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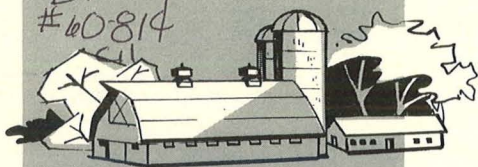
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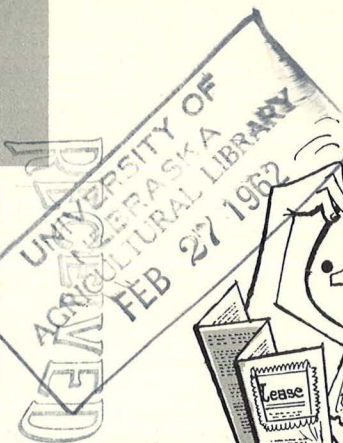


EC 60-814
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Is Your LEASE "FAIR"?

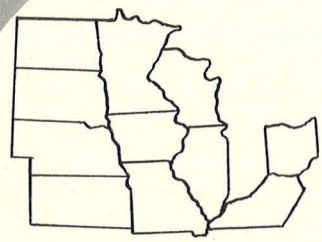
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IS YOUR LEASE "FAIR"

BY

PHILIP A. HENDERSON¹

Farm leases usually are developed on the basis of one or more of the following:

1. Customary rental terms in the neighborhood.
2. What would be "fair" to both parties.
3. Bargaining between the two parties.

In the final analysis, leasing boils down to the last of these three—bargaining. If one is to survive in this game of "horse trading" or "bargaining," he needs a keen sense of values. He needs to know what his stock-in-trade is worth, not only to the person with whom he is bargaining, but also to others, both in and out of farming. He needs to know what his competitors are offering and accepting in trade; and last, but by no means least, he needs to be able to make a reasonably close estimate of how his costs might compare with his probable income if he were to complete a bargain.

CUSTOMARY RENTAL TERMS

There is a strong tendency for farm rental terms within any one locality to be remarkably alike. Good farms rent for about the same share of crops as poor ones. Unimproved farms frequently rent for the same share as improved places.

To the extent that farms are alike in their ability to produce, similar rental arrangements make sense; but farms vary a great deal. Seldom do you find two farms that are really equally productive. How, then, can you justify a poor farm renting for $\frac{2}{3}$ of the crop, for example, when a good farm in the same locality also rents for $\frac{2}{3}$ of the crop?

More productive farms tend to attract better tenants. Similarly, less productive farms tend to be operated by tenants with fewer resources and less managerial ability. But even so, there is reason to believe that customary rental practices fail to recognize fully the differences in the productive capacities of farms and in the contributions landlords and tenants are able to make.

In many instances, today's leases represent "piece-meal" revisions of yesterday's "horse and buggy" lease. Consequently, many leases need to be examined from the standpoint of whether or not the contributions of the two parties are approximately in line with the objectives of the farm and with the division of income.

WHAT IS "FAIR"

In developing a lease, most landlords and tenants want an arrangement that is "fair" to both parties. The object of this circular is to show how this type of lease can be developed. Rental arrangements

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Figure 1. Example of How Fixed Contributions of Tenant and Landlord Can Be Calculated

CONTRIBUTION	Tenant			Landlord		
	Value	Rate	Value of Annual Contrib.	Value	Rate	Value of Annual Contrib.
LAND AND BUILDINGS						
1. Interest (4-6%) of valuation				\$48000	5%	\$2400
2. Real Estate tax						\$ 640
BUILDINGS, WATER SYSTEMS, FENCES AND OTHER PERMANENT IMPROVEMENTS						
3. Depreciation (2-3% of replacement value)				\$22800	3%	\$ 648
4. Repair (1-2% of replacement value)					1½%	\$ 342
5. Insurance						\$ 131
POWER AND MACHINERY*						
6. Interest (6-8% of new cost)	\$14,500					
÷ 2)	2	6%	\$ 435			
7. Depreciation (5-10% of replacement cost)		10%	\$1450			
8. Repair (3% of new cost)		3%	\$ 435			
9. Insurance			\$ 30			
LIVESTOCK**						
10. Interest (6-8% of current value)						
11. Depreciation, if any (breeding stock only)						
12. Insurance						
13. PERSONAL PROPERTY TAX*			\$ 100			
LABOR AND MANAGEMENT*						
14. Operator 8 mo. 225/mo.			\$1800			
15. Family help 1 mo. 175/mo.			\$ 175			
16. Hired Labor			\$ 50			
17. Management						
18. CASH RENT (Paid to landlord by tenant)		Add +	\$ 300		Subtract -	\$ 300
19. TOTAL			\$4775			\$3897
20. PER CENT OF CONTRIBUTIONS BY EACH			55%			45%

* Only that portion used for crop production in case of crop share or crop share-cash leases.

