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Iowa Farm Leases – Legal, Economic, and Tax Considerations

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Overview

There are numerous concepts associated with creating an effective lease for a farming operation. A good lease can be a useful tool, but a lease that is inadequate can cause uncertainty and create problems. Also, income tax, social security tax, estate and business planning as well as other economic issues are associated with farm leases.

Basic Principles

Leasing is of primary importance to agriculture, permitting farmers to operate larger farm businesses with the same amount of capital and assisting beginning farmers in establishing a farming business.[1] Farm leases are conveyances of a possessory interest in property for a specific length of time,[2] but are also contractual obligations which must meet the basic requirements of any contract: offer, acceptance, consideration, and capacity to enter a contract.[3]

- Offer--Party A indicates a willingness to enter into a bargain which leads Party B to believe that Party B's agreement to that bargain is invited and will conclude the bargain.
- Acceptance--Party B indicates agreement to the terms of the bargain in the manner invited or required by the offer.
- Consideration--A bargained for promise, performance, forbearance.
- Capacity--The ability to understand the nature and effects of one's acts. Those with mental illness or defect and minors may void contracts.

Should a Farm Lease Be in Writing?

Although many farms are leased under oral agreements in Iowa (and an oral farm lease that doesn't exceed one year is enforceable in Iowa) it is preferable to have a written lease. Rather than rely on the selective memories of both parties, a written lease provides a record of the exact terms and conditions agreed to by both the landlord and tenant. In this way, a written lease will clarify the issues if disputes arise between the landlord and tenant.

In Iowa, the statute of frauds requires leases of more than one year to be in writing.[4] This means that for farm leases that are longer than one year, an oral agreement is not valid. However, the principles of partial performance, detrimental reliance and promissory estoppel may be utilized, with the right set of facts, as exceptions to the statute of frauds.[5]

A Written Farm Lease – Basic Elements

Thus, for many reasons it is just good business for each party to protect their interests with a written lease. The important elements of an agricultural lease are:

1. An accurate description of the land;

   Note: An accurate legal description can be critical in determining rights to crop proceeds pursuant to security interests and landlord liens and can help avoid legal battles over boundary locations. A precise legal description can be obtained from the abstract of title to the

property. The owner should be able to obtain the abstract for the correct legal description of the farmland. Another method of identification that can be used to supplement the legal description is the farm number used by the USDA for federal farm programs.

2. The identity of the parties and their signatures;

   Note: Iowa law specifies that the person holding the leasehold interest must produce crops or provide for the care and feeding of livestock, including grazing or feeding of livestock on the land.[6] A lease should include a clear identification of the landlord and the tenant by name and address. It is also appropriate to identify the parties by their tax identification numbers (Social Security number for individuals and federal identification numbers for other entities) for the purpose of eligibility for farm program payments.

3. The length or term of the lease;

   Note: For most leases, the term will be at least one year. Farm leases usually begin on March 1 and end on the last day of February of the next year. Multiple-year leases may not exceed 20 years.[7] From an economic standpoint, a tenant may prefer a multiple-year lease if they must invest in long-term improvements. Such leases should be considered carefully by both parties because the lease is a contractual obligation to the undesirable provisions of the lease as well as the beneficial ones. Often, it is better to include an automatic renewal clause and a compensation clause as a means of mutual goal evaluation.

4. The kind and amount of rent and time and place of payment;

   Note: In many farm leases, it may be wise to include a provision that compensates the tenant for the unused portion of longer-term investments.

   Example: For example, the application of lime and other soil conditioners may be effective for a period of years. If the tenant applies and pays for the soil conditioner, the lease should provide for a method of calculating payment to the tenant for the unused portion of time the application remains effective.

   A written lease containing such a provision will prevent one party from reaping the benefit of the other party's long term investment without compensation.

5. Responsibility for building maintenance;

   Note: The tenant may want the lease to include a provision specifying that the tenant will be compensated for any improvements the tenant makes to the buildings.

6. Indemnification clause – liability for negligence;

   Note: Many leases contain an indemnification provision that states the tenant will compensate the landlord any loss resulting from the tenant's negligence (and vice versa). A written contract should give both parties an idea of who will be liable for any accidents which occur on the farm and specify who is responsible for maintaining insurance coverage.

