ILLINOIS FARM LEASES: ONE VARIABLE CASH RENT OPTION
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Abstract: This article describes a Variable Cash Rent Lease in which the farmland owner and operator negotiate a Base Cash Rent based on expected corn yields and the current price for new-crop corn futures contracts. The Actual Cash Rent will be the Base Cash Rent adjusted for changes in corn futures prices between the time the lease is negotiated and about March 1. The principal advantage of such a lease is that it allows a landowner and farm operator to negotiate a lease much earlier in the fall because the rent automatically adjusts for changes in futures prices occurring after lease negotiation but before Spring planting. The article also provides one example of key language for calculating the variable cash rent under the lease. However, the parties should seek legal counsel before using such a lease or the sample language. This article is part of a law-related educational program for Illinois family farmers made possible by a gift from the Illinois Bar Foundation. The assistance of the Agricultural Law Section Council of the Illinois State Bar Association in reviewing the article also is appreciated.

Introduction

Fluctuating commodity prices, such as those witnessed in 2007-2008, create difficulties for landowners and operators in setting fair cash rents because gross revenues from the rented farm will vary significantly depending on what happens to commodity prices. Farm tenants and owners, however, can tailor the traditional cash lease to “automatically adjust” to changing price scenarios. A “variable cash rent” lease is one way in which both the farm operator and farm owner can share in the benefits of unanticipated increases in commodity prices, as well as the adverse financial impact of falling prices.

A 2007 farmdoc article by Schnitkey and Lattz titled Flexible Cash Leases Based on Crop Insurance Parameters describes several specific variable cash rent arrangements. Click here [http://www.farmdoc.uiuc.edu/manager/newsletters/ef007_13/ef007_13.pdf] to see this farmdoc article. Schnitkey and Lattz propose that landowners and operators consider a lease in which the amount of the cash rent is determined by parameters used in setting revenue guarantees on Group Risk Income Plan (GRIP) crop insurance policies, i.e., the amount of rent is based on county yields and prices for futures contracts traded on the Chicago Board of Trade.

The purpose of this Agricultural Law and Taxation Brief is to further discuss the Flexible Cash Rent concept proposed by Schnitkey & Lattz and to provide one example of language that could be used to modify a traditional Cash Lease between a landowner and farm operator. Because there are numerous factors to consider, landowners and farm operators should seek legal counsel before deciding to use such a lease.

The Core Idea of the Variable Cash Rent Lease Described in this Article

The basic idea of the Variable Cash Rent Lease described below is that …

- A Base Cash Rent/Acre is negotiated based on expected yields, current prices, and other factors specific to the farm.
- The Base Cash Rent is adjusted later by an indexing factor reflecting changes in Futures Prices occurring between the time the Base Cash Rent is negotiated and about March 1 when the Actual Cash Rent is “set”.
- Changes in Futures Prices will be determined from readily available Crop Insurance data published by USDA’s Risk Management Agency (www.rma.usda.gov).

There are many potential measures of price and yield that could be used in variable cash rent lease arrangements. For example, changes in new-crop futures prices could be based on one crop, e.g., corn, or on multiple crops, e.g., corn and soybeans, and the futures prices could be based on several potential time periods, e.g., the
period ending just before March 1 and/or the period ending just after harvest. The cash rent also could be adjusted for actual yields (county average or specific farm) that are higher or lower than expected and for unanticipated changes in input costs. However, in this article, the authors have chosen to illustrate the variable lease concept by “flexing” only for changes in the futures price for corn occurring after the lease is signed but before March 1. In effect, the authors have chosen to illustrate the concept of the variable cash rent lease with a relatively simple conceptual approach.

Example – Cash Rent Adjusts Only for Changes in the Futures Price of Corn

The Lease. On October 1, 2008, Landowner and Farm Operator negotiate a lease for a 100 acre farm for the 2009 crop year. They agree to a “Base Cash Rent” of $20,000 ($200 per acre) based on their expectations of yields and prices for the new crop, and other factors such as the productivity of the farm, its proximity to cash markets, anticipated input costs for the operator, and the local “rental market” for farmland.

