

# KANSAS LANDOWNER CONFERENCE

## ELEMENTS OF A GOOD WRITTEN FARM LEASE

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## PART ONE

### Basics of a Farm Lease

Farm leases are conveyances of a possessory interest in property for a specific length of time. However, they are also contractual obligations that must meet the basic requirements of a contract:

- Offer- Party A indicates a willingness to enter into a bargain, which leads Party B to believe that B's agreement to the bargain is both invited, and that it will conclude the bargain.
- Acceptance: Party B indicates that he will agree to the terms of the bargain in the manner that A provided or required by the offer.
- Consideration: Party A bargained for a promise, performance and forbearance.
- Capacity: This is the ability to understand the nature and effects of one's acts. For example, those with mental illness, or minors, may not be eligible to enter into a binding contract.

### What should be in the lease?

It is preferable to enter into a *written* farm lease, rather than rely on oral representations of the parties. A written lease clarifies the terms of the lease if disputes arise between the landlord and tenant.

Key components to a solid farm lease include:

- The description of the land;
  - An adequate description should include the exact amount of property leased. The legal description of the property is typically

the description that is utilized. This may be obtained in the owner's abstract of title to the property. Another option is to utilize the USDA farm number assigned to the property for eligibility in federal farm programs.

- The identity of each party and each party's signature;
- The terms of the lease;
- The length of the lease;
  - Typically, leases last one year, starting March 1 and ending at the end of February of the following year. If a multiple-year lease is desirable, consider including an automatic renewal clause and/or a compensation clause.
- Any special provisions related to the rights or duties of each party. For example:
  - Landlord's right of entry and inspection: In the event that the farm lease is terminated, this provision allows the landlord to enter the property after *termination* (see below), to conduct tilling or fertilization after harvest. The provision can also allow the landlord to enter the property at any reasonable time for the purpose of viewing, seeding, preservation of crops, making repairs or for other reasonable purposes.
  - Good Husbandry: A provision requiring the tenant to treat the landlord's land in a "good and husbandlike manner." If the tenant violates this provision, the landlord can enter the property and properly care for the crops and land. Examples include: proper fertilization methods, tilling, weed control, control of soil erosion, manure application, and protection of the property and resources from harm or disposal. Landlords may be entitled to damages if a tenant uses improper farming methods. Contact your county extension office for more information.
  - Environmental provisions: With the increasing concern for environmental issues, every landlord should consider implementing an environmental section in any farm lease. These should include provisions such as: the landlord assuring the tenant there are no environmental problems on the land; and that the tenant will comply with all applicable environmental laws. *The tenant must understand that he is held liable for violation of environmental laws and for contamination occurring during their tenancy.*

- Compensation Clause: This provision allows both landlord and tenant to be compensated for unused portions of long-term investments in the event of a termination of the lease. For example, the application of lime may be effective for a period of years. If the tenant applies and pays for the lime up front, the lease should provide for a method of calculating payment to the tenant for the unused portion of lime through the length of the originally proposed lease.
- Building Maintenance: Include a written clause detailing which party is responsible for what maintenance tasks. For example: one relating to compensation to the tenant for any improvements the tenant makes to the buildings.
- Indemnification Clause: This provision explains that each party will compensate the other for any damage caused by his/her negligence.

### **Considerations after signing the lease**

When entering into a written lease, it is good practice to record the lease.

If a written lease is still not in the cards or the parties are unwilling to use a lawyer, it is imperative that both parties consider consequences if a future conflict arises, in absence of a written agreement. The parties should tailor the lease to cover individual requirements for their particular situation. Each party should be fully aware of the terms of the lease. A sample farm lease would be helpful in beginning the drafting process. Contact an attorney if necessary.

Modifications to a lease: It is best to make changes to leases in writing, rather than rely on hopes that a court will agree with that principle. A writing leaves little doubt about the actual terms of a lease.

### **Termination of the farm lease**

Farm leases must be *terminated* according to state law. A farm lease may continue automatically unless either party gives *notice* of termination. Notice of the lease termination must be in writing and be served at least 30 days before March 1. That notice must timely attach in order for the termination to take place by the following March 1. If proper notice is not served, the lease will continue for another crop year under the same conditions and terms. The common methods for proper service include personal service, certified mail, and publication.

For example, if a tenant does not pay rent, the landlord may, without notice, commence a forcible entry and detainer action for non-payment of rent.

