

In addition to giving parties to a lease greater legal certainty, in some cases written leases may be required for other reasons. For instance, lenders may require written leases as proof or verification that a tenant farmer actually does have the acreage he/she claims. Federal and state conservation programs may require a written lease to prove that the tenant has control of the land where conservation practices are to be installed.

Types of Leases

Landlords and tenants have a variety of lease types from which to choose depending on their various goals. The following discussion is an overview of four common arrangements between landlords and tenants: the *cash lease*, the *flex lease*, the *crop-share lease*, and the *custom farming contract*. Parties will want to pick the best leasing arrangement that works for their needs.

Under a *cash lease* or a *fixed cash lease*, the tenant pays the landlord a cash sum per acre or lump sum for the rights to use the land and other farm resources. For a landlord, a cash rent lease represents a fixed income per year with little involvement in the management of the agricultural operation. Landowners need not concern themselves over the types of crops grown or amount of production costs, nor about price and yield fluctuations. For a tenant, a cash lease allows the tenant to make all the management decisions, provides an incentive for the tenant to reap the highest yields possible, and allows the tenant to retain windfall profits from yield or price increases.¹

Cash leases face the challenge of determining the right per acre rental rate that should be charged. The two parties can agree to use the current cash rental rate in the area, but cash rental rates can also be set using a variety of factors and the current rate may just be a starting point. Factors in calculating the cash rent rate may include: 1) the amount of federal and state farm program “payment acres;” 2) expected crop returns; 3) improvements on the land and whether or not those improvements (e.g. barn, lots, irrigation, or other fixtures) could be used by the tenant during the lease term; 4) the size of the farm; 5) location of the farm; 6) land quality; and 7) the reputations of the two parties. These factors provide some examples of items that could drive the cash rental rate for the land but others might exist and if so, should be incorporated. Worksheets are available through organizations, such as AgLease101.org, to aid the parties in calculating a fair rental rate.²

With cash rent leases, tenant will pay the crop insurance premiums, because the landlord has no interest in crops grown. The tenant will also receive 100 percent of all federal and state farm program payments that may come from the rented farmland. Federal and state farm program regulations require that a party actively participate and take some risk to be eligible for program payments. Under a cash rent lease, a landlord does not meet these requirements.

A hybrid cash rent lease is a *flexible cash rent lease* or a *flex lease*. A flex lease is similar to a cash lease in that the landlord charges the tenant an amount per acre. Unlike a cash rent lease, rent under a flex rent lease can fluctuate up or down depending on crop yield, market price, or a combination of both.³ A flex lease allows the landlord to gain when market prices or crop yields increase during the crop year. But in return for the possible increase in rental payments, a landlord also loses when market prices or crop yields decrease. Under a flex

¹ For a more detailed review of the advantages and disadvantages of a cash lease for either party, see North Central Farm Management Extension Committee, *Fixed and Flexible Cash Rental Agreements For Your Farm* (Dec. 2011), available at <http://aglease101.org/DocLib/docs/NCFMEC-01.pdf>.

² See North Central Farm Management Extension Committee, *Fixed and Flexible Cash Rental Agreements For Your Farm* (Dec. 2011), available at <http://aglease101.org/DocLib/docs/NCFMEC-01.pdf>.

³ For information on how to set a flexible rental rate, see North Central Farm Management Extension Committee, *Fixed and Flexible Cash Rental Agreements For Your Farm* (Dec. 2011), available at <http://aglease101.org/DocLib/docs/NCFMEC-01.pdf>.

lease, the tenant benefits from the possibility of lower rent payments during low yield or low price years. However the tenant also has to share his gains during high yield or high prices years through higher rental payments.

Under a *crop share lease*, a tenant pays the landowner a certain percentage of harvested crops. In return, a landlord agrees to allow the tenant to use the land and may pay a percentage of certain input costs. The percentage of crops and the percentage of selected expenses are usually based on local custom. For example, Tenant agrees to crop share rent Landlord's farm for corn production. Terms of such a lease might require Tenant to give Landlord 25 percent of the corn crop produced on Landlord's farm in exchange for the use of the farm and Landlord paying 25 percent of the drying and herbicide costs.