The “Actual Cash Rent” paid by the operator will be the “Base Cash Rent” adjusted for any change, up or down, in the price of the December 2009 corn futures contract on the Chicago Board of Trade. The change in price will be the difference between the futures contract price on the day nearest the date of lease signing (the futures price can be obtained at www.farmdoc.uiuc.edu) and the average trading price of the same futures contract (the December 2009 corn contract) during February.¹

Determining the Actual Cash Rent. Assume that on October 1, 2008 (the day the variable cash rent lease was signed), the “settlement price” for the December 2009 corn futures contract on the CBOT is $6.50/bushel (futures prices are available from the farmdoc Website). Also assume that in early March of 2009 USDA’s Risk Management Agency publishes the “Expected Price”, also known as the “base price”, for corn and this price is $7.15/bushel (this price is used in calculating “GRIP” Crop Insurance, is published on the RMA Website, and will be the average trading price during February 2009 of the December 2009 corn futures contract). The “Actual Cash Rent” per acre is now “set” at 1.10 x $200/acre, where 1.10 = $7.15/$6.50. The Actual Cash Rent is 10% higher than the Base Cash Rent because the futures price for new crop corn rose 10% between the time the lease was negotiated and the time RMA calculated the “Expected Price”, also know as “Base Price”, in early March.

Comparison to a “Crop Share” Lease. With the Variable Cash Rent Lease described above, the income of Landowner fluctuates in much the same manner as the income of a landowner with a share lease, assuming yields are normal and input costs are “locked in” at the lease signing.

Advantages of This Variable Cash Rent Lease

The principal advantage of the variable cash lease described above is that it allows a landowner and farm operator to negotiate a fair lease much earlier in the fall preceding the crop year because the rent automatically adjusts for changes in futures prices occurring after the lease is negotiated, but before Spring planting.

For example, assume that in October 2008 our Tenant in the previous example was anxious to renew the cash lease at a reasonable rent because Tenant wanted to pre-purchase seed, fertilizer, etc. and to start fall tillage. Owner was reluctant to sign a lease at this time because a fair cash rent based on historic yields and the October outlook for “new crop” prices might not be a fair lease a few months later if “new crop” futures prices rise. Owner and Operator resolved this timing problem by deciding to use a variable cash rent lease instead of a traditional fixed cash lease. Both realized that if they signed a

¹ USDA’s Risk Management Agency uses the February trading of this December corn futures contract in setting the “Expected Price” (also know as “Base Price”) used in “GRIP” Crop Insurance. RMA posts this price on its website (www.rma.usda.gov) in early March.
variable cash lease that was fair based on the October outlook for prices, and would “flex” the rent upward if new crop prices rose and downward if prices fell, there was no need to delay signing the lease.

Other advantages of this particular variable cash rent lease are:

- The information needed to “set” the rent is readily available on the Internet, thanks to USDA’s Risk Management Agency and farmdoc.
- All the needed data for this lease will be available about March 1 – at the start of the crop year – because this lease only adjusts for futures price changes occurring between the time the parties sign the lease and the end of February.
- Although the yield risk is borne by the farm operator, the rent is “set” at about the same time that the operator is managing risk by making crop insurance decisions.
- The variable cash rent lease is likely to be signed earlier than a fixed cash rent lease; this will give operator more time to lock in prices and otherwise manage input costs.

**Some Factors to Consider before Deciding to Use a Variable Cash Rent Lease**

The exact nature of a farm lease can have legal implications far beyond the profit or loss of the farm operator and the net amount of rent received by the farmland owner. Some of the implications of a variable cash rent lease are described below.

**Estate Planning and SE Tax Implications.** Whether the lease is structured to preserve eligibility for “Agricultural Use Valuation” in a deceased landowner’s estate may be important. Also, whether the lease is structured to cause the rent received to be “Self Employment Income” can have significant tax management implications. These are just two examples of the many considerations that may be important to a farmland owner and should be discussed with a legal advisor.

