Management Notes...

Fixed Cash Lease Arrangements for Colorado's Farms and Ranches

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

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

What Is A Fixed-Cash Lease Agreement?

A fixed-cash lease is a rental agreement in which the landowner receives a predetermined cash fee from the tenant irrespective of crop yields or product prices. The tenant produces crops on the land and makes general management decisions as if the land were owned by the tenant.

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

1. The landowner has less managerial input than with other lease agreements reducing the possibility or likelihood of friction between the landowner and tenant;
2. There is little concern over accurate division of the crop, expenses and marketing;
3. The tenant has greater freedom in crop selection, production strategies, marketing, and participation in government programs; and
4. Cash rents reduce the likelihood that the landowner will be considered a "participating landlord" when calculating social security payments.

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

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

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Developing A Fair Fixed-Cash Lease Agreement

There are four primary methods that can be used to establish a “fair” fixed-cash rent for a particular farm: (1) cash rent market approach; (2) landowner's cost or desired return approach; (3) landowner's net share rent approach; and (4) tenant's ability to pay approach. Regardless of the approach used, the landowner and tenant will likely bargain to a final rental rate.

Cash Rent Market Approach: This method requires knowledge of cash rents being paid for lands in the area. Adjustments should be made to the rent to account for differences in productivity of the land, use of improvements, and other factors of the rental arrangement.

Landowner's Cost or Desired Return Approach: This method requires the landlord to calculate land ownership costs (“DIRTI 5” – depreciation, interest, repairs, taxes, and insurance) or establish the kind of return he wishes to receive on the investment.

It is important to recognize that landlords seldom receive enough rent to cover total ownership costs of buildings and improvements. Consequently, this method may result in an unrealistically high figure, especially if the farm is highly improved. Nevertheless, it does give the landowner a basis for setting an "asking price" in cash rent.

Landowner's Adjusted Net Share Rent Approach: This method presumes that cash rents should be related to share rents. Normally, fixed cash rents are expected to be lower than net share rents since the landowner shifts price and weather risks to the tenant. With strong demand for land and for various other reasons, cash rents in some areas may actually exceed net share rents.

Tenant's Ability to Pay Approach: This method determines fixed-cash rents on the tenant's projected return above production costs, using anticipated yields and prices. Subtracting all costs and a return for labor and management from gross income leaves a figure that approximates the maximum rent the tenant can afford to pay.

Any (or more than one) of the four approaches can be used to negotiate a fixed-cash rent acceptable to both the landowner and tenant.

The bargaining process provides a means of arriving at a rent acceptable to all involved parties, and an opportunity for everyone to understand the others' point of view. Intelligent bargaining can only occur if the landowner and tenant each know what is being contributed by each party.

Putting The Agreement In Writing

It is highly desirable to put the terms of any fixed-cash rental agreement in writing. A written lease agreement enhances understanding and communications between all involved parties, serves as a reminder of the terms agreed to, and provides a valuable guide for the heirs if either the landowner or tenant dies. Further, a written lease may be required by a creditor, for involvement in government programs, or to purchase crop insurance.

Every lease should include certain items – the names of the parties involved, an accurate description of the property being rented, beginning and ending dates of the agreement, amount of rent being paid and when and how it is to be paid, and the signatures of the parties involved. Furthermore, other provisions (such as the rights and responsibilities of both parties) should be included in the written lease.

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

Colorado State University's ABM Team has created and made available to producers and others a spreadsheet template for evaluating the fairness of alternative crop lease arrangements. The template and other information about crop, pasture, and building lease agreements are available from Colorado State University Extension on the Agricultural and Business Management web site. (www.coopext.colostate.edu/ABM/).