



# Ag Decision Maker

## A Business Newsletter for Agriculture

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### How will cash rents respond to higher grain prices?

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Bullish news is rampant in agriculture, at least where there is a significant demand for grains to use in making biofuels. Although the production of ethanol has been on the increase for several years, corn

prices have reacted sharply only in the last six months. Soybean prices have been pulled along for the ride. Previous periods of high grain prices have usually been the result of below average production and reduced supplies of grain, which lasted only until the next average or better crop was produced. Recent price increases are due almost entirely to increased demand, however. How long the ride will last is very uncertain.

Higher grain prices will eventually reverberate though other agricultural markets, including the market for land. Surveys of farmland values have shown considerable strength, and most of the factors causing it are impacting the rental market, as well.

In Iowa, cash rental contracts must be terminated by September 1 each year or they continue

in effect for another year under the same rates and terms. Therefore, many rents will not respond to the higher grain prices until 2008. Some landowners routinely cancel contracts so that rental rates for the following year can be negotiated after the current year's harvest. Terms can always be adjusted by mutual agreement.

### Determining the Rent

Setting a fair cash rent can be done several ways. Many people simply want to match what other farms in the same area are renting for.

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**Handbook updates**  
For those of you subscribing to the handbook, the following updates are included.

**Estimated Costs of Crop Production** – A1-20 (12 pages)

**Cash Corn and Soybean Prices** – A2-11 (4 pages)

**Flexible Farm Lease Agreements** – C2-21 (6 pages)

**Historic Farmland Values** – C2-72 (10 pages)

Please add these files to your handbook and remove the out-of-date material.

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ISU Extension carries out a survey of cash rental rates every spring, after rates for the year have been agreed on. Results for 2007 should be available in May. Past surveys are available on the ISU Ag Decision Maker web site under Information File C2-10, <http://www.extension.iastate.edu/agdm/wholefarm/html/c2-10.html>. Informal information about cash rental rates is plentiful, too, but often focuses on extreme cases. Most farm rental agreements in Iowa are not required to be recorded, so there is little factual information available to the public.

Rental rates should be in line with expected income from the crops to be produced. More information about estimating a fair cash rent is available in Information File C2-20, <http://www.extension.iastate.edu/agdm/wholefarm/html/c2-20.html>. A Decision File spreadsheet is available, as well. In the past decade, average cash rents in Iowa compared to gross revenue per acre have been in the 35 to 40 percent range for corn and the 45 to 50 percent range for soybeans. Gross revenue was estimated as the state average yield multiplied by the average cash marketing price for that year's crop. USDA loan deficiency payments were included in gross revenue.

Another approach is to estimate the net return to the landowner based on a traditional 50-50 crop share lease. The calculation would be 50 percent of the expected yield multiplied by the expected market price, minus one-half of the seed, fertilizer and pesticide costs. Estimates of crop production costs for 2007 can be found in Ag Decision Maker Information File A1-20, <http://www.extension.iastate.edu/agdm/crops/html/a1-20.html>.

Traditionally the same cash rental rate has been paid for acres planted to corn or to soybeans. Under current market price relationships, the approaches just outlined will result in significantly higher rates for corn than for soybeans. The overall rental rate should still be an average for both crops, though, based on the actual acres planted.

### Cautions

Several cautions are in order. First, much of the 2006 crop was priced prior to harvest, when prices were considerably lower than they have been since September. Bushels to be produced in 2007 can be forward priced at very profitable levels today, but most producers will not sell 100 percent of their expected production in advance. Prices could decline by harvest time, if they follow traditional patterns. Costs for seed, fertilizer and pesticides continue to increase, as well. Estimates are that farmers will spend approximately \$20 per acre more on corn inputs this year than last year.

If grain prices stay at historically high levels, higher cash rental rates are both inevitable and financially feasible. Past history tells us, however, that other sectors of the economy will eventually adjust and push prices closer to more traditional levels. Producers who obligate themselves to high cash rents need to consider ways to limit their downside risk. Several tools are available.

### Risk Management

Volatile grain prices have created a great deal of interest in flexible cash lease agreements this year. Under a flexible lease the tenant and owner agree that the cash rent to be paid will be determined after harvest, based on actual yields and/or prices. One common formula is to set the rent equal to a percent of the gross value of the crop, much like the approach explained above for estimating a rate in advance. Another approach is to set a base rent and add a bonus payment if gross revenue is above a certain level. More information on flexible rental agreements is available in Information File C2-21, <http://www.extension.iastate.edu/agdm/wholefarm/html/c2-21.html>. Various formulas for setting a flexible rent can be tested using the Decision Tool available with Information File C2-21.

Some owners and tenants are considering switching to traditional 50-50 crop-share leases. This would give the landowner the opportunity to benefit from higher prices, but reduce the tenant's financial risk in case of lower prices or poor yields.

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Crop revenue insurance is also an important risk management tool for tenants. Gross income guarantees are based on average farm yields and the average futures price during the month of February. The number of dollars that can be protected this year promises to be the highest since revenue insurance was introduced in 1996. Of course, premiums will be higher, as well.

High crop prices have added a great deal of uncertainty to the farmland rental market in 2007. Fortunately, the prospect of above average profits is a problem that is more pleasant to deal with than when the pendulum swings the other way.



### IRS Notice on SE Tax for CRP payments\*

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The uncertainty in handling conservation reserve program (CRP) payments existing since 2003 has been partially reduced, in a manner adverse to taxpayers, by the issuance of Notice 2006-108 in early December, 2006. The Internal Revenue Service response to the controversy was to –

- (1) issue Notice 2006-108;
- (2) announce that a revenue ruling is forthcoming;
- (3) obsolete Rev. Rul. 60-32, a key ruling in this area for nearly 50 years; and
- (4) invite comments on the Notice through March 19, 2007.

The action taken by the Internal Revenue Service is in direct opposition to what was well-settled law dating back to 1988 and will mean a significant tax increase for retired and disabled taxpayers and for investors whose CRP land does not bear a “direct nexus” to a trade or business of farming.

### IRS Guidance being relied on by taxpayers

In 1988, the Internal Revenue Service issued a private letter ruling indicating that payments received by a retired landowner who bid land into the conservation reserve program were not subject to self-employment tax. Various statements from both

IRS and the Social Security Administration indicated that where the farm operator or owner was materially participating in the farm operation, CRP payments were properly includible in net earnings from self-employment, subject to self-employment tax. Additional guidance came from a 1996 Tax Court case involving a Texas farmer who bought land already under a CRP contract. The Tax Court held that the CRP payments were subject to self-employment tax because of the “direct nexus” or connection with the farming operation. The farmer used the equipment and employees from the farming operation to maintain the seeding on the CRP acreage and to clip the weeds and admitted that, at the end of the 10-year CRP contract, the land would be part of the regular farming operation. Under that case, retired landowner who had land enrolled in the CRP would not have SE income from the payments and neither would a mere investor who had land in the CRP. A 1998 Tax Court case held that CRP payments were “rent” and not subject to self employment tax but that decision was overturned on appeal. The appellate court, in dictum, specifically rejected the application of “material participation” to CRP contracts (pointing out that material participation was applicable only to landlord-tenant relationships).

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