** Not to be considered in case of crop-share or crop-share-cash lease.

are considered "fair" if the shares received by the two parties involved are approximately in proportion to their respective contributions to the farm business.

This principle applies to individual enterprises as well as to the entire farm business.

A form which can be used as a basis for developing a "fair" rental agreement is shown in Figure 1. It is especially adapted to situations where a landlord and tenant are working out a suitable leasing arrangement for the first time. In such cases there is no record of cash expenses for seed, feed, gas, oil, etc. from past years which can be used in developing the rental agreement. The method outlined in Figure 1 establishes a basis for dividing the income from the farm without these figures.

It is desirable for the landlord and tenant to work together in evaluating these respective contributions. However, in some cases it might be well if the landlord and tenant would each fill out a form independently of the other. After each has completed the form according to his own thinking, both are better prepared to discuss any differences in their evaluation of the contributions to be made by each. It might be well to have a banker or some other individual whose judgment is valued sit in on the discussion of contributions, or at least have him look over the figures before the lease is actually drawn up. This will serve as a check against any tendency toward a marked bias in one direction or the other as a result of a dominating personality.

Contributions of Tenant, Landlord as a Basis of Rental Terms

Income from a rented farm should be shared by the tenant and landlord in about the same proportion as the contribution each makes toward the business. Contributions consist of interest and taxes on land; interest, depreciation, repairs, and insurance on buildings, machinery and equipment; interest, depreciation, and insurance on livestock; labor, management, and variable costs of production.

In order to develop a "fair" or equitable arrangement, figure the value of the contributions shown in Figure 1. In general, these are the overhead or fixed costs. The proportion of the total fixed contributions for the entire farm which each party contributes can then be calculated. This is done by dividing the total value of all fixed contributions which each one makes by the sum of the contributions made by both parties. Variable cash operating expenses as well as income can then be shared in the same proportion. The value of all contributions should be mutually agreed upon. Use the suggested rates for depreciation, interest, repairs, etc. shown in Figure 1 as a guide.

Estimating Values of Contributions

Values placed on some of these contributions are difficult to estimate. Nevertheless, estimates should be made as carefully and accurately as possible.

Interest and Taxes on Land and Improvements

The value placed on land and improvements should be the current market value (based on agricultural uses) as nearly as it can be estimated. This can be based on sales of similar farms in the area. Unusually high values, because of industrial or residential uses or potential uses, should be avoided. Opinions of other farmers or of reliable real estate dealers might be helpful.

Interest should be figured and credited to the landlord regardless of whether or not the farm is owned free of debt. The money represented by the value placed on the farm has potential earning power in other uses. Therefore, the amount which this money could earn in other uses represents a real contribution toward the farm business. The rate of interest charged might well be in line with interest rates charged by lending agencies on farm mortgage loans. Figures on **taxes** actually paid during the last several years should be used unless it is known that tax levies are going to be changed as the result of revaluation or of substantial changes in the mill levy.

Cost of Maintaining Improvements

Depreciation (initial cost less salvage value divided by years of expected life) on permanent improvements should be based on the estimated cost of replacing the building, well, fence, etc. with improvements designed to do the same job.

For example, in the case of a horse barn, which is being used only for hay and grain storage, the cost used as a basis for depreciation would **not** be the cost of replacing the horse barn as such, but rather, the cost of erecting a building capable of storing equally well a similar amount of hay and grain.

A cob house or wash house may no longer have any practical use. Costs of maintaining such buildings should not be considered as part of the landlord's contribution.

The figure used for **repairs** should reflect an average cost of repairs over the lifetime of the improvements. Cost studies indicate that each year this might amount to about 2-3% of the new cost. If several years of records are available, the average amount of such costs can be used.

Insurance charges used should reflect the actual annual cost of insurance on insurable permanent improvements such as buildings. **No interest** is charged on the buildings as such, since interest was charged on the total value of all land and permanent improvements.