**Risk Sharing Implications.** Farming is a risky business and the nature of the lease determines how yield and price risks are shared (or not shared) between the owner and tenant.

In the typical “Crop Share” lease, both parties share the risks of low yields or crop prices because the landowner’s rent is a predetermined share of the crop actually produced. When yields or prices are good, both the landowner and operator benefit. When yields or prices are bad, both suffer. In contrast, with the typical fixed “Cash” lease, the landowner receives the agreed upon cash rent regardless of whether yield and crop prices are high or low. Thus the tenant bears all the risks associated with price and yield variability (and input cost variability).

Farm operators and owners are exploring ways in which the cash lease can “automatically adjust” to changing price scenarios. However, making the cash rent payments dependant on changing price or yield scenarios also can affect whether the tenant and farmland owner must divide farm program payments.

**Farm Program Payment Implications.** Whether a farm lease meets the technical definition of a “cash” or a “share” lease under applicable federal regulations determines whether the farm operator, alone, or both the operator and the farmland owner receive certain USDA farm program payments. “Flexible” or “adjustable” cash rental arrangements can be especially problematic. ALTB 06-01, available on the farmdoc Website, discusses this important implication. ([Click Here for ALTB-06-01](http://www.farmdoc.uiuc.edu/legal/articles/ALTBs/ALTB_06-01/ALTB_06-01.pdf)).

The Schnitkey and Lattz proposal for a variable cash rent based on federal crop insurance parameters (e.g., the rent is based on expected or actual county yields and/or futures prices determined on the Chicago Board of Trade) appears to be a “cash lease” under federal regulations because the amount of rent is not dependent on actual yields on the rented farm or actual prices received for the crops grown.
However, this matter and other legal issues should be discussed with your attorney.

As a practical matter, there are many different variable cash rent possibilities and many local Farm Service Agency offices reviewing farm leases. Thus, the initial determination by the FSA about whether a particular lease is a “cash lease” or a “share lease” can not be predicted with complete certainty.

It is possible that the administrative rules might change for the 2009 or later crop years. If, for example, new rules allowed the landlord and tenant to agree about how the farm program payments were to be divided, the classification of the lease as a “share” lease or a “cash” lease would be less significant.

Resolving Key Questions

If, after considering all implications, an owner and operator decide to consider a variable cash rent lease like the one described in this article, they must resolve key questions. A checklist follows.

1. What commodity will be used to determine changes in commodity prices? (A simple approach would be to focus only on corn and changes in the price of the “new-crop” December futures contract between the time the Base Cash Rent is negotiated and about March 1. The “Expected Price” for corn, also known as the “Base Price”, used in GRIP Crop Insurance is released by RMA in early March, based on the February trading of “new crop” futures contracts. This is the approach of this article.).

2. Is any rent to be paid “up front” and, if so, how much and when? (March 1 is one date to consider for an “up-front” rent payment.)

3. When is the balance of the cash rent to be paid? (September 1 or December 1 or another of many possibilities.)

4. Is there a “floor” on the variable cash rent? (A floor might be desired by the landowner. Any “floor” generally should be not less than any “up-front” rent payment.)

5. Is there a “cap” on the variable cash rent? (A cap might be desired by an operator wishing to limit operator’s risk if widespread drought results in much lower than expected yields and high prices. Some would argue that if there is a floor on the variable rent, their also should be a cap.)

Possible Language for the Lease

The key language in a Variable Cash Lease is the description of how to calculate the variable cash rent. Otherwise, the Variable Cash Lease is similar to the traditional “fixed” Cash Lease. One possibility is for the “amount of cash rent to be paid” clause to refer to an appendix that further describes in detail the calculation of the variable cash rent. Alternatively, the “amount of cash rent to be paid” clause in the lease could describe how to calculate the rent. In Appendix A to this article the authors include possible language describing variable cash rent calculations. You should discuss this potential language with your legal advisor.

