

## AGRICULTURAL

# MU Guide

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## Flexible Cash Rental Arrangement

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Flexible cash rental agreements are designed so that landowners and tenants share in the boom-bust cycles of farming. The tenant assumes nearly all the risk in a cash rental arrangement. In a crop-share agreement, the tenant and landowner share risk in proportion to input costs paid or output received. A flexible cash rental arrangement is a hybrid between a cash and a crop-share rental agreement. It allows for some of the tenant's risk under a traditional cash rental arrangement to be shifted to the landowner. With increased risk there is a greater chance for higher profit. Therefore, over several years the landowner should receive a monetary return that is greater than would have been received in a cash rental agreement, but less than the landowner's share in a crop-share rental agreement.

Flexible cash rental arrangements allow a landlord to share in high prices and yields; however, the landowner also must share in low prices and yields. Tenants decrease their risk relative to a cash lease agreement and in turn give up some profit potential. An advantage is that if a flexible cash lease can be designed to satisfy both parties, the arrangement can be used for multiple years. Of course a new written and signed lease should be completed each year (unless the lease is a multiple-year lease), but the method for calculating the rent would stay the same.

### Which arrangement is right for me?

This publication discusses three basic types of flexible cash rental arrangements: (1) revenue, (2) price and (3) yield. The price and yield flexible cash rental arrangements are typically easier to develop and compute. As the names imply, price and yield arrangements vary only one factor, whereas a revenue arrangement varies both factors. This distinction is important if, for example, flexing of the cash rental arrangement for price during a high price year — paying a high rental rate — occurs when yield is simultaneously low. The revenue flexible cash rent agreement takes into account both yield and price in determining the rental rate.

### Types of revenue flexible cash rents

Flexing for revenue involves indirectly flexing both price and yield simultaneously and holds advantages for all parties. For example, flexing for gross revenue allows the following scenarios to be avoided: (1) when only yield is flexed and actual yield is below normal but the price received by the tenant is substantially above average, the tenant receives disproportionate returns, and (2) when only price is flexed and actual yield is low and price is high, the landowner receives disproportionate returns. Below are three examples of flexing for gross revenue.

#### Basic gross revenue flex

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

**Example:** Assuming the tenant will plant corn on the acreage, the lease states the base rent is \$80 per acre and the base gross revenue is \$200 per acre. The base gross revenue might be determined by using the last five-year average gross revenue for the field. Any year's gross revenue is determined using actual production and a stated local price, such as the average local weekly Wednesday price between September 15 and December 1. If the actual gross revenue is \$220, then the rent is

$$[\$80 \times (220/200)] = \$88 \text{ per acre}$$

#### Percentage of the current crop's value

Before the crop year begins, 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 similar to a crop-share agreement except that price is included and no input costs beyond land are incurred by the landowner).

**Example:** The agreement states that the landowner will receive a cash rent payment equal to 30 percent of the actual yield at a set price (such as the average local weekly Wednesday price from September 15 to

December 1). If the actual corn yield is 110 bushels per acre, and an average price from September 15 to December 1 is \$2.10/bushel, rent would be

$$[(110 \times 30\%) \times \$2.10] = \$69.30 \text{ per acre}$$

### Minimum base rent plus a percentage of increased value

Both parties agree in advance on a fixed base cash rent, current year's base 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:** Tenant and landowner agree on a minimum base rent of \$55 per acre, based on an average soybean yield of 35 bushels per acre and past average price of \$5.75 per bushel for a typical expected value of \$201.25 per acre. Assume a good year with an actual yield of 40 bushel/acre and a price of \$6.00 per bushel. If it were agreed that rent would increase 30 percent for increases in value per acre, then rent would be

$$\begin{aligned} & \$55 + (((40 \times 6.00) - (35 \times 5.75)) \times 30\%) \\ & \$55 + ((240 - 201.25) \times 0.30) \\ & \$55 + 11.63 = \$66.63 \text{ per acre} \end{aligned}$$

### Types of yield flexible cash rents

There are many methods of flexing rent based on yield. The rental payment is adjusted (whether higher or lower) based on a predetermined method. Generally, a base cash rent is set and adjustments are based on actual production. Following are two examples.

#### Basic yield flex

Rent is determined by adjusting the base rental rate by the ratio of current yield to a pre-established yield level based on a historical average. The tenant and landowner will need to determine the base rent and base yield before agreeing to the contract, and this arrangement should be stated in the contract. A floor and ceiling rental amount clause could be added to the contract.

**Example:** Assuming the tenant will plant corn on the acreage, the lease states the base rent is \$80 per acre and the base yield was determined to be 100 bushels per acre. The actual production was 78 bushels/acre. The rent would be

$$[\$80 \times (78/100)] = \$62.40 \text{ per acre}$$

#### Base rent with stated adjustments for yield outside a specified range

Both parties agree on a base cash rent, as long as the yield falls within a range. Yield levels outside this range cause the rental rate to be adjusted reflecting the actual production. Again with this method, floors and ceilings could be used on total amounts per acre.