7. Personal property remaining on the premises;

   Note: Iowa does not have any statutory provision concerning how to handle the tenant's personal property that is left behind after the lease terminates. Without a contract provision addressing the issue, the landlord does not have any duty to store or maintain a tenant's personal property, but a constructive bailment (not a true bailment) may be imposed. The landlord's duty of care under a constructive bailment is less than what would be required under an express bailment and requires only minimal care.[8]

8. Any special provisions concerning the rights and duties of the parties.

   It is a good practice to record written leases. After the lease is notarized, it can be recorded, for a fee. If the lease exceeds five years in duration with renewals, Iowa law requires that the lease be recorded.[9]

   Note: The full lease need not be recorded. Instead, recording a memorandum of the lease is sufficient to satisfy the statutory requirement. If a memo is recorded, the memo must contain: (1) the names and addresses of the parties to the lease; (2) a description of the real property subject to the lease and the interests of the parties in the real estate; (3) the initial term of the lease; (4) a statement concerning whether any party to the lease have or are subject to renewal rights and, if so, a specification of what triggers renewal and the number of renewal terms and their length.

   Failure to record these leases within 180 days is punishable by a fine not to exceed $100 per day for each day of violation.[10]

   The increased complexity of farm operations and the conflicts that arise regarding the way they should be operated demonstrates a real need for written farm leases.

   Note: While many farmers still prefer oral leases and are unwilling to use lawyers, the contracting parties should always consider what the consequences could be if a conflict arises in the future without a written memorial of their agreement.

Other Legal Issues

A good husbandry provision. A written farm lease will often contain a provision requiring the tenant to farm the land in a "good and husbandlike manner." If the tenant fails to do so, the lease typically allows the landlord to enter the property and properly care for the crops and land. "Good husbandry" is usually defined to include such things as, proper fertilization methods, tilling, weed control[11], control of soil erosion, manure application, and a general requirement that the tenant protect the property and its natural resources from harm or disposal. A landlord may be entitled to damages that can be proven as a result of the tenant's use of improper farming methods.

Note: Expert advice is available from Iowa State University Extension specialists for help in determining what constitutes proper farming practices.

But, in order to successfully sue for damages allegedly caused by the tenant's poor farming practices, the landlord may need to rely on a good husbandry provision in a written lease. While a tenant may have a general duty to use proper farming techniques, the landlord does not necessarily have an associated right to control and supervise the tenant's farming practices. So, a provision in a written lease detailing the specific farming practices the tenant is to utilize is the best way for a landlord to prevail on a lack of good husbandry claim.[12]

Note: Good husbandry is related to the issue of "waste." A tenant has a common law duty not to "waste" the leased premises – not cause permanent or substantial damage to the leased premises. Poor husbandry practices are a subset of waste.

However, simply having a good husbandry provision in a lease that a tenant breaches does not give the landlord the absolute right to terminate the lease and bring a forcible entry and detainer action, if necessary. A forcible entry and detainer action is an equitable remedy. Thus, the courts will typically require that the tenant be treated in a fair manner by, for example, requiring the landlord to give the tenant notice of the breach and a right to cure before the lease can be terminated.[13] A good example of this is the 2012 Iowa case, *Mart v. Mart*.[14] In this case, the tenant (who was also a co-owner) planted crops on the leased land in violation of federal farm program "Swampbuster" provisions which triggered a substantial penalty. The other co-owners were ultimately not penalized under the "landlord exception" for such violations. The written (and recorded) lease was for a 20-year term at a set cash rental rate. The non-farmer co-owners attempted to

terminate the lease 10 years into the 20-year term based on the tenant's alleged breach for tilling the designated wetlands in question. They brought a forcible entry and detainer action against the farmer co-owner. However, the trial court dismissed the petition. On appeal, the court agreed that the tenant had breached that part of the lease agreement. The court also determined that the tenant breached the part of the lease requiring the tenant to comply with conservation and environmental plans for the land. On the good husbandry provision of the lease, the court noted that a tenant that was utilizing good farming practices could still be in breach of a good husbandry clause in a written farm lease. Thus, the court concluded that while the tenant was utilizing farming practices that generally conformed to the principles of good husbandry, the tilling of designated wetlands without the landlord's approval was contrary to the principles of good husbandry. However, all of these breaches by the tenant did not mean that the landlords had an automatic right to terminate the lease. Instead, the court noted that the tenant had the right to cure the breaches. Under the facts of the case, the tenant had restored the wetland the following year, and the other co-owners already had been determined to not be in violation of the federal farm programs. As such, termination of the lease was not an appropriate equitable remedy.

