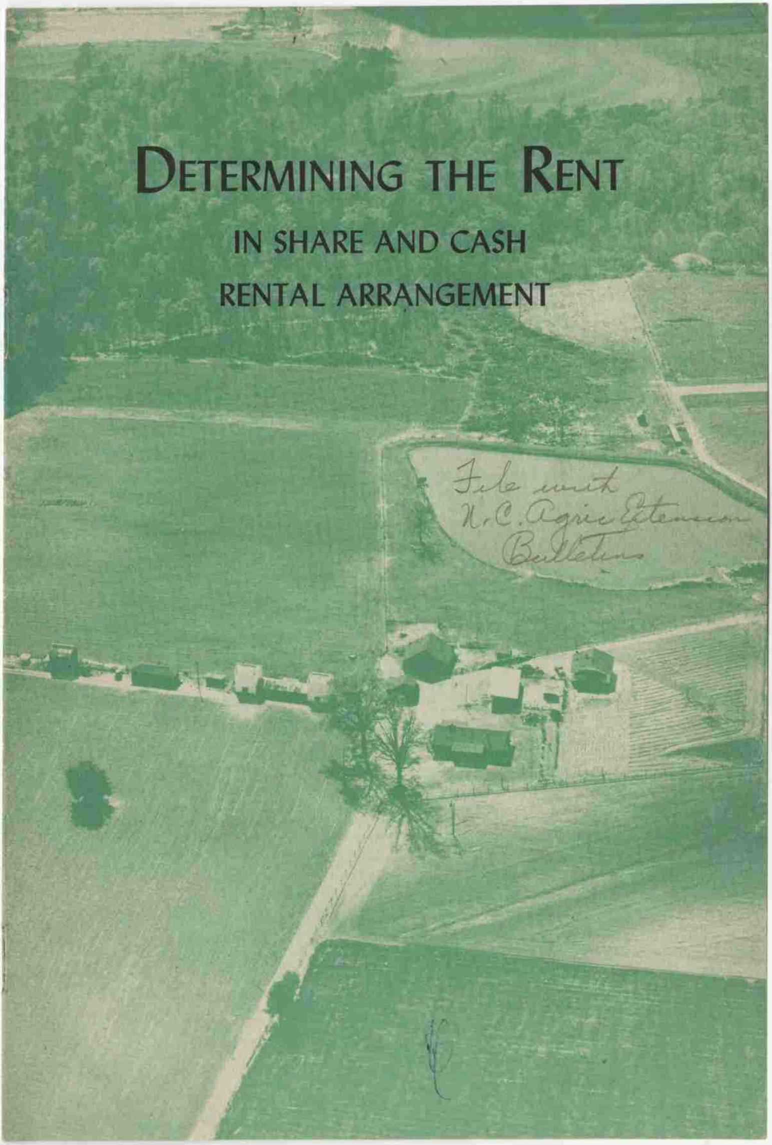
DETERMINING THE RENT

IN SHARE AND CASH RENTAL ARRANGEMENT



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PREFACE

This publication was developed by the Southern Farm Management Extension Committee in response to the many questions being raised by Southern farmers concerning rental contracts. It suggests methods of determining fair rental rates in share and cash leases.

A companion publication, "Rental Arrangements for Progressive Farming," suggests provisions in the rental contract to permit and encourage better farming by Southern farm operators.

This publication is based largely on unpublished research in rental arrangements, performed at North Carolina State College. The manuscript was written by C. B. Ratchford, who participated in the original research and checked the findings against results of other studies of rental arrangements. Mr. Ratchford is in charge of Extension Farm Management and Marketing work at North Carolina State College.

The responsibility for final development of this publication was assigned to a farm tenure subcommittee of the Southern Farm Management Extension Committee. The subcommittee was composed of M. C. Rochester of South Carolina, Chairman; W. L. Gibson, Jr., of Virginia; C. B. Ratchford; and E. P. Callahan of the Federal Extension Service Staff. In carrying out this assignment, the subcommittee had the benefit of many valuable suggestions from other members of the Committee.

