Consider All your Lease Options Heading into the September 1 Farm Leasing Season

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With tight farm incomes and the push for increased sustainability, getting the right farm lease type and terms can make all the difference. There is no one size fits all agreement. Consider other lease types to best align both the farm owner and farm operator's objectives in the short and long term.

A farm lease is more than just a contract. It is a conversation and alignment tool. Farm owners and farm operators may agree that earning a fair return and taking care of the land are key objectives, but each party may have different financial circumstances or achieve their objective differently.

The first step in alignment is to understand what is important to each party, what is the farm like and what market opportunities exist.

There are three fundamental objectives when aligning a farm lease. These include the following:

- Personal
    - Return expectations and Risk tolerance
    - Investment objectives – income and growth
    - Tax bracket
    - Desired environmental impact
    - Level of involvement desired
- Farmland
    - Productivity
    - Topography and soil type
    - Drainage/Water Management
    - Conservation and other improvement needs
- Local Market
    - Access to value added crop income stream

Once each party understands their objectives, various farm leasing options can be considered.

Farm Lease Types

While the dominant lease in Iowa is a fixed cash rent, there are a variety of other lease types that can align objectives and balance returns and risks. There are variations of cash rent including a percentage lease and a variable cash rent. Cash rent and their variations are considered non-participating landowner leases because the operating returns and risks belong to the farmer. There are also landowner participating leases in which the landowner participates in a portion or all of the operating returns and risks. These participating lease types include modified crop share, traditional crop share or custom operations.

The USDA and IRS treat non-participating and participating landowner leases differently, so these lease types have a different access to USDA program benefits and different tax treatment.

Cash Rent Lease Types and Variations

With a cash rent arrangement, a landowner provides the land and receives a fixed cash payment, usually in March before the crop is planted. A farm operator provides labor, machinery, fuel and all the crop inputs and receives all the crop income and government payments. Under a cash rent lease, the operator has all the financing risk of providing capital for machinery and cash rent.

Variable, or flexible, cash rent leases are becoming more common. This variation is still a non-participating type of lease, but landowners and farm operators share more risk and return compared to a fixed amount. Under this arrangement, a landowner will receive a lower fixed, or base, amount before the crop is planted and will receive an additional payment after harvest depending upon production, price and revenue targets.

Cash Rent Lease Perspectives

From the landowner perspective, there is no sharing in production and market risk, and the payment amount is negotiated annually for one year. There is less involvement in determining how a farm is operated and any farming practice expectations are taken into consideration as terms in the negotiations and lease contract. As a non-participant, there are fewer tax benefits when investing in capital improvements. While the returns for improvements benefit the landowner in the long run through increased land values, the short term benefits accrue to the farmer so that the value of improvements must be considered in the rental negotiation. When it comes to investing in sustainability and soil stewardship practices, landowners need to determine how much to invest to receive the longer-term benefits. If the farm operator pays for these expenses rather than the landowner in the short term, adjustments to the agreement are needed in either a longer term lease or reduced rent.

From a farmer perspective, the cash rent payment is determined before the production and crop prices are determined and the payment is made before there is any revenue generated from the farm creating a financing risk. The accounting and management is simplified because there are little to no splits to account for and how the farm is operated is primarily their decision. For improvements or investments in sustainability and soil stewardship, farmers receive the year to year benefit but they may also have to provide the upfront capital and take on the effectiveness risk if a landowner does not want to pay for those improvements.

The Beginning Farmer state specific tax credit is available with cash rent arrangement. In Iowa, the tax credit is at a rate of 5% of the cash rent paid by the beginning farmer.

Crop Share

Crop Share Leases involve dividing income and expenses in some type of percentage. A traditional 50/50 Crop Share lease is typically the first lease type one thinks of when discussing crop share. Under a 50/50 arrangement, a landowner provides the land, the operator provides the machinery and labor and the crop income, government payments and input expenses are divided equally. However, changes in farming practices, technology, crop prices and land values have put pressure on the terms of a 50/50 lease resulting in various adjustments and splits. These adjustments can include provisions for drying and storing and landowner's grain, additional cash rental, or alternative cost splits.

Modified Crop Share/Percentage leases

A Modified Crop Share typically involves a landowner providing land and the seed, herbicides, a percentage of fungicide and fertilizer with the operator providing labor, machinery, and fuel. The landowner receives 65 to 80 percent of the crop and government payment depending upon the quality of the land. A percentage lease works the opposite in that the operator provides crop inputs and the owner receives a percentage of the crop.

Custom Operation

A Custom Operation is another participating operating arrangement. It is technically an agreement and not a lease. With a custom agreement the landowner provides the land and the crop inputs and pays either a lump sum amount or a per activity rate to a farm operator for their machinery and labor. The landowner receives the crop and government payments.

Participating Lease Perspectives

From a landowner perspective, a participating lease or custom operations creates enables a landowner to participate in production and crop markets which gives them more tax management tools, a better return for capital improvements and more upside potential. With crop insurance, some production and price risk can be mitigated. Because they are involved in purchasing the inputs and share risk, a landowner has more influence over operations and what farming practices will be used. A landowner will also receive direct benefit from any investment in farm improvements and sustainability and soil stewardship practices. If conservation, soil health and sustainability are high priorities for a landowner, these types of leases can provide easier alignment. This also reduces the need to negotiate longer term leases because the costs and benefits of implementing these practices are shared and not shifted to one party. Another benefit of this market linkage is that rental amounts will not have to be negotiated as frequently when crop markets or land values move rapidly.

A custom operation may offer additional benefits above a crop share lease including higher returns from the increased production and price risk and there are additional tax benefits depending upon how one interprets being an active business and what an individual's estate tax situation looks like.

From a farmer perspective, a landowner participating lease provides an opportunity to benefit from good production and crop prices while not having to finance an upfront, fixed cash rent payment. It enables them to implement sustainability and soil stewardship practices without having to take on the full burden of the costs.

A custom operation provides a fixed income and cash flow for machinery purchases. There is no operating financing and a farm operator may be able to provide additional services or inputs.

The Beginning Farmer Tax credit is another consideration for landowner participating lease in certain situations. This state specific benefit for eligible farmers is more lucrative in a crop p share arrangement. For example in Iowa, the tax credit is 15% of a landowner's gross profit and could amount to $50-80 per acre in state tax credits.

Professional Help

Members of the Iowa Chapter of the American Society of Farm Managers and Rural Appraisers (ASFMRA) work with close to 2 million acres across Iowa. They are experts in helping landowners and farm operators achieve their objectives with their farm leases. An ASFMRA Accredited Farm Manager (AFM) has a minimum of 4 years of experience, completed a rigorous education program and a comprehensive exam. The AFM designation represents the highest level of professionalism and commitment in the professional farm management industry. You can connect with an Accredited Farm Manager in your area by visiting https://www.asfmra.org/directory/find-experts2