Financing the Farm

A law bulletin series on legal arrangements for farm financing

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Leasing Arrangements

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Leases play an important role in facilitating the agricultural economy. These legal agreements allow farmers to use land or equipment of another and provide an important source of revenue to those who own the land and equipment. This bulletin explains what a beginning farmer should understand before entering into a lease.

What is a lease?

A **lease** is an agreement by an owner of property to grant the right to use, possess, or control that property to another for a set period of time in exchange for a payment or other benefit. The owner of the property is the **lessor** and the leasing party is the **lessee**. When the lease involves real estate, we often call the lessor a **landlord** and the lessees the **tenant**. A valid lease gives both parties the legal right to enforce the other party's obligations under the lease in a court of law.

When do farmers use leases?

Land and equipment lease are among the most common leases in agriculture today. Retiring farmers and absentee landowners may choose to lease their land and equipment to a tenant farmer rather than to sell the property. The leasing arrangement can allow an existing operation to expand without having to purchase land and equipment. Farmers and landowners also utilize leasing arrangements to lease livestock and buildings to one another. Landowners typically develop resources like oil and gas and solar energy through a leasing arrangement, and many landowners benefit from leasing hunting and other recreational rights on farmland.

How does a lease work?

A lease is a contract that becomes enforceable when both parties agree to the terms of the agreement. The **terms** of a simple lease include names of the parties, identification of the property being leased, and the payment or benefit to be exchanged for the leasing rights. On the other hand, a lease can be complex and contain rights

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to assign payments to others, default damages, arbitration of dispute requirements, choice of law clauses, and other legal provisions.

A lease grants **limited rights** in the property rather than full ownership, and may impose restrictions on how the lessee uses the property. For example, an equipment lease may limit how much the lessee uses the equipment and charge additional fees if the lessee goes beyond the limit.

A lease lasts for a set period of time, known as the **lease term**, and often includes an option to renew and continue the lease. When a lease does not specify the lease term, state **default** rules apply. These default rules vary from state to state. Often, in the absence of a specified timeframe, the lease term may be established based upon when payments are due. An attorney in your state can help you determine the default lease terms in your state if your lease does not contain a specified lease term.

A lease is a **legally binding contract**. When you sign a lease, you are agreeing to the terms of the lease. A defense of "but I didn't read it" will not provide you with much protection. Note that the consumer protection laws that protect consumers in contracting situations don't apply to farm contracts like leases.

Understanding types of leases

The content of a leasing agreement varies based upon the type and subject matter of the lease. A farmland lease, for example, is much different than an oil and gas lease or a hunting lease. Even within the area of farmland leases, a lease can be structured as a cash lease, a share lease, or a flexible cash rent lease. It's important, then, to understand the type of lease necessary for a situation and the issues and needs for that type of leasing arrangement. There are many resources for farmers on farmland leases, grazing leases, building leases, equipment leases, livestock leases, oil and gas leases, wind and solar leases, and hunting and recreational leases. Be sure to research the specific issues related to the type of lease needed for your situation.

Leases should always be in writing

Because we value property rights in this country, states have enacted laws known as **statutes of frauds** that aim to prohibit fraudulent property claims. The laws won't enforce a contract for an interest in land, such as a lease, unless a signed, written agreement exists. This means that in most states, a lease of land must be in writing in order to be enforceable in court.

Even if the law doesn't require a certain type of lease to be in writing, such as an equipment lease, a written agreement can benefit both parties. A written lease provides **details and certainty**, so that each party knows its rights and obligations under the agreement. Putting a lease in writing allows the parties to have a clear vision of the leasing arrangement and what happens if something doesn't go as planned. Without a writing, the parties must rely on memory, develop solutions to problems they didn't predict, or take unresolved issues to court.

Hiring an **attorney** to draft or review a written lease can be well worth the expenditure. An experienced attorney will know what terms to include in the lease, points of negotiation, and laws that apply to the leasing arrangement. Likewise, involving an **accountant** can be beneficial to understanding the economic implications of a leasing situation.

Comparison to installment contracts for tax purposes

An installment contract results in a transfer of property ownership upon completion of the payment provisions. In contrast, a lease is an agreement to grant rights to use, control, or possess the property of another. There is no transfer of ownership.

How the IRS treats these two types of contracts presents an important tax distinction between installment contracts and leases. A lessor's income from each lease payment is treated as income in the year during which each lease payment is due. However, installment contracts for depreciable property such as equipment may result in the seller having to pay taxes for depreciation recapture in the first year. Even if the seller will not receive all payments in year one, recapture taxes are due.

Lease-to-own agreements

Somewhere between lease agreements and installment contracts are lease-to-own agreements. These contracts provide the lessee with the right to use, possess, or control the lessor's property for the duration of the lease term. At the end of the lease term, the lessee gains ownership of the property, whether automatically or for a fee. While these are leases, they have the same final result as an installment contract.

The taxation of lease-to-own agreements looks at two phases: the lease and the purchase. The lease phase is taxed just like a lease, and income is due in the year the lease payments are made. The purchase phase is then taxed like a purchase, except that when personal property is involved, the asset will have depreciated in value, which results in fewer capital gains taxes being due.

Most states impose **consumer protection** restrictions on lease-to-own agreements. Note that consumer protection laws often do not apply to business situations, however, and a lease-to-own agreement for a tractor used in a farm business will not likely fall under a state's consumer protection laws.

Other titles in this series

To continue to learn more about common legal documents for farm financing arrangements, see our law bulletins on *Mortgages, Promissory Notes, Installment Contracts* and *Secured Transactions.*

References and Resources

Ag Decision Maker: Whole Farm--Leasing, IOWA STATE UNIVERSITY EXTENSION AND OUTREACH, https://www.extension.iastate.edu/agdm/wdleasing.html.

Ag Lease 101, NORTH CENTRAL FARM MANAGEMENT EXTENSION COMMITTEE, https://aglease101.org/.

Farm Leasing Law Library, OHIO STATE UNIVERSITY EXTENSION, https://farmoffice.osu.edu/our-library/farm-leasing-law.

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Phillip L. Kunkel, Jeffrey A. Peterson, & Jason Thibodeaux, "Farm Leases," *Farm Legal Series*, UNIVERSITY OF MINNESOTA EXTENSION (June 2015) https://conservancy.umn.edu/bitstream/handle/11299/199831/farm-leases.pdf.