The cost of maintaining buildings not used in the farm business (including those reserved by the landlord for personal uses such as storage space for a boat, a summer home, etc.) should be omitted.

Costs of maintaining buildings erected or used solely for the purpose of resealing the landlord's share of grain under CCC loans should not be included as part of the landlord's contributions. However, if storage is provided and used for resealing both the tenant's

and landlord's grain under CCC loans, the costs should be counted and the income from storage should be divided.

Maintenance Costs of Machinery and Equipment

Costs of supplying machinery and equipment for a farm operation include or are based on the "dirti" five (*d*—depreciation, *i*—interest, *r*—repairs, *t*—taxes, and *i*—insurance), as was true for buildings.

Information will not be available on these costs when a landlord and tenant are contemplating working together for the first time. Therefore, estimates will have to be used.

The **valuation** or investment used as a basis for estimating these costs should be the estimated new cost of a line of machinery to do the required work as satisfactorily as it could be done with the present machinery.

If the farming operations call for a machine not now owned but which would be added if the lease is completed, then the cost of this machine should be taken into account. On the other hand, if some items of machinery or equipment are owned which will not be used in the farm business, costs of maintaining these items should be omitted.

Under crop-share or crop-share-cash lease arrangements, the livestock programs carried on belong to the tenant and he receives all the income from livestock. Therefore, costs of equipment such as feed bunks, hog waterers, etc. used exclusively for livestock operations should not be included as contributions. Similarly, if part of the tractor use is for the tenant's livestock, then only that part of the tractor costs from which both parties benefit should be included as a contribution.

Interest should be calculated at somewhere near the rate charged on chattel loans. The estimated replacement cost divided by two, or the average value of machinery, can be used as a basis for estimating the interest on machinery.

Depreciation should be based on the estimated replacement cost. The rate of depreciation used will vary, depending on the nature of the machinery and the use which is to be made of the machinery. Somewhere between 5-10% would appear to be reasonable.

Repairs should be based on the same estimated new cost. Studies have indicated that repairs will average about 3% of new costs.

Insurance costs, if any, should be figured on the basis of going rates and average investments (estimated new cost \div 2).

Livestock (applies only in case of livestock-share leases)

Costs associated with livestock should enter into the calculation of contributions only when the income from livestock and/or livestock products is to be divided between tenant and landlord.

Interest should be calculated on the basis of the estimated market value at the beginning of the leasing period or the actual cost when

purchased during the year and the going rate of interest on chattel loans.

Depreciation would enter in only where dairy or breeding stock is involved and where the cost or value at the beginning of the leasing period exceeds the expected selling price. For example, a bull purchased for \$1,000 probably will not bring more than \$200 as a meat animal when his usefulness as a breeding animal has expired. Assuming that he might be used for four years, the annual depreciation would be $(\$1,000 - \$200) \div 4$ or \$200 a year. Insurance, if any, would be figured at actual cost.

Personal Property Tax

Personal property taxes can be estimated either on the basis of experience or on the basis of tax assessment schedules and the mill levy in force. In the case of crop-share or crop-share-cash leases, only those taxes assessed against crop machinery and equipment, crop supplies, crops, etc. should be included, while taxes on livestock and livestock equipment should be omitted.

Labor

A value should be placed on the operator's labor. The going wage rate (without board) for a married man doing farm work might be used as a basis for estimating the value of the operator's labor, although most men who can qualify as tenants might be worth more than the average hired man. This kind of value would not include any allowance for the operator's contribution in the form of management. (See discussion of management).

If the operator spends part of his time off the farm at other work, or on enterprises not involved in the leasing arrangement (such as livestock enterprises on crop-share rented farms), this portion of his time should not be considered as a contribution toward the farm business. In other words, only that portion of his time which is devoted to the shared enterprises should be considered as a contribution.

Family Help

Work done by the operator's family on farm enterprises, the income from which is to be divided, should be valued on the basis of what it would have cost to hire the work done.

Hired Labor

The amount spent for labor employed to do work on enterprises, the income from which is shared by both the landlord and tenant, should be included as a contribution.

Management

Although management is very important, it is hard to evaluate. Frankly, we do not know how to evaluate the management contribu-

tion. The suggestions which are made here are very rough at best. The job of management may or may not be shared. Experienced landlords may make substantial contributions to the management of a farm business.

