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# The Agricultural Leases of Choice in South Dakota

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# ECONOMICS COMMENTATOR

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## THE AGRICULTURAL LEASES OF CHOICE IN SOUTH DAKOTA

by

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### Introduction

Agricultural land leasing is a vital part of today's production agriculture. But, choosing the type of lease can be a confusing and challenging task for landowners and tenants in South Dakota. The rental payment, regardless if cash or a share of the crop, should be related to expected future income. However, typically, there is considerable uncertainty about what prices and yields will be in the upcoming year(s), and anticipating revenues is further complicated with the uncertainty of farm program payments, particularly in low income years when Congress may appropriate unexpected assistance. Still, the lease of choice, as long as the terms and conditions are legally enforceable, the specifics of a particular lease are only limited by the imagination and negotiation skills of lease participants.

The lease types used most often in South Dakota can be broadly grouped into four categories; 1) cash lease, 2) share lease, 3) combined cash/share lease and 4) the flexible lease. Other lease types, such as a bushel rent lease, are seldom used in South Dakota but should be considered an option if the circumstances so dictate. When comparing lease types landowners and tenants should consider the advantages, disadvantages, and risk associated with each type. A more detailed discussion of issues pertaining to agricultural land leasing is available in a recently released SDSU Experiment Station Bulletin 739, titled "South Dakota Farmland Leasing 2003". It can be obtained by contacting the authors or it is available as a free download at:

<http://agbiopubs.sdstate.edu/articles/B739.pdf>.

### Leasing Patterns

Given that nearly 40 percent of South Dakota's agricultural land is leased each year, what type of leases are market participants choosing? In South Dakota during 1999, there were an estimated 71,500 farm land leases of which an estimated 57 percent were cash leases and 29 percent were share leases. Most of the remainder (11 percent) were a combination cash/share lease (Table 1). Over time, the general trend has been a gradual shift from the share lease to the cash lease or the combination cash/share lease due to preferences of the landowners and tenants. Those seeking an alternative to the share lease but not wishing to fully embrace the cash lease may alternatively choose the flexible lease. The flexible lease is thought to be increasing in popularity, though the evidence is somewhat anecdotal.

**Table 1. Predominant Agricultural Lease Types in South Dakota, 1999<sup>1</sup>**

Type	----- Lease -----	
	Number	Percent Distribution
All Leases	71,535	100.0
Cash Leases	41,080	57.4
Share Leases	20,875	29.2
Cash/Share Leases	8,043	11.2
All Other Leases	1,537	2.1

<sup>1</sup>Source: AELOS, 1999. Table 99.

Although share leasing remains an important crop rental arrangement in South Dakota, cash leases account for the larger share of total acres leased, largely due to the fact that pasture/rangeland leases are included in the leasing statistics. Cash leasing, rather than livestock share leasing, is the predominant form of pasture/rangeland leasing, which contributes to the greater proportion of leased acreage under cash arrangements.

Cash/share leases are a combination of the two most common types of agricultural leases. In a cash/share lease, the tenant pays part of the rent in cash and part of the rent in product shares. An

example of a cash/share lease is a share rent for the cropland and a cash payment(s) for the pasture or use of the buildings. This is in contrast to a flexible cash lease which has a cash rental payment adjusted based on the crop price or yield, or on total revenue.

### **Advantages and Disadvantages of Share Leases and Cash Leases**

Crop share leases and cash leases each have particular advantages and disadvantages. The share rental arrangement provides a mechanism for sharing risks in agricultural production between landlords and renters. From the landlords' perspective, share leases require their involvement in crop production and conservation decisions. Landlords benefit from a superior crop year associated with higher yields and commodity prices and have a greater degree of control over what is produced and how it is produced. However, if low yields or financial risk associated with low prices occur, landlords bear at least a portion of the production and financial risks. Moreover, an important disadvantage for some landlords is assuming a share of the production costs. Another source of risk for some landlords (especially absentee or elderly landlords) is the verification of yields on which their share rental payments are based.

Tenants share the production and financial risk with the landowner. In addition, tenants are relieved of some of the financial burden of ownership as property tax, insurance, and debt-servicing cash costs are often higher than net rental payments. However, disadvantages for tenants include: (1) losing some managerial freedom, and (2) sharing benefits from a "good year" and the results of superior management with the landowner.

For landlords, the major advantages of cash leases are: (1) landlords receive guaranteed income for the contract period as long as the tenant remains financially solvent; (2) landlords are free from the management responsibilities of the farming operation; (3) landlords have no dollar investment tied up in production costs. The cash lease is generally a more straight forward lease with less chance for misunderstandings than might occur with other lease arrangements. Further, landlords have no need for concern over the accurate division of crops and expenses. Retired landlords may prefer cash leasing to avoid "materially participating" in the

farm business, thereby endangering some of their social security benefits.