If a landlord is genuinely concerned of his tenant's ability to timely pay rents, it may be good practice to consider giving notice of termination on a yearly basis. This avoids being locked into another year with a questionable tenant. A landlord is then free to lease to another party or enter into a lease with the current tenant once that tenant can assure the landlord that rents will be paid.

### **Exceptions to the Statutory Notice of Termination Requirement**

A "mere cropper" is excluded from the requirements for termination date and notice of termination. Croppers are distinguished from tenants on the basis that croppers have no property right in the land, but receive a portion of the crop as pay for labor.

### **Landlord's liens**

A landlord has a statutory lien (a legal claim against the tenant's property to recover money) for the payment of rent, upon all crops grown on the leased land. Additionally, the landlord has a lien on the following: any increase in the livestock, goods kept for sale and any personal property of the tenant which has been used or kept upon the real estate during the tenancy and which is not exempt from execution. Exempt property includes: some specific personal property, life insurance, social security, disability, pension, alimony and veteran's benefits.

### **Security Interests**

A security interest deals with steps legally required to give a secured party (landlord) an interest in property (crops) against the tenant's creditors (banks). Liens ensure payment of debt. A security interest is a greater protection than a landlord's lien. Typically, farm leases include a grant of a security interest, or a signed security agreement from the tenant. Perfection (validation of the security interest) of the interest is achieved by filing a UCC-1 Financing Statement with the Secretary of State. A landlord's lien will be paid before a lender's security interest.

### **Wind Energy Leases and Issues for Landlords and Tenants**

When wind energy leases are negotiated, wind energy companies typically are not willing to negotiate the terms of the lease. In fact, the terms of such contracts may be permanent on the tract of land negotiated for the project. This can mean that a landowner relinquishes rights to that specific land, driveways, and even buffer areas around the wind turbine. Before entering into a binding agreement with such a company, consult an attorney. Some issues to discuss with your attorney include: if the proposed contract is a lease or an easement; if an easement, if it includes substations, air space, buffer areas, vegetation restrictions, building restrictions, transmissions or associated rights of way; and most importantly, what your rights are concerning usage of the property. Issues concerning tax credits and local energy companies should also be discussed.

## **Summary**

Leases should be customized to fit the individual needs of each party. Both parties should be fully aware of the terms and conditions of the lease. Additionally, each party should consider problems or situations that may occur in the future and consider how these situations should be handled.

## **PART TWO**

### **Tax Considerations When Leasing Farmland**

#### **Overview**

A lot of farmland is leased. Farmers (and landlords) are often good at understanding the components of economic risk associated with a farm lease and utilize the best type of lease accordingly. But what about tax issues? There are numerous income tax issues associated with leasing farmland. Sometimes the tax issues of leasing also impact estate and business planning issues for the farm landlord. These can be very important issues that shouldn't be overlooked when deciding the type of lease to utilize.

#### **Types of Leases**

Different types of agricultural land leasing arrangements exist. The differences are generally best understood from a risk/return standpoint.

- Cash leases involve the periodic payment of a rental amount that is either a fixed number of dollars per acre, or a fixed amount for the entire farm. Typically, such amounts are payable in installments or in a lump sum.
- A flexible cash lease specifies that the amount of cash rent fluctuates with production conditions and/or crop or livestock prices.
- A hybrid cash/guaranteed bushel lease contains elements similar to those found in crop-share leases. For example, a hybrid cash lease usually specifies that the rental amount is to be determined by multiplying a set number of bushels by a price determined according to terms of the lease, but at a later date. The tenant will market the entire crop. The landlord benefits from price increases, while requiring no management or selling decisions or capital outlay. However, the rental amount is adversely affected by a decline in price. The tenant, conversely, will not bear the entire risk of low commodity prices, as would be the case if a straight-cash lease were used, but does bear all of the production risk and must pay all of the production costs. The tenant delivers a set amount of a certain type of grain to a buyer by a specified date. The landlord determines when to sell the grain, and is given an opportunity to take advantage of price rises and to make his or her own marketing decisions. However, the landlord must make marketing decisions, and also is subject to price decreases and the risk of crop failure. For the tenant, the required capital outlay will likely be less, and the tenant should

have greater flexibility as to cropping patterns. While the rental amount may be less than under a straight-cash lease, the tenant will continue to bear the risk of crop failure.