It should not be overlooked that the arrangements under which this publication was developed were made through cooperation of the directors of the Extension Services of the Southern States, the Farm Foundation, and the Extension Service of the U. S. Department of Agriculture. The publication was approved and published jointly by the Extension Services of 12 Southern States.

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Southern Farm Management Extension Committee

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Determining the Rent in Share and Cash Rental Arrangements

by

C. B. Ratchford

What is a fair division of income when the tenant furnishes a tractor and equipment? What is the correct cash rent for an acre of improved pasture? Should the landlord pay for half the cotton picking and tobacco grading? These and similar questions are arising in the minds of landlords and tenants. Departures from traditional farming systems and farming methods are creating additional questions as to fair rental arrangements.

Having a "fair" rent is the primary concern of many landlords and tenants. While having a "fair" rent is important, too much emphasis is often placed on the subject. Research work in the South indicates that the major problem is securing more income to divide.

Consideration should be given to the total income as well as the share contributed and received by both the landlord and the tenant. For example, either party is better off receiving 40 per cent of a $10,000 income than 60 per cent of a $5,000 income, even though 40 per cent may be too small a share. The method of dividing income and costs may affect the size of the income to be divided. While the rent should be fair, the size of the income to be divided can not be ignored.

A method that will assist in arriving at a fair rent and at the same time increase the total farm income is presented in this circular. The data used to illustrate the method will probably not apply to any particular farm. In fact, the method can not be followed rigidly in determining the rent for a particular farm. Any particular rental arrangement is the result of local custom and practice and bargaining between the landlord and tenant.

Many landlords and tenants have adjusted aspects of their leases to the local situation. It is suggested that the good practices and customs be built upon and that adjustments be worked out for those that hamper the maximization of income on rented farms. The bargaining can not and should not be removed as an element in the determination of the division of receipts and expenses between the two parties.

Custom does not provide a reliable guide in determining rental rates when departures are made from traditional farming systems and rental arrangements. When radical changes are made in farming systems, landlords and tenants frequently feel that they do not have the information they need to satisfactorily determine a division of costs and returns. In such cases, a guide is needed to assist in arriving at rental rates that are mutually satisfactory. The methods presented in this circular will assist in arriving at satisfactory rental rates.[1]

Guide to Determine Proper Shares

To help the landlord and tenant in their bargaining, it is assumed that income is shared properly between a landlord and tenant when it is shared in the same proportion as costs. Costs include a charge for labor, management, equipment, land, livestock, buildings and improvements as well as cash costs such as fertilizer and insecticides.

The following steps should be followed in determining the share of income due each party:

(1) Place a value on the items for which the cost is not shared (land, labor, buildings, equipment, pasture and workstock in the example in Chart 1) and upon the items for which the cost is shared in fixed proportions (management in the example in Chart 1).

(2) Determine the total value of items mentioned in number (1).

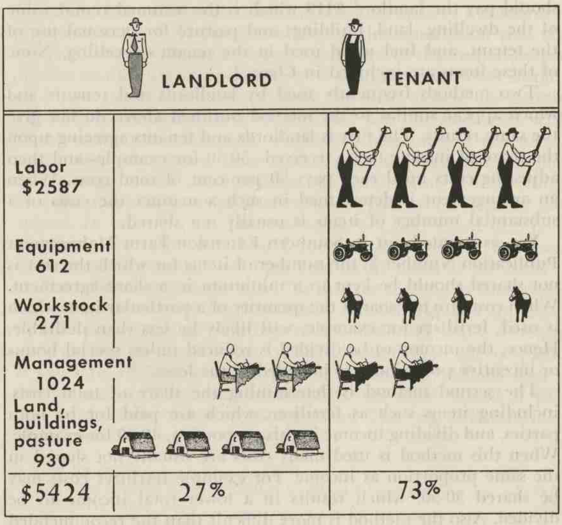
(3) Determine the share of the total cost of the listed items as computed from number (2) to be furnished by each party.

The proportions of the costs as computed in number (3) are the proper shares of income. They are also the proper share of cash cost items, such as fertilizer, to be paid by each party and the proper share of ownership of productive livestock owned jointly. The method keeps to a minimum the number of economic conflicts which tend to reduce total income. The lease must still include provisions for securing the optimum rate of application for the items for which the cost is not shared in the same proportion as income.

