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Flexible cash leases and crop insurance proceeds

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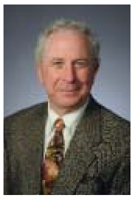

Flexible cash leases and crop insurance proceeds

by William Edwards, extension economist, 515-294-6161, wedwards@iastate.edu

Flexible cash leases have grown in popularity in Iowa. A 2007 survey showed that 12 percent of the state's cash rent agreements had provisions for adjusting the rental rate based on actual yields, prices and/or other factors. Recent volatility in corn and soybean prices has pushed that percentage even higher.

Most flexible leases start with some measure of gross crop revenue for calculating the actual rent each year. The rent may be equal to some fixed percent of the gross revenue, or a rent bonus may be calculated based on a percent of the amount by which the gross revenue exceeds a base level of revenue. In either case, the gross revenue is the product of the farm level actual yield (or county yield) and some measure of actual market price.

Crop insurance indemnity payments

The widespread production losses due to hot, dry weather in 2012 have raised the question of whether crop insurance indemnity payments also should be included in the gross crop revenue used to determine the cash rent. Landowners who are part of a flexible lease contract cannot purchase crop insurance directly because they do not have an interest in the crop; that is, they never actually own any of the grain. However, they can indirectly "insure" their rental payment by including indemnity payments received by the tenant in the gross revenue calculation.

The premiums paid by the tenant should be subtracted first, however. This is true even in years when no payments are received; that is, premiums should be subtracted from the gross revenue before the percentage is applied to calculate the rent or bonus. In this way, the landowner is indirectly paying for a share of the insurance coverage, which is supporting the gross revenue and rent each year.

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Handbook updates

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

Historic Cattle Prices – B2-12 (5 pages)

2011 Iowa Farm Costs and Returns – C1-10 (12 pages)

Farmland Value Survey (Realtors Land Institute) – C2-75 (2 pages)

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

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Extension and Outreach

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Example

For example, assume a farm planted to all corn has a flexible rent equal to 30 percent of the gross revenue each year. The tenant purchases a Revenue Protection policy with a 75 percent guarantee for a cost of $20 per acre. The farm's APH (proven) yield is 160 bushels per acre, so the guarantee is for 120 bushels per acre. However, the actual yield turns out to be only 100 bushels per acre this year, 20 bushels per acre below the guarantee. If the indemnity price turns out to be $7.50 per bushel (average of the December corn futures contract price during the month of October), then the indemnity payment will be 20 bushels x $7.50, or $150 per acre.

Subtracting the original premium of $20 would leave a net insurance payment of $130 per acre. Adding this to the gross revenue would increase the flexible rent by $130 x 30 percent, or $39 per acre, enough to offset the loss in "actual" revenue. If there had not been a crop loss, the gross revenue estimate would have been decreased by the value of the premium, $20 per acre, and the rent would decrease by 30 percent, or $6 per acre, as a result.

Some flexible lease contracts that call for a base rent plus a bonus set the base revenue value equal to the tenant's cost of production. If the crop insurance premiums are included in the cost of production value, then it would not be necessary to net them out of the gross revenue used to calculate the bonus—they have already been accounted for.

Other considerations

Indemnities and premiums for production insurance policies for hail, wind and fire losses can be handled in the same manner as multiple peril policies. If the acres included in the insurance unit include multiple rented or owned farms, it may be necessary to pro-rate the crop insurance proceeds among the farms, based on the size of the losses on each farm.

How to handle crop insurance premiums and payments should be discussed at the beginning of the lease period. If no consideration was given to including insurance indemnity payments in the 2012 lease, then the tenant would not be obligated to do so. However, some agreement should be reached about how to handle potential payments in the future.

Fairness in estate and business planning*

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Farm and ranch estate and business planning involves countless choices and numerous wrenching decisions but none that ranks with pursuing fairness between and among the heirs. In almost every situation where it is planned for the farm or ranch business to continue into the next generation, and it is contemplated that there will be both on-farm and off-farm heirs, the issue of fairness is paramount if one of the objectives of the parents is to assure harmony within the family after the deaths of the parents. The trend of family conflict has been clearly on the upward swing in such situations with all too many ending in bitterness if not in litigation. The observation is heard, all too frequently, ". . . had our parents known just how much conflict within the family their decisions would generate, they would have handled it differently."

If anything, the recent increases in farm and ranchland values have stoked the disagreements and led to more serious (and more formal) challenges to the plans left behind by the parents.

Relationship between the parents and the on-farm heir or heirs

The issue of fairness nearly always begins with the understandings over the sharing of income

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