- A minimum cash or crop share lease, involves a guaranteed cash minimum. However, the landlord has the opportunity to share in crop production from a good year (high price or high yield) without incurring out-of-pocket costs. For a tenant, the minimum cash payment likely will be less than under a straight-cash lease because the landlord will receive a share of production in good years. The tenant, however, still retains much of the production risk. In addition, the tenant typically does not know until harvest whether the tenant will receive all or only part of the crop. This may make forward cash contracting more difficult.
- Under a crop-share leasing arrangement, the rent is paid on the basis of a specified proportion of the crops. The landlord may or may not agree to pay part of certain expenses. There are several variations to the traditional crop-share arrangement. For example, with a crop share/cash lease, rent is paid with a certain proportion of the crops, but a fixed sum is charged for selected acreage such as pasture or buildings, or both. Under a livestock-share leasing arrangement, specified shares of livestock, livestock products and crops are paid as rent, with the landlord normally sharing in the expenses. For irrigation crop-share leases, rent is a certain proportion of the crops produced, but the landlord shares part of the irrigation expenses. Under labor-share leases, family members are typically involved and the family member owning the assets has most of the managerial responsibility and bears most of the expenses and receives most of the crops. The other family members receive a share of yield proportionate to their respective labor and management inputs.

## **Self-Employment Tax**

**Type of lease matters.** Self-employment tax is imposed on net earnings derived from self-employment. *I.R.C. §1402*. That phrase is defined as gross income derived by an individual from a trade or business that the taxpayer conducts. *Id.* However, rents from real estate and from personal property leased with real estate are excluded from the definition of net earnings from self-employment. *I.R.C. §1402(a)(1)*. Likewise, income from crop-share and/or livestock-share rental arrangements for landlords who are not materially participating in the farming operation are not classified as self-employment income subject to Social Security tax (and, thus, do not count toward eligibility for Social Security benefits in retirement). *I.R.C. §1402(a)(1)(A)*. Only if the rental income is produced under a crop or livestock-share lease where the individual is materially participating under the lease does the taxpayer generate self-employment income. *Id.*

**Avoiding self-employment tax.** Income received under a cash rental arrangement is not subject to self-employment tax, nor does such income count toward eligibility for Social Security benefits in retirement. An exception to this rule exists if the lessor leases land to an entity in which the lessor is materially participating. *I.R.C. §1402(a)(1)(A)*. IRS has won several cases in which they have successfully attributed the lessor's material

participation in the entity to the leasing arrangement with the result that passive cash rent income is transformed into material participation income subject to self-employment tax. But, if the rental income represents a fair market rate of rate, the rental income is not subject to self-employment tax. *Martin v. Comr.*, 149 T.C. 293 (2017). So, the key to avoiding self-employment tax on “self-rentals” is to make sure that the lease is a “passive” lease (i.e., a cash lease) and that the rental rate is set at a fair market rate of rent (or very closely to it).

**Material participation leases.** The key concept for farm landlords attempting to *qualify* rental income as self-employment subject to Social Security tax is material participation. Rental income is self-employment income if it results from a material participation lease. If the lease is a material participation lease, the income is subject to self-employment tax. If it is not such a lease, the income is not subject to the tax. A lease is a material participation lease if (1) it provides for material participation in the production or in the management of the production of agricultural or horticultural products, and (2) there is material participation by the landlord. Both requirements must be satisfied. While a written lease is not required, a written lease does make a material participation arrangement easier to establish. In addition, agricultural program payments that are received under a crop-share or livestock-share lease are considered to be self-employment income for Social Security purposes if the landlord materially participates under the lease.

**Observation:** Managing earned income in retirement years is important and can influence the type of lease that is utilized. Once full retirement age is reached, a taxpayer can receive an unlimited amount of income without the loss of Social Security benefits. Full retirement age is either 66, 67, or 66 and a certain number of months, depending on your year of birth. For persons age 62 to 65, the earnings limit in 2021 is \$18,240. For excess amounts, benefits are reduced \$1 for every \$2 over the limit. For a person reaching full retirement age in 2021, the limit increases to \$50,520. Above that level, \$1 in Social Security benefits are lost for every \$3 of earnings. A key point in all of this is that, for retired farm landlords under full retirement age, they may not be able to receive full Social Security benefits if they are materially participating under a lease.

## **Income Tax Considerations**

**USDA cost-sharing payments.** Under certain federal farm programs, especially those programs designed to provide environmental benefits, the USDA shares in part of the expense associated with complying with the program. If certain requirements are satisfied, the farmer that receives cost-share payments can exclude them from income. *I.R.C. §126*. Crop-share and livestock-share landlords are eligible to exclude cost-share payments from income.