In those instances where the landlord takes an active part in management, a contribution can be credited to him on the basis of some percentage of his share of the estimated gross value of shared crops, (or crops and livestock, less the cost of purchased feed and feeder stock in the case of livestock share leases). If the landlord is responsible for most of the management decisions, perhaps ten per cent would not be too high a figure to use. On the other hand, inexperienced landlords who know little about agriculture may contribute very little in the way of management. In this case, little should be credited to the landlord for management.

Similarly, a management charge can be calculated for the tenant—on the basis of some percentage of his share of the gross value of shared crops (and livestock in the case of livestock share leases). Experienced tenants may have much to offer in the form of management whereas young tenants may lack both the knowledge and/or experience to contribute much in this way. Generally speaking, it is up to the tenant to make most of the day-to-day, on-the-spot decisions.

The management contribution credited to each party will be largely a bargaining proposition.

Some may prefer not even to try to evaluate management in terms of exact figures. Those who follow this latter procedure must rely entirely on the bargaining process to recognize and evaluate the management contribution made by each party.

Cash Rent

If the tenant pays the landlord cash rent, this amount should be entered in the tenant's column as a contribution. It should be deducted from the landlord's column. In effect, any cash rent paid by the tenant adds to his contribution and reduces the costs borne by the landlord.

Total (contributions)

The sum of the contributions listed in the tenant's column represents his total contribution. The sum of the contributions listed in the landlord's column, less any cash rent received from the tenant, represents the landlord's total contribution.

Per cent of Contributions Made by Each

The total fixed contribution of the tenant (line 19) divided by the combined totals of his contributions and those of the landlord gives the per cent of the combined total which the tenant has contributed. This percentage, subtracted from 100, gives the percentage contribution made by the landlord.

It is probable that the percentage contributions may turn out to be

something other than the more or less standard divisions of $3/5-2/5$, $2/3-1/3$ or $1/2-1/2$. There is nothing wrong with this development, however, as long as income or production is shared in the same proportions as the fixed contributions.

If the parties involved wish to divide the income on some specific basis such as $3/5-2/5$, contributions can be brought into line by shifting all or part of some expenses from one party to the other. Care must be exercised, however, to be sure that such shifts do not lead to divided interests and thence to dissatisfaction on the part of one party or the other.

In those instances where a son (or other young man) is growing into a business, the relative contributions of tenant and landlord should be refigured frequently, depending on how rapidly the son increases his contribution in relation to that of his father. In most instances, it should be refigured at least every 2 or 3 years.

Division of Other Cash Costs and Income

The percentages obtained and shown on line 20, Figure 1, are the basis for dividing other cash costs such as seed, fertilizer, fuel, etc., as well as income. In other words, if the tenant's total contributions amount to 55 per cent of the combined contributions shown in Figure 1 he should pay for 55 per cent of the cash costs involved if he expects to receive 55 per cent of the income.

In some instances, one or both parties may prefer to share cash operating costs in some manner other than that indicated by the percentages shown on line 20. If so, the form shown in Figure 2 can be used in place of the one shown in Figure 1. The amounts for expenditures indicated on lines 20 through 29 should be estimated and added to line 19 for both the landlord and tenant. The totals should be entered on line 30 in the respective columns. The tenant's portion of the total farm contributions (line 30) can be calculated by dividing line 29 in the tenant's column by the combined totals on line 29 (both the tenant's and landlord's columns). The landlord's portion is the difference between 100 and the percentage contributed by the tenant. These percentages can then be used as a basis for dividing income in place of those shown on line 20 in Figure 1.

Where a father-son arrangement is being contemplated, the cash costs may be pretty well known. Here again, the form shown in Figure 2 can be used.

HOW TO TEST YOUR PRESENT LEASE

As indicated before, contributions to the farm business on a rented farm should be borne by the tenant and landlord in approximately the same proportions as the division of income.