The following example will illustrate the method of determining the shares of income for each party. Suppose the landlord

[1] A study of the division of income and costs in actual rental arrangements may be helpful to both landlords and tenants. Information on the division of income and costs on some typical rental arrangements now in use in North Carolina will be available in the near future in a publication sponsored by the Southeastern Land Tenure Committee.

Chart 1: Assign Values to Certain Production Items*



furnishes cropland, permanent pasture, buildings and one-half of the management. The tenant supplies labor, equipment, workstock and one-half of the management. The total cost of these items and the share of costs furnished by the landlord and tenant are indicated in Chart 1.

As the landlord furnishes 27 per cent of the sum total of (a) items for which the cost is not shared such as labor, and (b) items for which the cost is shared in fixed proportions (management in this case), assuming income shared in the same proportion as costs, he should receive 27 per cent of the farm income. He should also own 27 per cent of productive livestock if livestock is produced on shares and pay 27 per cent of all other costs, such as fertilizer.

* Does not include value of land, buildings and other items used for personal use of tenant or landlord. The term "personal use" means that one party gets all the benefits. Examples include the residences of both parties, the tenant's garden, and pasture furnished the tenant for livestock owned in full by the tenant.

In addition to the 27 per cent of gross farm income, the tenant should pay the landlord $419 which is the assumed rental value of the dwelling, land, buildings and pasture for personal use of the tenant, and fuel wood used in the tenant's dwelling. None of these items are included in Chart 1.

Two methods frequently used by landlords and tenants and which appear similar to the method outlined above do not give the same results. The first is landlords and tenants agreeing upon the share of income to be received—50-50 for example—and then adjusting costs until each pays 50 per cent of total costs. When an arrangement is determined in such a manner the costs of a substantial number of items is usually not shared.

Yet, as pointed out in Southern Extension Farm Management Publication Number 3, the number of items for which the cost is not shared should be kept to a minimum in a share agreement. When costs are not shared the quantity of a particular item which is used, fertilizer for example, will likely be less than desirable. Hence, the income to be divided is reduced unless special bonus or incentive provisions are included in the lease.

The second method is determining the share of total costs, including items such as fertilizer, which are paid for by both parties, and dividing income in this proportion, 40-60 for example. When this method is used many costs are usually not shared in the same proportion as income. For example fertilizer costs may be shared 50-50, which results in a lower total income to be divided. Also the method is more difficult than the recommended method as a larger number of items must be included in the computations.

Guide to Determine Cash Rent

Cash rental arrangements usually provide for the landlord furnishing only land and buildings, a dwelling and other farm privileges for the tenant, and in some cases a small share of management. The farm is simply an investment from the standpoint of the landlord.

It is assumed that a "fair" cash rent should give the landlord a return on his investment equal to that which could be received if the farm was sold and the money invested in non-farm property.[2]

[2] In cash, as in share rental arrangements, the rent actually paid is the result of custom and bargaining between landlords and tenants as well as the actual earning power of the investment. This assumption is a useful guide, however, for landlords and tenants to use in checking a rental rate and to use when determining the rent for a new investment such as improved permanent pasture.

At the present time 5 to 6 per cent can be earned on farm mortgages which is a likely alternative investment open to a landlord if he sells the farm. Hence, according to the assumption that the landlord should receive a return equivalent to that which he can receive on alternative investments, he should receive a net income of 5 to 6 per cent on the value of the farm. There are certain expenses connected with a farm which are not associated with an investment in mortgages. These expenses include real estate taxes, depreciation on farm buildings and pasture, insurance, annual repairs on farm buildings, the rental value of a dwelling, and the value of farm products such as fuel wood used by the tenant. In order for the landlord to earn a net return of 5 or 6 per cent, the cash rent should include payment for the costs mentioned above plus 5 or 6 per cent of the value of the farm.

