



Flexible-Cash Lease Agreements

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Any lease is basically an agreement that gives the use of an asset to a lessee for a specific period of time at a specified rate. A lease does not transfer title of ownership nor an equity interest in the asset.

Labeling a document as a lease does not necessarily mean it is a lease according to the Internal Revenue Service (IRS). This document does not address any of the questions concerning the IRS treatment of a lease; if you have such questions, contact your tax management professional. Nor does this document address any questions concerning the legalities of the lease that should be addressed by professional legal counsel.

A flexible-cash lease agreement is a rental arrangement in which the landowner receives a predetermined cash fee from the tenant adjusted for changes in prices and/or yields. 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 retains the right to share in the additional income resulting from unexpected increases in crop prices and above-normal yields.
2. The tenant has less risk than with a fixed-cash lease. Rent expense is lower if prices and/or yields are below normal.

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

1. Flexible-cash rent increases risk for both the landowner and tenant.

2. The higher the yield, the more the tenant will pay to the landlord. This may reduce his incentive to manage for higher yield.
3. Flexible-cash rents are more difficult to calculate than are fixed-cash rents.

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. Few, if any, methods for flexing cash rents concern unexpected changes in the cost of purchased inputs. Consequently, flexible rents should be periodically re-examined for possible adjustments due to input costs.

Flexing for price

This method calls for flexing the cash rent for changes in price only. This method would best be used in areas where crop yields are quite stable. A base rent is multiplied by the ratio of current year's price to a pre-determined base price. The landowner and tenant must agree on a base rent base price (discussed later in this paper) and what current year's price to use (i.e., average of the closing prices at Farmers' Elevator from November 15 to December 1st).

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

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 to be made for any price change, for only an increase in price, or for only a decrease in price.

Flexing for yield

This method calls for flexing the cash rent for changes 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.

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

Flexing for price and yield

This method calls for flexing the cash rent for changes in yield and price and requires the landowner and tenant to agree on a base 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 can be used with this approach to calculating flexible-cash rents.

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

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 Farmers' 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.

Other types of revenue flexible cash rents ¹

Rather than a flexible cash rental agreement based upon fluctuations in price and yield, some flexible rental arrangements have been developed based on revenues. Flexing for revenue involves indirectly flexing both price and yield simultaneously.

There are advantages, to all parties, of flexing both yield and price. For example, flexing for gross revenue allows the following scenarios to be avoided: 1) a situation in which only price is flexed and actual yield is low and price is high, allowing the landowner to incur disproportionate returns; 2) a situation in which only yield is flexed and actual yield is below normal but the price received by the tenant is substantially above average, allowing the tenant to incur disproportionate returns.

Below are four examples of flexing for gross revenue.

1. Basic gross revenue flexibility alternative

Rent is determined by adjusting the base rental rate by the ratio of current gross revenue to some pre-established gross revenue level based on historical observations. The tenant and landowner will need to determine the base gross revenue prior to agreeing to the contract.

Example: Assuming the tenant will plant corn, the lease states the base rent is \$80/acre and the base gross revenue is \$200/acre. The base gross revenue was determined by using the last 5-year average gross revenue for the field. The current year's gross revenue was determined using actual production and the average local price between September 15 and December 1. The actual gross revenue was \$220. Therefore, the rent is $[(\$80 \times (\$220/\$200))] = \$88/\text{acre}$.

2. Stated percentage of the current crop's value alternative

Prior to the crop year, both tenant and landowner agree how to determine the current year's yield and price, as well as the percentage share of the crop used for calculating rent. (This is very similar to a crop-share agreement. The difference is that in this type of agreement the price is included and no input costs beyond land charges are incurred by the landowner).

Example: The agreement states that the landowner will receive a cash rent payment equal to 30% of the actual

¹ This section is adapted for South Dakota from Flexing Gross Revenue in the Flexible Cash Rental Agreement authored by Mary Sobba and Joe Parcell of the University of Missouri and provides additional background information and alternatives to the methods of establishing a flexible cash rental payment presented previously.

yield at a set price (such as the average local weekly Wednesday price from September 15 to December 1). Assume an average corn yield of 110 bushels per acre, and an average price from September 15 to December 1 of \$2.10 per bushel, rent would be [(110 bushels x 30%) x \$2.10] = \$69.30/acre

3. Minimum base rent plus a percentage of increased value alternative

Both landlord and tenant agree in advance on a fixed base cash rent, current year's price, normal yield, and how rent will increase. A ceiling could be used with this method, but the floor price would be the fixed base rent.

Example: Fixed base rent is agreed to at \$65 per acre, based on an average soybean yield of 40 bushel/acre and past average price of \$5.75 per bushel. The expected value of the gross revenue would then be (40 bushels x \$5.75) or \$230 per acre. In this example, assume a good year where the actual yield was 60 bushel per acre and the price received was \$6.00 per bushel. If the landlord and tenant agreed that rent would increase 30% for increases in value per acre, then rent would be:

$$\begin{aligned} & \$65 \text{ (base rent)} + (((60 \text{ bu} \times \$6.00 / \text{bu}) - (40 \text{ bu} \times \$5.75 / \text{bu})) \\ & \times 30\%) = \$65 + ((\$360 - \$230) \times .30) = \\ & \$65 + \$39 = \$104/\text{acre rent to be paid} \end{aligned}$$

The rent is the greater of the \$104/acre calculated or the \$65/acre fixed rent. In this particular example, because of the good year for production and price, the rent is higher than the base rent. In a year where gross revenue was lower than the base calculation of \$230 per acre, the base rent would be paid.

