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LEASE EQUITY IN CROP-SHARE LEASES

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Customary rental practices often fail to fully recognize the contributions of each party in a rental contract. This is particularly true as new technologies are continually being adopted and input and product prices are changing. Leases continually need to be examined to see if the contributions of the two parties are equitable in the sharing of income and expenses.

What's a Fair Lease?



Some people are not concerned about lease equity. They are satisfied to follow the traditional leases of their parents or use the crop-share that "everybody else" is using. No two farming operations are exactly alike, so no two leases should be the same. The information in this leaflet will be useful if you are concerned with equity.

A lease, to be fair, must compensate the landlord and tenant in the same proportion as their inputs of resources into the business. The following incentive conditions must be met to fully achieve equity:

1. The variable expenses of the farm business must be shared in the same ratio as the receipts. Variable expenses include fertilizer, seed, gasoline, weed spray, etc.
2. All crops receipts are shared in the same rental proportions.
3. The landlord and tenant must each receive the full share of income earned by his resources. (If tenant is contributing 40 percent of the resources, he should receive 40 percent of the crop.)
4. Each lease party must have the opportunity to receive full return on his investments or be compensated for unexhausted improvements at the termination of the lease.

If your lease does not follow these rules, your farming operation is not producing at maximum economic efficiency and either you or your landlord/tenant are losing profits or one is gaining profits at the expense of the other.

Establishing an equitable lease would be simple if all contributions were in cash; however, problems arise in assigning monetary values to land, buildings, machinery, and management. Judgment is necessary to arrive at these values, and the values arrived at by the tenant may be entirely different than those determined by the landlord. This leaflet presents two methods for establishing an equitable crop-share lease:

Method I: Calculate the fixed contributions and then share all crop income and variable costs in the same proportion.

Method II: Share income in the same proportion that the sum of fixed contributions and variable expenses is; contributed.

Both methods use similar calculations and either can yield an equitable lease for your farming operation. In Method I all variable expenses must be shared in the same proportion as fixed contributions. Method II is longer, but does not require all variable expenses be shared alike. Both methods are identical for the first 13 items of the contributions worksheet and are outlined below. An example is provided for each method and worksheets for each are attached to this leaflet for your use.

Example: Assume an average size rented tract consisting of 960 acres of land (with 10 acres in farmstead) at \$275 per acre; \$60,000 of tenant's machinery; \$12,000 worth of buildings; and the tenant furnishes all the labor. The farm is seeded entirely to wheat for simplicity in the example.

Item

1. Estimate the total value of the land. The value used should be the current market value as nearly as it can be estimated. It is the value

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CALCULATING YOUR CONTRIBUTIONS TO YOUR RENTED TRACT

Item of Expense (1)	Estimated		Estimated Annual Cost		
	Total	Interest	Total	Land-	Tenant's
	Value	Rate	Annual	lord's	Share
(1)	(2)	(3)	Use-Value	Share	Share
	dollars	percent	dollars	dollars	dollars

I. FIXED EXPENSES

A. Fixed Investment Expenses:

1. Land	264,000	7	18,480	18,480	
2. Farm Buildings	12,000	7	840	840	
3. Machinery & Equipment	60,000	9	5,400		5,400
4. Total Section A	XXX	XXX	24,720	19,320	5,400

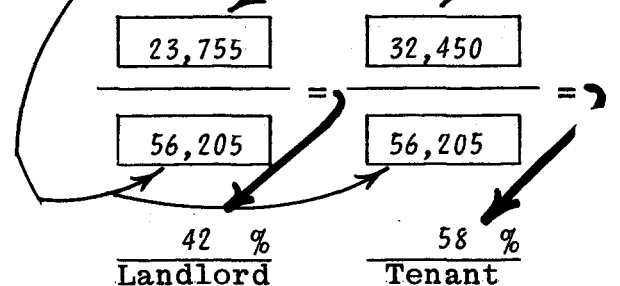
B. Fixed Operating Expenses:

5. Labor					
a. Tenant's			8,000		8,000
b. Unpaid Family					
c. Landlord's					
d. Hired					
6. Depreciation					
a. Buildings			600	600	
b. Machinery & Equipment			6,000		6,000
7. Repairs					
a. Buildings			360	360	
b. Machinery & Equipment			3,000		3,000
8. Real Estate Taxes			3,300	3,300	
9. Building Insurance			175	175	
10. Machinery Insurance			360		360
11. Management			9,690		9,690
12. Total Section B			31,485	4,435	27,050

13. Total Section I (4+12)

56,205	23,755	32,450
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METHOD I:



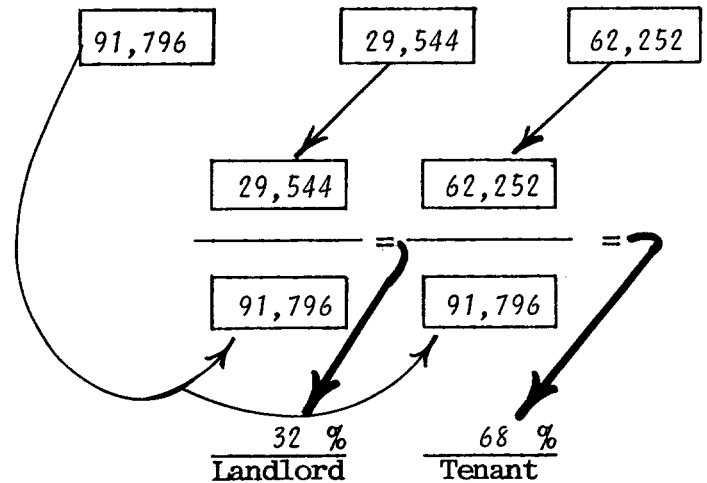
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CALCULATING YOUR CONTRIBUTIONS TO YOUR RENTED TRACT (CONTINUED)

METHOD II: Combine Items 1-13 and 14-28.

	Estimated Annual Cost		
	Total Annual Use-Value (4)	Landlord's Share (5)	Tenant's Share (6)
	dollars	dollars	dollars
II. VARIABLE EXPENSES			
14. Fertilizer	<u>10,354</u>	<u>5,177</u>	<u>5,177</u>
15. Seed	<u>8,492</u>		<u>8,492</u>
16. Gasoline	<u>2,821</u>		<u>2,821</u>
17. Weed Spray	<u>950</u>		<u>950</u>
18. Custom Weed Spraying			
19. Swathing	<u>1,900</u>		<u>1,900</u>
20. Combining	<u>7,600</u>		<u>7,600</u>
21. Grain Hauling	<u>2,250</u>		<u>2,250</u>
22. Crop Insurance	<u>1,224</u>	<u>612</u>	<u>612</u>
23. Machine Work Hired			
24. _____			
25. _____			
26. _____			
27. Total Section II	<u>35,591</u>	<u>5,789</u>	<u>29,802</u>

28. Grand Total (13+27)



PERCENT CONTRIBUTED BY:

arrived at in the sale of similar land and size of tracts in the area or the value a willing buyer and seller would agree upon. Enter in Column 2.

Interest is credited to the landlord to reimburse his farm investment at the same rate his money could be earning elsewhere. The rate should be similar to the going rate of interest for investments with similar risks and returns in the community. The interest rate paid on a sound real estate mortgage may be used as a basis for negotiation. Enter the rate you agree upon in Column 3. Multiply Column 3 by Column 4 to calculate the total annual use value for the land. Assign this value to the landlord.

- 2-3. Estimate the current market value for all buildings and farm machinery used on the rented land. Only buildings and machinery actually used in crop production should be included. The tenant includes only the percentage of machine time used on this rented land if he operates land other than that owned by the landlord.

The interest rate for buildings is similar to the rate used for calculating the total annual use value for land. Machinery and equipment rates vary near that paid on a chattel mortgage and usually run slightly higher than that paid on a real estate mortgage.

Again, multiply the estimated total values by the interest rates to obtain their annual use values. Assign each to the contributing party.

4. Add Columns 4, 5, and 6 for Section A.
5. Place a value on the annual labor contributed to the farm operation. The going wage rate can be used as a basis with the wage paid to a good full-time hired man living on the farm used as a negotiation basis for valuing the tenant's labor.

Assign each expense to the party that contributes or pays it.