The following example will illustrate the method of computing cash rent. Assume that the farm has 55 acres of cropland appraised at $100 per acre, farm buildings valued at $3,195, and a dwelling with an annual rental value of $250. Included in the cropland is five acres of Ladino clover pasture which the landlord seeded and maintains. The tenant is furnished fuel wood valued at $35. The landlord furnishes no management. The rent is determined as follows:

Rent for land:	
50 acres land for crops at $100 = $5,500 at 5.1 per cent[3]	$225.00
Property taxes	59.00
	$314.00
Rent for buildings:	
$3,195 at 5.1 per cent	$162.95
Depreciation and annual repairs	279.00
Property taxes and insurance	49.75
	$491.70
Rent for 5 acres of improved pasture:	
Rent on land, depreciation and interest on cost of establishing improved pasture, plus maintenance costs	$133.20
Value of perquisites:	
Rent on dwelling	$250.00
Value of fuel wood	35.00
	$285.00
Total Rent	$1,223.90

[3] This is the interest rate prevailing in North Carolina on farm mortgages in 1949.

If the landlord supplies part of the management a charge should be included in the rent for the management. If the tenant furnishes labor or materials for the upkeep of the farm, this should be deducted from the total rent.

As the tenant ordinarily does not share in income from woodland, only the open land should be included when computing the value of the farm.

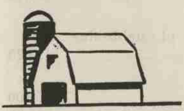
Computing Costs for Non-Cash Items

One of the difficulties in computing share or cash rentals is determining the proper charge for non-cash items, as computing the rent is simple once the costs are secured.

The principal of alternative costs is suggested as the method for computing all costs. This simply means the proper charge is that which can be earned in some other employment or investment. For example, the value of family labor is what this labor could earn if it was employed for wages off the particular farm.

The alternative cost method is based upon assumptions which may not prevail and for this reason may not provide an exact determination of values in an individual case. But the method certainly gives information which provides a basis for bargaining between the landlord and tenant.

1. LAND. The annual cost of land includes interest on the value and taxes. The appropriate value of land is the present sale value. An interest rate which may be used is that which is charged on farm mortgages in the community. The landlord should know the appropriate tax charge per acre. Another method for securing the annual charge for land which can be used in areas where cash rental arrangements are common is to use the rent usually charged for similar land.



2. BUILDINGS. The annual cost of buildings includes interest on the value, annual depreciation, normal repairs, taxes and insurance. The present value of buildings may be secured by determining the cost of constructing similar buildings at the present time and depreciating this value to account for age and the state of repair.

Depreciation is the decrease in value due to age and wear and tear. In computing depreciation estimate the number of years the building will last providing normal repairs are made. Then divide the estimated years of life into the value of the building. This gives annual depreciation. Normal repairs are difficult to compute as they usually are not made annually. It may be simpler to ignore annual repairs, and in estimating the life of a building for depreciation purposes, assume that there will be no repairs. This inflates depreciation in lieu of annual repairs.

Taxes and insurance should not be difficult to determine. Also the interest rate applicable to land is also applicable to buildings.

One caution must be observed in determining a charge for buildings. If there are excess buildings, a charge should not be placed on the excess as it does not contribute to production. For example if there are dairy barns which will not be used, a charge should not be included for the dairy buildings.

3. LABOR. The charge for labor depends upon the wage rate and the hours or days worked. An appropriate wage rate is the wages currently paid in the area. The amount of work may be determined (1) from a set of standard labor requirements for crop and livestock enterprises which are available from your agricultural college or county agent; or (2) by the actual number of days or months labor supplied by the tenant.

Difficulties may be encountered if the second method is used. This method would penalize the efficient laborer and benefit the inefficient laborer. For example, one laborer who does twice as much per day as another would be penalized.

4. EQUIPMENT. The cost of equipment includes interest on investment, depreciation, annual repairs, and operating costs such as fuel, oil and grease. The costs can be computed. Another possibility is to charge the custom rate for the various kinds of equipment. Data on the annual cost of operating tractors and equipment are available from some agricultural colleges and will be helpful in determining the cost of equipment. These costs were computed by the Experiment Station on the basis of records obtained from many farmers.

5. WORKSTOCK. The cost of workstock includes interest on the value of the animals, depreciation, feed, veterinary fees and the cost of harness. The annual cost of workstock has also been computed by several Experiment Stations in the South.