To determine whether your present lease is reasonably "fair," the contributions made by the landlord and tenant should be evaluated and added up as shown in Figure 2. Fixed contributions are figured

Figure 2. Example of How Both Fixed and Other Costs Can Be Used in Developing or Testing a Lease

CONTRIBUTION	Tenant			Landlord		
	Value	Rate	Value of Annual Contrib.	Value	Rate	Value of Annual Contrib.
LAND AND BUILDINGS						
1. Interest (4-6% of valuation)				\$48000	5%	\$2400
2. Real estate tax						\$ 640
BUILDINGS, WATER SYSTEMS FENCES AND OTHER PERMANENT IMPROVEMENTS						
3. Depreciation (2-3% of replacement value)				\$22800	3%	\$ 684
4. Repair (1-2% of replacement value)					1½%	\$ 342
5. Insurance						\$ 131
POWER AND MACHINERY*						
6. Interest (6-8% of new cost ÷ 2)	\$14500	6%	\$ 435			
	2					
7. Depreciation (5-10% of new cost)		10%	\$1450			
8. Repair (3% of new cost)		3%	\$ 435			
9. Insurance			\$ 30			
LIVESTOCK**						
10. Interest (6-8% of current value)						
11. Depreciation, if any (breeding stock only)						
12. Insurance						
13. PERSONAL PROPERTY TAX*			\$ 100			
LABOR AND MANAGEMENT*						
14. Operator 8 mo. 225/mo.			\$1800			
15. Family help 1 mo. 175/mo.			\$ 175			
16. Hired Labor			\$ 50			
17. Management						
18. CASH RENT (paid to landlord by tenant)		Add +	\$ 300		Subtract -	\$ 300
19. TOTAL			\$4775			\$3897
20. CASH COST OF BOARD FOR HIRED LABOR						
21. PURCHASED FEED FOR PRODUCTIVE LIVESTOCK**						
22. MACHINE WORK HIRED*			\$ 150			
23. LIVESTOCK EXPENSE**						
24. SEEDS			\$ 205			\$ 40
25. TWINE AND BALING WIRE						
26. FERTILIZER (PURCHASED) AND LIME			\$ 600			\$ 370
27. TRACTOR FUEL*			\$ 465			
28. MISCELLANEOUS*			\$ 83			\$ 52
29. TOTAL EXPENSES			\$6278			\$4359
30. PER CENT OF TOTAL CONTRIBUTIONS			59%			41%

* Only that portion used for crop production on crop-share leases.

** Not to be considered in case of crop-share or crop-share-cash lease.

in the same way as indicated for Figure 1. Other cash costs should be listed on lines 20 through 29 as they have actually occurred. Use an average of more than one year, if several years' records are available.

The tenant's total contribution to the farm business (line 29) will be the sum of those costs which appeared on the form in Figure 1 and of other cash costs which he has paid. The landlord's total contribution is calculated in the same way. The two added together represent the total contribution. The proportions which the landlord and/or the tenant contributed can be calculated by dividing the total contribution made by each one by the sum of the totals in the landlord's and tenant's columns.

If the contributions toward the farm business are shared in about the same way in which the income is shared, the lease can be considered "fair" in its overall aspects. Although it is not always feasible to have the landlord and tenant share in all cash operating expenses, it is desirable to have both the tenant and landlord share as many of the cash costs as possible so that each has a stake in the outcome from such expenditures.

BARGAINING

Once the proposed or existing lease has been tested for "fairness," the landlord and tenant should be in a better position to do any "bargaining" they may want to do. They should have a better idea of what each one has to offer in "trade." Assuming that they have also acquainted themselves with customary rental terms in the neighborhood, the availability of farms and the availability of tenants, they should be fairly well prepared to start "dickering" or "bargaining."

There are many ways to drive a bargain.

A lease that is unfair to the tenant encourages dishonesty. It is a poor bargain that invites its own destruction.

A large number of tenants in relation to the number of farms available may put landlords in a strong bargaining position. On the other hand, the number of **good** tenants may be small; they may find that their bargaining position is also strong.

Landlords should bear in mind that they may be better off to rent to a **good** tenant for $\frac{1}{3}$ or $\frac{2}{5}$ than a **poor** tenant for $\frac{1}{2}$. Similarly, tenants should remember that they may better afford to pay $\frac{1}{2}$ share of crops for a **good** farm (and the privilege of working with a **good** landlord) than to rent a **poor** farm for a $\frac{2}{5}$ or $\frac{1}{3}$ share.

Make your lease fair; make it good; make it written. Such leases make for better understanding, better working relationships, and better farming. Remember, too, that no lease, regardless of how "fair" it may be, can take the place of sound organization and management. The successful tenant-operated farm must have sufficient volume of business to provide a reasonable and acceptable level of income to the tenant in addition to providing a reasonable return on the landlord's investment.