**Example:** Assume the agreement is specified for a soybean crop. The agreed base cash rent is \$65 per acre, if the current year's soybean yield is in the range of 25 to 35 bushels per acre. For each 5 bushel per acre outside

the range (higher or lower), the rent moves \$5 per acre. If the current year's field average yield is 20 bushels, which is 5 bushels outside the range, then rent would be lowered \$5 per acre [(5 bushel outside the range ÷ 5 bushel movement change) × \$5]. Thus, the cash rent would be \$60 per acre.

### Types of price flexible cash rents

There are many methods of flexing rent based on price. The rental payment is adjusted (whether higher or lower) based on a predetermined method of pricing. Following are two examples.

#### Basic price flex

Rent is determined by adjusting the base rental rate by the ratio of current price to some pre-established price level based on a local historical price. The tenant and landowner will need to determine the base rent and base price before agreeing to the contract. The location and time period used to determine the actual price should be agreed upon in advance and stated in the lease agreement

**Example:** Assuming the tenant will plant corn on the acreage, the lease states the base rent is \$80 per acre and the base price is \$2.50 per bushel. The actual price will be based on the average local weekly Wednesday cash price from September 15 to December 1. The price used in flexing the rent (the weekly Wednesday price from September 15 to December 1 in this example) is \$2.00 per bushel. The rent would be

$$[\$80 \times (2.00/2.50)] = \$64 \text{ per acre.}$$

#### Base rent with stated adjustments for prices outside a specified range

Both parties agree on a base cash rent, as long as the price falls within a specified range. If the price goes higher or lower, then adjustments to rent are based on predetermined adjustments. Ceilings and floors can be used on the total rent paid. This guarantees the landowner a minimum rent level, as well as allowing for the tenant to receive the rewards of good management when revenue is above the ceiling.

**Example:** Assuming the tenant is planting soybeans, the base cash rent is \$75 per acre. The local average historical price (in this case average price between September 15 and December 1), is between \$5.25 per bushel and \$5.50 per bushel. For each \$0.10 outside the range, the rent adjusts \$1.50 per acre. If the current year's price is \$4.85 per bushel, which is \$0.40 outside the range, then rent would be lowered by \$6 per acre. The rent paid to the landowner is \$69 per acre.

### Determining base payment, yield and price

The above methods require a base cash rent, base yield or base price. Here are a few tips for determining

those values. These are only guidelines, and individuals can choose to use whatever works best.

**Base cash payment:** A good method for establishing a fair base cash rent, for both the landlord and the tenant, takes some negotiating by each party. If the landlord calculates the cost of ownership and the desired return, and the tenant calculates the amount that he or 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 percent of the current agricultural value of the land. See North Central Regional publication NCR75, *Fixed and Flexible Cash Rental Arrangements for Your Farm*, for worksheets to help in determining tenant and landowner contributions.

**Base yield:** An office of the Farm Service Agency can provide information on the production history of 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 can be used if there are no other records, but it is important to keep in mind that county averages may not present an accurate picture of a specific farm. It is suggested that a historical 3- to 5-year average be used as a beginning point in the negotiation.

**Base price:** Several options exist for a base price. One method for determining a base price is to use the local historical (3- or 5-year) harvest season average. If a multiple-year lease is agreed upon, then the historical harvest price should be a moving average price that represents the most recent 3 or 5 years. Why use the harvest average price, which is typically lower than yearly price? Any increase in price beyond harvest reflects the tenant's marketing ability and involves storage costs. Therefore the price increase would be a return to tenant management and not landowner contribution. A note of caution is that current government programs allow for farmers to receive — if enrolled in the government program — a minimum price. This price, which varies by county, should be used in years when the market price is below the government-established minimum price (known as the county loan rate).

## Tax implications

The tax implications of using a flexible cash rental agreement are not clear. In particular, it is important to determine whether the landowner is a material participant in production agriculture, because if the landowner can waive material participation, then the landowner can choose to be exempt from the self-employment tax. The issue with a flexible cash rental

agreement is whether the landowner is a material participant. The farmer's tax guide provides criteria with which landowners can determine whether they are material participants. The criteria listed in the farmer's tax guide should be considered when specifying the flexible lease agreement.

## 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. Why would the tenant and landowner be interested in floors and ceilings? In a year of low prices and low yields, the landowner would still get a guaranteed payment. In a good year with 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 for doing this, but here is one suggestion. The first step is 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 agree to go \$25 either direction. Therefore, the floor or minimum rental payment would be \$50 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, and in an extremely good year, the landowner could get up to this amount.

## Minimal requirements of a flexible cash rental agreement

When a flexible cash rental agreement is agreed upon, be sure 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.

### Lease requirements (minimum)

- name(s) of parties
- accurate description of land
- beginning and ending dates
- determination of base rent
- method of determining price
- method of determining yield
- statement of how and when rent is to be paid
- signature of all parties involved

### For further information

- G403 *Farm Land Values for Missouri Counties*
- G404 *Farm Land Values*
- G424 *Missouri Crop-Share Leasing Patterns*
- G426 *Farm Lease Agreement*
- G427 *Cash Rental Rates in Missouri*
- NCR75 *Fixed and Flexible Cash Rental Arrangements for Your Farm*

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