6. Calculate the annual charge for depreciation based on the estimated life for each item.
7. Figures entered for repairs should reflect an average annual repair cost over the lifetime of the building or machine. Cost studies indicate that repairs average 3 percent per

year for buildings and 5 percent annually for machinery as a percentage of new costs.

Multiply the total estimated values determined in Section A by the appropriate repair percentage to calculate annual repair costs. Assign each repair cost to the contributing party.

8. Enter the annual amount of real estate taxes.
- 9-10. Enter the annual insurance premiums for land and buildings.
11. Management is very important to the farming operation, but again it is difficult to assign a monetary value to it. Both the landlord and tenant should be credited with the value of the actual management they perform. All management functions may be provided by the tenant or a substantial amount may be furnished by an experienced landlord.

Professional farm managers commonly charge 6 to 10 percent of the farm's gross income as their management fee. This figure may be used as a basis for negotiation.
12. Add the figures in Section B.
13. Add Section I by adding the totals arrived at in Items 4 and 12.

Method I

Divide the total annual contribution of the landlord by the total annual use-value of the farm (Item 13, Column 5 ÷ Item 13, Column 4). This figure is the percentage of fixed farm operating resources contributed by the landlord. Enter the tenant's total annual contribution (Item 13, Column 6) into the formula to determine his contributed percentage.

The percentages arrived at in Method I are the total annual fixed expense contribution that each lease party puts into the farming operation. This is the basis for sharing all variable expenses and all income in an equitable lease. Any division other than this percentage results in loss of profits to one or both lease parties.

Method I's solution for the example reveals that the owner furnishes 42 percent of the total use-value or fixed cost contributions for the operation, while the tenant furnishes 58 percent. All income and returns must be divided on this basis. The landlord should pay 42 percent of all variable costs and receive 42 percent of the crop income. The tenant pays 58 percent of the variable costs and receives 58 percent of the crop income.

If you and your landlord/tenant are unwilling to divide all variable expenses in the same proportion (seed, fertilizer, fuel, etc.)—or if time, additional record keeping, and cost do not make it feasible—then the second method of establishing equity may be preferred.

Method II (utilizes the first 13 items, plus items 14-28).

14-26. Judgment again plays an important factor in estimating variable expenses. You and your landlord/tenant must agree on which variable cost resources are to be used, what quantity of each will be used, their cost, and who is going to pay for them. A projected farm plan and past farm records may help establish what variable resources are needed and their respective quantities. The quantities estimated and current prices are used to calculate the total cost of each variable resource.

Assign the cost or percentage of cost to the appropriate contributors.

27. Add Section II.

28. Add Section I and Section II (13 + 27).

Calculate the resource contributions of each lease party. Divide the total annual contribution of the landlord by the total annual use-value of the farm (Item 28, Column 5 ÷ Item 28, Column 4). Substitute the tenant's total annual contribution (Item 13, Column 6) into the formula to determine his annual contributed percentage.

The percentages arrived at in Method II are the total annual resource contributions of each lease party. This is the proportion that all farm income and receipts must be divided if an equitable lease is to exist. Again, any division other than this per-

centage results in the loss of profits to one or both lease parties.

The example in Method II is the same farming operation as Method I, but the landlord has agreed to pay one-half the costs of fertilizer and crop insurance. The first 13 steps in each example are identical.

Method II's solution for the example shows that the landlord furnishes 32 percent of the total resources and the tenant furnishes 68 percent. Each lease party, in an equitable situation, would receive that same ratio of income.

Put Your Lease in Writing

Now that you have determined the equitable shares for contributions and receipts, put your lease in writing. A properly prepared lease could solve many landlord/tenant conflicts. A good farm lease contract must be written and should include:

1. Number of years leasing contract will be in effect.
2. Automatic renewal on one-year leases.
3. A six-month cancellation notice if leasing rights will not be returned to you when contract ends.
4. A clause that pays tenant for unused improvements he made to the farm; i.e., summer fallow not used, fertilizer applied for next year, fall plowing, drainage ditches, etc.

The most important aspect of developing an equitable lease is a willing spirit of cooperation between the landlord and tenant in establishing their respective contributions. Many questions and areas of opinion conflicts may arise, but the best time to solve these questions and conflicts is at the time the lease is being negotiated, not after it is in effect.