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

Flexible 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 Flexible Cash Lease Agreement?

A flexible-cash lease is a rental agreement in which the landowner receives a predetermined cash fee from the tenant adjusted for changes in crop yields and/or prices (increases and decreases). The tenant produces crops on the land and makes general management decisions as if the land were owned by the tenant.

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

1. The landowner has opportunities to share in the additional income resulting from unexpected increases in crop prices or extra-normal yields.
2. The tenant has less risk than with a fixed cash lease because the base rent paid will be lower if prices and/or yields are below normal (expected).

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

1. Flexible cash rental arrangements increase risk for both the landowner and tenant.
2. The tenant gives up some of the benefits of higher than expected yields due to the tenant's management input, thus possibly reducing incentive to do the best possible job.
3. Flexible cash rents are more difficult to calculate than fixed cash rents.
4. There is more record keeping needed for a flexible cash rental arrangement than for a fixed cash rental agreement.

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Developing a Fair Flexible-Cash Lease Agreement

There are three primary methods that can be used to establish a flexible-cash rent for a particular farm: (1) flexing for price changes only; 2) flexing for yield changes only; and (3) flexing for both price changes and yield changes. Few, if any, methods for flexing cash rents concern unexpected changes in the cost of purchased inputs. Consequently, flexible cash rents should be periodically re-examined for possible adjustments due to increased input costs.

Flexing For Price: This method calls for flexing (up or down) the cash rent for changes in price only. It is best used in areas where crop yields are quite stable. A base cash rent is multiplied by the ratio of current year's price to base price. The landowner and tenant must agree on a base rent price and what current year's price to use (i.e., Jones Elevator closing price on December 31st).

$$\textit{Flexed Cash Rent} = \textit{Base Rent} \times \frac{\textit{Current Year's Price}}{\textit{Base Price}}$$

To illustrate flexing cash rent for price, assume the base cash rent is $100 per acre and the base price for the crop is $4.00 per bushel. If the current year's price is actually $5.00 per bushel, the actual cash rent would be $125 per acre. Conversely, if the current year's price dropped to $3.50 per bushel, the flexed cash rent would be $87.50 per acre.

$$\textit{Flexed Cash Rent} = \$100 \times \frac{\$5.00}{\$4.00} = \$125 \textit{ per acre}$$

$$\textit{Flexed Cash Rent} = \$100 \times \frac{\$3.50}{\$4.00} = \$87.50 \textit{ per acre}$$

A variation of this method is to flex the base rent for prices outside a specified range. Adjustments are made for incremental changes (up or down) in the price. The landowner and tenant must agree on the base rent, what prices to use, and the incremental changes. For example, cash rent will be $55 per acre if the current year's price is within a $3.00 to $3.50 range; for each $0.20 change in price above or below the stated range of prices, the rent would increase or decrease $2.00 per acre.

Flexible cash rents may also be adjusted when the current year's price is not exactly equal to the stated base price. No range of prices is permitted before a change in rent occurs. Lease arrangements may allow for adjustments for any price change, only an increase in price, or only a decrease in price.

Flexing For Yield: This method calls for flexing the cash rent for changes (increases and decreases) in yield only. A base rent is multiplied by the ratio of current year's yield to base yield. The base yield could be each field's "proven" (historical) yield, the farm's proven/historical yield, or some other agreeable yield. County averages are generally not advisable since they may vary tremendously from a particular farm and they may not be finalized until the next year.

$$\textit{Flexed Cash Rent} = \textit{Base Rent} \times \frac{\textit{Current Year's Yield}}{\textit{Base Yield}}$$

To illustrate flexing cash rent for yield, assume the base cash rent is $100 per acre and the base yield is 90 bushels per acre. If the current year's yield is actually 110 bushels per acre, the actual cash rent would be $122 per acre. Conversely, if the current year's yield was 60 bushels per acre, the flexed cash rent would be $66.67 per acre.

$$\textit{Flexed Cash Rent} = \$100 \times \frac{110}{90} = \$122 \textit{ per acre}$$

$$\textit{Flexed Cash Rent} = \$100 \times \frac{60}{90} = \$66.67 \textit{ per acre}$$

Flexing For Price And Yield: This method requires the landowner and tenant to agree on a base cash rent tied to a base yield and a base price for each crop. Any or all of the variations for flexing for prices or yield (increases and decreases) can be used with this approach to calculating flexible cash rents.

$$\textit{Flexed Cash Rent} = \textit{Base Rent} \times \frac{\textit{Current Year's Price}}{\textit{Base Price}} \times \frac{\textit{Current Year's Yield}}{\textit{Base Yield}}$$

To illustrate flexing cash rent for both price and yield, assume the same increases and decreases used in the previous examples.

$$\textit{Flexed Cash Rent} = \$100 \times \frac{\$5.00}{\$4.00} \times \frac{110}{90} = \$152.50 \textit{ per acre}$$

$$\textit{Flexed Cash Rent} = \$100 \times \frac{\$5.00}{\$4.00} \times \frac{60}{90} = \$83.75 \textit{ per acre}$$

$$\textit{Flexed Cash Rent} = \$100 \times \frac{\$3.50}{\$4.00} \times \frac{110}{90} = \$106.75 \textit{ per acre}$$

$$\textit{Flexed Cash Rent} = \$100 \times \frac{\$3.50}{\$4.00} \times \frac{60}{90} = \$58.63 \textit{ per acre}$$

One variation of this method is to set rent equal to the value of a given quantity of the crop. The price used for determining the value would be based on price quotations at a particular location and period. For example, "the amount of cash rent shall be equal to the value of 5,000 bushels of wheat based on the July 15th closing price at Jones' Elevator."

Another variation of this method is to determine a minimum base rent and then adjust it upward on a percentage basis as the value of the crop increases due to increases in price and/or yield.

Putting the Agreement in Writing

It is highly desirable to put the terms of any crop 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 IRS treatment of a lease should be addressed by your tax management professional. Also, the legalities of the lease should be addressed by professional legal counsel.

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/).