**Soil and water conservation expenses.** Taxpayers engaged in farming can (upon satisfying several requirements) deduct soil and water conservation expenses in the year

incurred under a one-time election, rather than capitalizing the expenditures. *I.R.C. §175*. One of those requirements is that the taxpayer be engaged in the business of farming. A farm operator or landowner receiving rental income under a crop-share or livestock-share lease satisfies the test. But, a landlord collecting rental income on a cash rent basis is not eligible to deduct soil and water conservation expenses on the associated real estate. The landlord must materially participate in the farming operation.

**Fertilizer and lime.** A taxpayer can deduct fertilizer and lime costs by making an election on the tax return, if the taxpayer is in the trade or business of farming. *I.R.C. §180*. For farm landlords, the lease must be a crop-share or livestock-share lease. A landlord under a cash rent lease cannot deduct the cost of fertilizer and lime. A farm landlord must be materially participating under the lease.

**Interest.** Most farm interest is fully deductible as business interest. Crop-share and livestock-share leases with substantial involvement in decisionmaking by the landlord are deemed to be “businesses” for this purpose.

**Farm income averaging.** Income averaging is available for farmers and fishermen, and allows current farm income to be averaged over three prior base years. *I.R.C. §1301*. The provision is available by election (by filing Schedule J) and provides the benefit of applying lower income tax rates from the prior base years. A “farming business” for purposes of income averaging is defined as the trade or business of farming involving the cultivation of land or the raising or harvesting of any agricultural or horticultural commodity and includes operating a nursery or sod farm or the raising or harvesting of trees bearing fruit, nuts, or other crop or ornamental trees (but not evergreen trees more than six years old when severed from the roots). Also included in the definition is the raising, shearing, feeding, caring for, training and managing animals. Crop-share landlords are deemed to be engaged in the business of farming if the lease is in writing and is entered into with the tenant *before* the tenant begins significant activities on the land.

### **Special Use Valuation.**

A special use valuation election can be made in an estate to value the farmland used in farming at its agricultural value rather than fair market value. That eliminates factors that put upward price pressure on the land and helps the land stay in farming by the family by reducing or eliminating the federal estate tax on the decedent’s estate. However, many tests have to be satisfied to make the election, one of which requires the decedent (if the decedent was a landlord) to have had material participation under a lease for five of the last eight years before the earlier of retirement, disability or death if a special use valuation election is going to be made for the agricultural real estate included in the decedent-to-be’s estate. *I.R.C. §2032A(b)(1)(A)*.

The solution, if a family member is present, may be to have a non-retired landlord not materially participate, but rent the land that is to be elected in the landlord’s estate upon death to a materially participating family member or to hire a family member as a farm



manager. Cash leasing of elected land to family members is permitted before the landlord dies, but generally not after death. The solution, if a family member is not present, is to have the landlord retire at full retirement age or older, materially participate during five of the eight years immediately preceding retirement, and then during retirement rent out the farm via a non-material participation crop-share or livestock-share lease.

### **Leases and Farm Program Benefits**

Leases can also have an impact on a producer's eligibility for farm program payments. In general, to qualify for farm program payments, an individual must be "actively engaged in farming." Each "person" who is actively engaged in farming is eligible for one payment limit of federal farm program payments. A tenant qualifies as actively engaged in farming through the contribution of capital, equipment, active personal labor or active personal management. Likewise, a landlord qualifies as actively engaged in farming by the contribution of the owned land if the rent or income for the operation's use of the land is based on the land's production or the operation's results (not cash rent based on a guaranteed share of the crop). In addition, the landlord's contribution must be "significant," must be "at risk," and must be commensurate with the landlord's share of the profits and losses from the farming operation.

A landlord who cash leases land is considered a landlord under the payment limitation rules and may not be considered actively engaged in farming. In this situation, only the tenant is considered eligible. Under the payment limitation rules, there are technical requirements that restrict the cash-rent tenant's eligibility to receive payments to situations in which the tenant makes a "significant contribution" of (1) active personal labor and capital, land or equipment; or (2) active personal management and equipment.

### **Conclusion**

Utilizing the "correct" farm lease for your farming operation involves more than just the economics of the relationship. Taxes and planning considerations also play an important role. Properly consideration should be made. Do your "due diligence."