With a crop share lease, both the tenant and landlord would pay crop insurance premiums based on the share of the crop each owns. Federal farm program payments could also be divided based on the crop share, as long as the landlord meets the eligibility requirements. Typically, the landlord and tenant agree upon the division of federal and state farm program payments prior to the current crop year.

Landlords will need to consider the tax implications of each type of lease. Rent paid to a landlord under the terms of a cash rent lease or flexible lease will be reported as income on a landlord's 1040 Form. Similarly, the income from the sale of crops paid to the landlord under a crop share rental arrangement could be taxed on the landlord's 1040 Form if the landowner had not materially participated. Landlords collecting only his share of the crops and paying his share of expenses—but who is not significantly involved in the operation—will likely not be found to be materially participating in the operation.

Alternatively, the income for the sale of the landowner's share of the crop could be considered self-employment earnings if the landlord materially participates in the farming operation. The IRS considers a landlord to have materially participated in the operation when the landlord meets any of the following four tests:

- A. Any three of the following:
 1. Pay, using cash or credit, toward at least half the direct costs of producing the crop or livestock
 2. Furnish at least half the tools, equipment, and livestock used in the production activities
 3. Advise or consult with the tenant
- B. Inspect the production activities periodically
- C. Work 100 hours or more spread over a period of 5 weeks or more in activities connected with agricultural production.
- D. Do things that considered in their totality, show you are materially and significantly involved in the production of the farm commodities (IRS, 2011).

With all these leases, the landlord will be able to deduct expenses for repairs to keep the property in working condition, depreciation on the property, uncollected rents, and operating expenses. For landlords collecting Social Security benefits, rental income will not adversely affect Social Security benefits. An alternative to leasing is a **custom farming contract** where a landowner contracts with a custom operator to perform all the machine operations on the landowner's land. The landowner takes all the risks involved in the operation and pays the custom operator a set fee for performing the work. The landlord will receive all profits, incur all production costs, pay all crop insurance premiums, and collect 100 percent of eligible federal and state farm program payments. Income earned on the farm will be reported on the landowner's Schedule F. This type of arrangement works well for landowners who still want to control the operation but may not have the time or ability to do the work required. This type of arrangement is also attractive for custom operators—those who wish to earn extra income from the equipment they currently lease or own.

One special note on types of lease agreements: the type of leasing agreement can have federal estate tax implications specifically Internal Revenue Code § 2032A. Landlords looking to qualifying for this federal estate tax provision need to discuss the implications of various leasing arrangements with an estate tax planning specialist. Current federal estate tax law allows for qualifying agricultural lands' value to be reduced below the fair market value if the land continues in agriculture under a qualifying family member. IRS currently views farms operating under a cash lease as ineligible for this reduction in the land's fair market value. For more information see University of Maryland Extension Factsheet entitled "Estate Planning for Farm Families."

Lease Renewal and Termination



Renewal and termination of a lease depends on the type of tenancy—the type of legal relationship between landlord and tenant—the lease creates. Certain types of tenancies may allow the lease to automatically renew, unless the parties give proper notice of termination. Renewing a lease will always be the responsibility of a tenant. Tenants should be the ones to request a renewal. By contrast, a landlord has the option of either agreeing to the renewal or giving

the tenant the proper notice that the lease will terminate at the end of a lease term. Contract provisions may be written to govern the rights of the tenant to renew the lease or the method by which the landlord may exercise her right of termination.

A **periodic tenancy** has a set period of time such as month-to-month or year-to-year. The periodic tenancy will be classified based on when rent payments are made. For example, if you pay rent once a year, you have a **year-to-year periodic tenancy**. If you pay rent once a month, you would have a month-to-month tenancy. The typical oral farm lease would be a year-to-year periodic tenancy. Periodic tenancies renew automatically at the end of lease period unless the landlord or tenant gives proper notice of termination. In Maryland, agricultural leases require *at least 6 months'*