The Importance of Communication about How the Dollar Amount of the Actual Cash Rent Has Been Determined

Memories may fade. Therefore, a farm operator with a variable cash rent lease should help the farmland owner understand the final calculations for determining Landowner’s rent check. A letter accompanying the final rent payment provides one opportunity to explain why the payment is what it is. A sample letter, based on our earlier example, i.e., based on the Base Cash Rent of $20,000 and a hypothetical futures price scenario previously noted, is provided below. The sample letter can be adapted as appropriate for your particular lease. Reading the sample letter now may provide you with additional insights into how the variable cash rent lease described above might actually work in practice.
Dear Farmland Owner:

I am happy to enclose a $7000 check as the final cash rent payment for your farm. This amount represents

- the $20,000 “Base Cash Rent” we agreed to last October,
- multiplied by a 1.10 Variable Cash Rent Indexing Factor (explained below),
- less the $15,000 advance rent payment that I made on March 1, 2009

Please recall that the variable cash rent lease we signed last October stated that the “Base Cash Rent” for the farm was $20,000 and that the Actual Cash Rent would be the “Base Cash Rent” multiplied by the “Variable Cash Rent Indexing Factor”. We decided on a Base Cash Rent of $20,000 because of various factors, including our expectations of new crop corn prices. We also knew that prices could move up or down between October 1, 2008 (when we signed the lease) and March 1, 2009 (when my current lease term for your farm began) so we decided to adjust the “Base Cash Rent” upward or downward depending on what happened to the futures price of corn during that time period. We also agreed that I would make a $15,000 rent payment on March 1, 2009.

Under our lease, the “Variable Cash Rent Indexing Factor” is A/B, where B was the assumed base price for corn when we signed the lease. Please recall that we checked the farmdoc website (www.farmdoc.uiuc.edu) on the evening we signed the lease to see the “Settlement Price” for the December 2009 Corn Futures Contract at that time. That settlement price was $6.50 and we recorded $6.50 in our lease as our Assumed Base Price for corn. Therefore, “B” (Our Assumed Base Price for Corn) in the formula “A/B” is $6.50.

We also agreed that “A” would be the “Actual Base Price” (also known as the “Expected Price”) for Corn for GRIP crop insurance purposes. In early March, USDA’s Risk Management Agency calculated this price which was based on the average price of the December 2009 Corn Futures Contract during the month of February 2009. This price, $7.15, was published on the Risk Management Agency’s Website in early March. You can verify this price ($7.15 – “A” in our formula) by visiting the RMA website. The specific Internet address is [insert correct Web address for 2009 price – FYI, the 2008 price was available at http://www.rma.usda.gov/bulletins/rd/2008/08-012.pdf].

With this background, it is now apparent why the enclosed check is for $7000:

- We agreed that $20,000 would be our Base Cash Rent for 2009.
- We also agreed that Actual Cash Rent would be the Base Rent of $20,000 multiplied by our “Variable Cash Rent Indexing Factor”, A/B
- As described in preceding paragraphs, A is $7.15 and B is $6.50, so the “Variable Cash Rent Indexing Factor” = $7.15/$6.50 = 1.10
- Actual Cash Rent = $22,000 ($20,000 x 1.10)
- Since I made a $15,000 rent payment on March 1, the balance that I owe is $7,000 (i.e., $22,000 minus $15,000 already paid)

One advantage of this variable cash rent approach is that we could sign our lease much earlier than if we had waited until March 1 because of uncertainty about how much grain prices might rise or fall between October and March. I think being able to sign the lease earlier rather than later because the rent automatically “flexes” for changes in price is good for both of us. From my standpoint, for example, I was better positioned to do necessary field work in the fall, and to order in a timely manner the seed and fertilizer used on your farm – all because we signed the lease in October rather than March.

I look forward to working with you in the coming year.