6. PERMANENT PASTURES. In most sections of the South, permanent pastures are expensive to build and last for a limited time. The cost of pasture includes interest and depreciation on the cost of establishing and rental value on the land before it was seeded to pasture. Unless annual maintenance costs such as fertilizer and clipping are shared, a charge should be included for these items. The following example will illustrate the method of computing annual cost. It is assumed that cost of establishing pasture is \$47 and the cost of fencing is \$20. The pasture will last five years and the fence 10 years. The pasture has been seeded two years.

Present value of pasture = \$47 – \$18.80 (two years depreciation) = \$28.20
Present value of fence = \$20 – \$4 (two years depreciation) = \$16
Present investment = \$28.20 plus \$16 = \$44.20

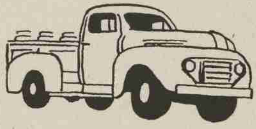
Interest on investment = \$44.20 at 6 per cent	\$ 2.65
Annual depreciation on pasture	9.40
Depreciation on fence	2.00
Rental value of land	6.29
Total Annual Charge	\$20.34

This example assumes that maintenance costs are shared.

7. MANAGEMENT. It is very difficult to determine the value of management, partially because of the wide variation in the quality of management. One way to arrive at a value is to estimate the cost of hiring someone to manage the farm. Professional farm managers usually charge about 10 per cent of the landlords share of gross income but they do not supply all management as the tenant is usually responsible for day to day management. Studies in North Carolina indicate that about 10 per cent of gross income is the average value of management.

8. DWELLING AND OTHER FARM PRODUCTS FURNISHED THE TENANT. The tenant is usually furnished a house, fuel wood, and a small amount of land for gardens and other personal uses. One way to determine the value of the dwelling is to estimate the amount of rent that could be earned if the house were rented to someone other than the tenant. The value and quantity of fuel wood used by a tenant is usually known. The method of computing the charge for land was given in number 1 above. If the house could not be rented for cash, the tenant should not be charged rent for the house.

9. TRANSPORTATION. A car and sometimes a truck are used in the farm business. The actual cost of the car or truck may be computed or a flat charge per mile may be made. It is not unusual for a car or truck to be driven three to 10 thousand miles per year for farm business.



See Southern Extension Farm Management publication Number 3 for information on leasing arrangements which help increase income on tenant operated farms.

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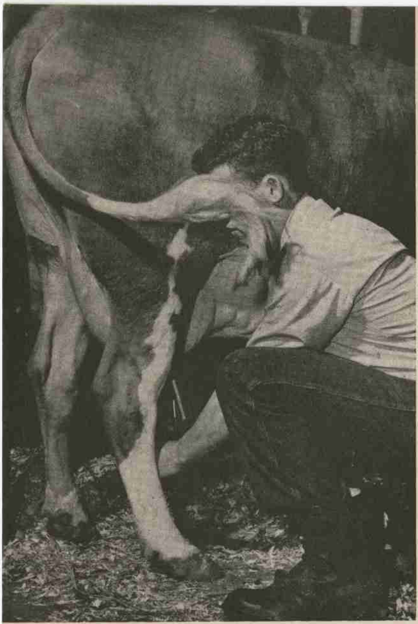

Do You Kick The Cow or Kill The Bugs

Fighting flies with the only weapon at her disposal, Bossy has no idea of the anger she provokes. Sure, you're tempted to hit 'er back, but would that do any good? No, if you want results, you get out the spray gun and go after the bugs.

And therein lies the secret of getting along with your landlord or your tenant. Owners gripe at their tenants for letting the farm run down, and tenants grumble about landlords who take too big a share of the crop. Actually the real culprits are often "the bugs" in farm leases.

Some of "the bugs" common in farm leases are:

(1) An oral agreement.

(2) A one year lease without automatic renewal provisions.

(3) An unfair rent.

(4) Provisions which prevent improvements on the land and in the home.

Other "bugs" and means of destroying them are included in this and companion publications.

The farm program in this publication offers just as much to the tenant farmer as to the owner. But to put these adjustments into effect, landlords and tenants must bring their leasing agreements up to date.

So before you take your spite out on your landlord or your tenant, be sure you've got all "the bugs" out of your leasing arrangement.