

Management and Marketing Notes 07-2007

CONSIDERATIONS FOR FARM LEASING

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Landowner

Pros:

- Opportunity to retain ownership.
- Potential for appreciation in land values.
- Contributes to cash flow.
- Small financial risk unless tenant requests that the landlord invest in specialized facilities.

Cons:

- Annual rental may lead to loss of soil fertility, poor weed control and lack of maintenance. This is usually less of a problem with long term leases because the tenant has an incentive to maintain the productive capacity of the farm.
- Potential for property damage.
- Loss of control over the farming activities.
- Time and expense of developing rent agreement.
- Potential friction with tenant.

Tenant

Pros:

- Rental rates are smaller than the equivalent debt service commitment on comparable investments in land and facilities. This can make a farm plan financially feasible and/or enhance the cash available for family living.
- Reduced business risk when specialized facilities are rented not owned.

Cons:

- Forgo potential for appreciation in land values.
- If land ownership is a goal, then the achievement of this must be postponed.
- Rented farm may not exactly match preferences or possess the resource mix desired to achieve business goals.
- It may not be possible to, or be more difficult to justify, making capital investments to improve the farm operation.
- Time and expense of developing rent agreement.
- Potential friction with landlord.

The Agreement

There are few if any standard lease agreements or rental rates. The landlord and prospective tenant must discuss their preferences and negotiate who will take responsibility for specific costs or activities. Each party must then make their own financial plans and projections. From a profit perspective, the lowest rent the landlord can accept is based on the next best alternative use of the farm and facilities. This might include renting to someone else and selling unneeded equipment. From the tenants perspective the plan must be financial sound from a business and family living perspective. The tenant must also consider the availability of other farms to rent and what they might cost. As long as the least the landowner can afford to accept is less than the greatest amount the tenant can afford to pay, there is the possibility of striking a deal. The final rent must be negotiated between the two parties.

The landowner typically remains responsible for the property taxes and farm insurance. Some other cost areas that may be borne by either party include maintenance on farm roads and lanes, fences and water supply, stream and ditches, and buildings and fixed equipment. The fewer costs the landlord agrees to the smaller the rent should be.

The tenant typically provides the investment in field and yard equipment and livestock. He or she also pays the agreed upon rent, provides the operating inputs such as fertilizer and seed, feed for livestock, utilities, and repairs to their own equipment. Under a cash lease, the tenant provides labor and makes all management decisions, takes all risks, and receives the net income from the farm operations.

Difficulties can arise over who will pay for major new investments or facility upgrades. A tenant prefers not to invest in items that have a useful life beyond the end of the lease. The landowner may find it hard to justify new investment, both from a cash flow perspective and because, after the tenant leaves, the investment may have no income potential. Whatever is decided, the rent should reflect this.

It is highly advisable that the lease spell out the details of the individual responsibilities of the tenant and landlord, to reduce the chance of misunderstandings. However, disagreements inevitably arise because it is not possible to foresee every situation and because the margins from farming tend to be small and variable, causing financial stress. The agreement may include an arbitration procedure to help in such situations.

The agreement should be in writing and drawn up with the help of an attorney. In North Carolina, leases for longer than three years must be in writing. Lending institutions may want certain conditions included in the lease.

Lease agreements identify the parties to the agreement, the date and the term of the lease, and the property to be leased. Long-term leases may specify an initial term, to be followed by automatic renewal unless either party gives notice that they do not intend to renew. Restrictions may be placed on the use of the property, the right of entry by the landlord may be guaranteed, and conditions imposed relating to the sale or transfer of the property. A cash lease normally specifies that no partnership is created, for the protection of the landlord. Other sections may deal with the responsibilities of each party for farm maintenance and operation, the rental rate and payment schedule, and arbitration procedures. Long-term rents are usually one lump sum for the agreed upon property, including facilities and acreage.