Yours truly,
Farm Operator
Summary

This article describes a Variable Cash Rent Lease in which a Base Cash Rent is negotiated based on expected corn yields and the current price for the new-crop corn futures contract. The Actual Cash Rent will be the Base Cash Rent adjusted for changes in corn futures prices between the time the lease is negotiated (this price is available from the farmdoc Website – www.farmdoc.uiuc.edu, for example – and should be stated in the lease when signed) and about March 1 (this price is reported on USDA’s Risk Management Agency (RMA) Website).

Appendix A contains possible language for the lease – language explaining how to determine this Actual Cash Rent. The preceding section of the article also contained a sample end-of-year letter from Operator explaining how the Actual Cash Rent in our example was calculated.

The principal advantage of this variable cash rent lease is that it allows a landowner and farm operator to negotiate the lease much earlier in the fall because the rent automatically adjusts for changes in futures prices. Another advantage is that the needed price data is readily available via the Internet.

Although the operator and owner share price risk in this variable cash rent lease, the operator continues to bear all the yield risk and the risk of higher than anticipated input costs like fuel and fertilizer. If the parties had used a crop share lease, rather than this variable cash rent lease, all three risks – price variability, yield variability, and input cost variability – would have been shared by both operator and owner.

Many other approaches to a variable cash rent lease are possible. For example, the rent also could be adjusted for changes in the county yield (this data probably would not be available from USDA’s Risk Management Agency until well into the new calendar year following harvest) or actual farm yields (but this may adversely affect how farm program payments are paid).

The adjustment in rent also could take into account changes in commodity prices occurring during the growing season (although under this approach, the rent probably could not be “set” until about December 1 of the crop year). The rent also could flex based on changes in prices or yields of more than one commodity.

In this article, the authors have chosen to illustrate the variable cash rent concept with a relatively simple approach – rent is adjusted for changes in the futures price of corn, only, occurring between the time the lease is signed and the about March 1.

In the authors’ opinion, all leases for Illinois farmland should be in writing as a general rule, but having a written lease is even more important when the lease is a variable cash rent lease. Just imagine the difficulty of explaining why the final rent payment is a certain amount without being able to refer back to the written lease and its description of how the Actual Cash Rent is to be determined.

Legal counsel can be very helpful in identifying important issues, negotiating the lease, and adapting the terms to the client’s needs. It is generally a good idea to seek legal counsel in negotiating a lease for farmland. It is even more important to do so, in the authors’ opinion, when the lease is a variable cash rent lease.

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Appendix A – Describing How the Variable Cash Rent Is Determined
(This or similar language could be inserted directly into the lease or included as an appendix to the lease – see back of Appendix A for instructions/comments – legal counsel is recommended – actual numbers appearing in the blanks below correspond to the Example previously described)

**AMOUNT OF ACTUAL CASH RENT AND MANNER OF PAYMENT**

**Amount of Actual Cash Rent**

**ACTUAL CASH RENT is:**
The Base Cash Rent multiplied by the Variable Cash Rent Indexing Factor, each as described below, subject to the minimum and maximum limitations also described below.

**BASE CASH RENT:** The Base Cash Rent is $20,000 ($200/acre x 100 acres)

The Base Cash Rent assumes that the Base Price* for corn, also known as the “Expected Price”*, in the crop year(s) covered by this lease, is $6.50 per bushel.

*The actual Base Price will be determined by USDA’s Risk Management Agency for purposes of GRIP crop insurance (USDA calculates and publishes Base Price, also known as “Expected Price”, in early March based on the average trading price on the Chicago Board of Trade of the December Corn Futures Contract during the month of February). The best predictor of the Base Price for corn will be the most recent trades on the Chicago Board of Trade of this futures contract.