Advantages of the cash lease for tenants are: (1) the tenant may operate the property freely, except as limited by the lease agreement or by common law, (2) the tenant receives full benefits from their management skills; and (3) tenants have the potential to achieve higher dollar returns than crop share leasing since they bear more of the production and marketing risks. Should yields or commodity prices exceed anticipated levels, the economic windfall belongs to the tenant operator. In addition, the tenant almost always receives all of the federal farm payments. Finally, tenants do not need to divide crops or income from sale of crops or document expenses for the landowner.

Disadvantages are also present for both landlords and tenants. Cash rental landlords usually forgo some economic benefit in return for accepting less risk. Particularly in years when yields or crop prices exceed anticipated levels the cash rent levels tend to be low relative to returns possible under other lease alternatives. In addition, farm commodity program payments are directed to the tenant operator rather than to the landowner. The greater managerial freedom offered tenant operators with a cash lease may also reduce incentives to farm with a long-term perspective by reducing tenant incentives to improve the productivity and value of a property by using improved farming practices. Tenants sometimes see such improvements bid away from them by landowners merely raising the cash rents in future years to reflect improved productivity. Finally, landowners assume the risk that their tenant will be able to make their rental payments, unless all of the payment is made in advance.

Tenants endure the full risk of poor crop yields and/or low crop prices with the cash lease and may find owners reluctant to provide needed farm improvements. For example, certain improvements in soil or water conservation practices may not directly increase the owner's return under a cash lease, and therefore be considered unnecessary. Tenants may experience local "bidding wars" for cash leases which can lead to paying excessive rent and seeing productivity improvements made in one year bid away by the landowner wanting higher cash rental rates in the following year.

## **Incorporating Flexibility in a Cash Lease Arrangement**

While conventional cash leases can be rather "generic" in nature, the flexible cash lease represents more of a "designer" type of lease. It is most beneficial to the parties involved when it is designed around their objectives and leasing outcomes on which the landowner and the tenant operator mutually agree. There are various approaches in building a flexible cash lease arrangement. But it should be recognized that deliberate involvement and negotiation will be needed by both parties. The landowner and tenant who are willing to work together in designing a flexible cash lease and then refining it over time may have considerably more opportunity to satisfy their mutual objectives than they would with a fixed cash rent agreement.

The advantage of flexible cash leasing is that financial risk is reduced for the tenant operator if the cash rent is lowered when revenues are low. However, the landowner can share in economic "windfalls" if the rent is adjusted upwards in those years when above-normal revenues are realized and if the arrangement qualifies for sharing farm program payments. Less communication and joint decision making are required than would be true of a typical crop-share lease, which may result in possible social security and income tax advantages for the landlord. Properly designed flexibility clauses can reduce the need for frequent renegotiation of cash leases and increase satisfaction with the rental arrangement.

A disadvantage of a flexible cash lease for the landowner is more financial risk than s/he would have with a fixed cash rent. If the rent adjustment is based on yield, the landowner needs to trust the tenant to accurately measure production - similar to that under a crop-share lease. The tenant operator will typically share some of the "economic windfalls" from above-average years. In the case of cropland parcels having multiple-crop enterprises, arriving at an adjustment mechanism involving prices and/or yields for two or more crops may be complicated. Establishing the initial framework for a flexible cash rent can be more difficult and time consuming than conventional leasing alternatives.

## **Keys to Successful Leasing**

Regardless of lease type, several factors contribute to successful leasing for the parties involved. Given the dollar value of the asset involved and the complexity of today's economy and technology, written agreements, with details spelled out, should be considered. Even leases between family members can lead to misunderstanding and ill will if details are not specified in writing. However, care must be taken to protect your rights in the written lease. Consult an attorney!

In addition to the cash rental rate, a number of other considerations are also important and should be spelled out in writing. Among these are: timing of payments, provisions for renegotiating rates, resource management and maintenance questions, provisions for subleasing (such as for winter stock grazing), and termination procedures including arrangements for compensation to the tenant for long-term investments, that are still providing benefits at the termination of the relationship.

Perhaps most importantly, the key to successful leasing in today's world is good communication on the part of both the landowner and the tenant operator. This means that goals and expectations should be stated clearly, building towards consensus of a common set of objectives for the land resource and its use. Given the legal and environmental aspects as well as the economic considerations, a smooth (and frequent) flow of communication is vital.

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