4. Fixed payment plus harvest payment alternative

For fixed payment plus harvest payment the tenant and landowner determine a base cash rent. For the base cash rent, 50% is paid in the spring. The remainder of the rent is paid by the tenant following harvest. The base cash rent is not used in the calculation of the fall payment. The fall payment is based on a pre-determined dollar per bushel value. This value should, in conjunction with the spring payment, be a little below the long-run cash rent payment because the landowner is assuming some of the production risk.

$$\begin{aligned} \text{Corn: } & [\text{Cash Rent} \times 50\%] + [\text{harvest yield} \times \$0.35/\text{bu}] = \\ & \text{Adjusted cash rent} \\ \text{Soybean: } & [\text{Cash Rent} \times 50\%] + [\text{harvest yield} \times \$1.00/\text{bu.}] = \\ & \text{Adjusted cash rent} \end{aligned}$$

Example: A tenant is renting two fields from a landowner. The tenant and landowner determine that the base cash

rent is \$80/acre for corn and soybean acreage based on historical yields of 110 bushels/acre for corn and 42 bushels/acre for soybean. The dollars per bushel flexibility arrangement is set at \$0.35 per bushel per acre for corn and \$1.00 per bushel per acre for soybeans for this particular example. (Landlords and tenants will have to negotiate these variables for their own arrangement.) The tenant pays the landowner a spring payment of \$40/acre (\$80 x 50%) for the corn acreage and \$40/acre (\$80 x 50%) for soybean acreage. At the time of harvest, yields are 120 bushels/acre for corn and 30 bushels/acre for soybean. The fall payment is then \$42/acre (120 x \$0.35) for corn and \$30/acre (30 x \$1.00) for soybean. The total payments are then:

$$\begin{aligned} \text{Corn: } & [\$80 \times 0.50] + [120 \times \$0.35/\text{bu}] = \$82 \text{ per acre} \\ \text{Soybean: } & [\$80 \times 0.50] + [30 \times \$1.00/\text{bu}] = \$70 \text{ per acre} \end{aligned}$$

Determination of Base Payment, Yield, and Price

Many of the above methods require a base cash rent, base yield, or base price. The following section contains a few tips that could be used in determining those values. Both landlords and tenants are cautioned that these tips are only guidelines and that through negotiation both parties should choose to use whatever works best.

Base payment

A good method for establishing a fair base cash rent for both the landlord and tenant takes some negotiating. If the landlord calculates the cost of ownership and the desired return, and the tenant calculates the amount that he/she can afford to pay, then both parties can work together to reach a compromise and fair cash base rent. Return for the landlord is typically calculated at 5 to 7% of the current agricultural value of the land.

Base yield

The local Farm Service Agency office should have production history on most farms. This is a good place to start. If the landlord or tenant has actual records from the farm to be rented, then those records would be ideal. County averages could be used if there are absolutely no records as long as landlords and tenants consider that the county averages may not reflect an accurate picture of that farm or parcel of land. It is suggested that a historical 3- to 7-year average be used as a beginning point in the negotiation.

Base price

Several options exist for a base price. One method is to use the local historical (3- or 5-year) harvest season average. Landlords and tenants might ask why the harvest

average price, which is typically lower than yearly price, is used in the setting of a base price. The harvest price is usually considered because any increase in price beyond harvest reflects the tenant's marketing ability. Therefore the price increase would be a return to tenant management and not landowner contribution.

Establishing a minimum and maximum payment

Many of the flex cash rental methods could easily have a clause for a rental rate floor and ceiling. Both landlords and tenants should be interested in establishing a floor and a ceiling for rental rates.

A floor rental rate is important to the landlord because in a low price-low yield year the landowner would still get a guaranteed payment. A ceiling rental rate is important to the tenant because in a good year of high prices and high yields, the tenant would benefit as a return to management.

How do the tenant and landlord agree on floor and ceiling prices? There are no exact rules, but here is one suggestion. The first step would be to set the base rent amount. Assume the base rent is \$75. At this point, both parties consider how far they could or would be willing to go in an extreme year. For example, assume both parties would agree to go \$25 either higher or lower. Therefore, the floor or minimum rental payment would be \$50.00 per acre, this amount would be guaranteed to the landowner, and in a

bad year the rent could go this low. The ceiling or maximum price would be \$100, so in a good year the tenant would not have to pay any more than this amount.

Minimal requirements of a flexible cash rental agreement

When a flexible cash rental agreement is agreed upon, landlords and tenants should be certain to include the method of calculation for all crops grown. It is possible to use different rental methods for different crops. If the lease agreement is for different crops, include the number of acres of each crop and how rent will be calculated.

Put the Agreement in Writing

Both landlords and tenants are reminded that it is highly desirable to put the terms of a lease agreement in writing. A written lease agreement enhances understanding and communication between all involved parties, serves as a reminder of the terms originally agreed upon, and provides a valuable guide for the heirs if either the landowner or tenant dies. For some types of lease agreements, such as leases for longer than one year, South Dakota Codified Laws specify that the lease be written. Consult your attorney for guidance. Sample lease forms can be found elsewhere in this publication series.

Adapted for South Dakota from Flexible-Cash Crop Lease Agreements, Agriculture & Business Management Notes, Section 4, No. 4.8, Cooperative Extension, Colorado State University.

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