**VARIABLE CASH RENT INDEXING FACTOR:** Variable Cash Rent Indexing Factor = A/B, where …
A = Actual Base Price (a/k/a “Expected Price”) for Corn for GRIP crop insurance, and
B = Assumed Base Price for Corn (i.e., the price inserted into the blank above)

[For example, if A = $7.10 and B = $6.50, then the indexing factor, A/B, is $7.10 / $6.50 = 1.10. Note that the Indexing Factor could be greater or less than 1.00, depending on whether corn futures prices rise or fall after the lease is negotiated.]

**MINIMUM AND MAXIMUM LIMITATIONS** (insert if applicable): Actual Cash Rent shall be …
not less than $15,000 ( $150/acre x 100 acres), and
not more than $30,000 ( $300/acre x 100 acres).

**Timing of Rent Payments and Manner of Payment**

The first $15,000 of the Actual Cash Rent will be paid on or before March 1, 2009.
The balance, if any, shall be paid on or before December 1, 2009 of the lease year.

[† Assumed to have been agreed to in the Example, even though not expressly stated.]
Instructions/comments regarding the Variable Cash Rent Lease Form
(this particular lease flexes for changes in the price of corn, only)

1. Landowners and farm operators should seek legal counsel concerning a farm lease, as a
general rule. Legal counsel is even more important for a variable cash rent lease.

2. The key language in a Variable Cash Lease is the description of how to calculate the variable cash
rent. Otherwise, the Variable Cash Lease is similar to the traditional “fixed” Cash Lease. Potential
language for the other sections of the Variable Cash Lease can be found at
http://www.farmdoc.uiuc.edu/legal/articles/MSWord/CashLeaseDLU01-0911.doc

3. Determining Base Cash Rent: Operator and Owner should agree on a base cash rent for the farm,
based on their expectations of yields and prices for the new crop and other important factors such as
the productivity of the farm, its proximity to cash markets, input costs expected by the operator,
property taxes to be paid by the owner, and the local “rental market” for leased farmland. Insert into
the form the total Base Cash Rent, the Base Cash Rent per acre, and the number of acres covered by
the Base Cash Rent.

4. Documenting the assumed Base Price of Corn (New-Crop December Futures Price) when the Lease is
Negotiated: The base cash rent will be adjusted upward or downward by a “variable cash rent index”
determined by changes in the futures price for “new crop” corn occurring after the lease is negotiated
but before planting. Operator and Owner should record the assumed “Base Price” for corn by
inserting the price per bushel for the most recent trades on the Chicago Board of Trade of New-Crop
December Futures Contracts for corn. [Go to farmdoc home page (http://www.farmdoc.uiuc.edu/),
click on “Futures and Options Contracts”, and select futures contracts for corn. Choose the December
contract for the applicable crop year and select the settlement price on or nearest the day the lease is
signed. Record the number in the lease. It will be needed later when Actual Cash Rent is calculated.]

5. Minimum and Maximum Limitations: If the owner and operator wish to set a floor and/or a
ceiling on the amount of rent to be paid, regardless of adjustments the variable cash rent
index might otherwise require, insert such minimum and maximum limitations. If no such
limitations are desired, insert N/A (Non Applicable) into the blanks.

6. Document the Timing Manner of Rent Payments: Complete as appropriate. Normally, any
“up-front” rent payment would not exceed any “minimum” payment limitation.

7. Determining the Variable Cash Rent Index and the Annual Cash Rent: The Annual Cash
Rent is the Base Cash Rent multiplied by the Variable Cash Rent Index. The index is the
“All Actual Base Price for Corn for purposes of GRIP crop insurance” divided by the “Assumed
Base Price for Corn used in determining the Base Cash Rent”. If, for example, the Actual
Base Price, also know as the “Expected price”, for Corn (calculated by USDA’s Risk
Management Agency for GRIP Crop Insurance; based on the February trading of the new-
crop December Futures Contracts for corn; available in early March) was 110% of the
assumed base price used in determining Base Cash Rent, the Annual Cash Rent would be
1.10 x Base Cash Rent. [The Base Price for corn, also known as the Expected Price for corn,
is published on the Risk Management Agency Home Page (http://www.rma.usda.gov/) in
early March.]