Permanent improvements. If the tenant erects permanent improvements on the leased property, the general rule, absent language in a written lease to the contrary, is that the tenant is not entitled to remove the improvements at the end of the term of the lease. Permanent improvements include permanent buildings, soil conservation terraces, and improvements to existing structures. In addition, the tenant is generally not entitled to compensation for the value of permanent improvements the tenant places on the property, or the value the tenant adds to existing structures. However, a tenant may remove items that the tenant adds to the property which are not considered to be part of the real estate – such as portable buildings and feeders.

Environmental issues. It may be a good idea to include an environmental-related provision in a farm lease. Such a provision, for example, could include language specifying that: (1) the landlord assures the tenant there are no environmental problems; and (2) the tenant will comply with all applicable environmental laws. In most instances, the tenant will be liable for violation of environmental laws (state and federal) and environmental contamination that occurs during the tenancy. In some instances, however, a landlord could also be held liable.

Aboveground plants. In its 2010 session, the Iowa legislature passed and the Governor signed into law HF 2380. The new law, codified at Iowa Code §562.5A, specifies that a farm tenant may take any part of the aboveground plant associated with a crop, at the time of harvest or after harvest, until the farm tenancy is terminated in accordance with Iowa law. Of course, the parties can specify differently in a written lease.

The landlord's lien and security interests. Under Iowa law a landlord can obtain a statutory lien (claim against the tenant's property), for the payment of rent, upon all crops grown upon the leased premises as well as the tenant's other non-exempt personal property which is either used or kept on the leased premises during the term of the lease. [15] The lien is applicable whether the lease is a cash rent lease or a crop-share lease, and applies also to any proceeds of the crop the tenant harvests.[16] Exempt property includes: specific personal property, life insurance, social security, disability, pension, alimony and veteran's benefits.

Note: If a tenant has more than one lease with a landlord, the landlord may not attach crops from one lease to satisfy a default on rent involving another lease.

Under current law, a landlord's lien is subject to treatment as an "agricultural lien." That means a landlord's lien, to be perfected, must be filed using a financing statement.[17] That's the same document used by a lender to handle a new secured loan. To be effective, the financing statement must be filed when the tenant takes possession of the leased premises or within 20 days after the tenant takes possession.[18] In addition, the financing statement must include a statement that it is filed for the purpose of perfecting a landlord's lien. Once a landlord's lien in farm products is perfected, it has priority over a prior perfected security interest.[19]

Note: A purchaser of a farm takes subject to any existing lease, but if the tenant has been in possession for more than 20 days the new owner (as landlord) would take subject to any previously perfected security interests.

But, if the new owner files a financing statement, such filing would be sufficient against subsequent lien creditors. Also if the new owner terminates the lease and enters into a new lease, the landlord could get priority over previously filed security interests as for next year's crop if filing is made within 20 days of the tenant taking possession.

Lien by contract. A landlord's lien can also be created by a language in a written farm lease. Such a provision can create a contractual lien against the lessee's exempt property that is not subject to the statutory lien. But, for a contractual lien to be valid against third parties, (e.g., subsequent purchasers and existing creditors), the lease must be recorded.

Security interests. In some instances, a landlord may want to take the steps necessary to perfect a security interest in the tenant's crops and/or livestock. Lenders and other creditors file security interests in farm products to ensure payment of debts. From the landlord's perspective, however, a security interest may provide greater protection than a landlord's lien, especially if the tenant files bankruptcy.

Note: A landlord's lien can be defeated (i.e., goes to the bottom of the list of priorities in the tenant's bankruptcy estate) if the tenant files bankruptcy. Thus, it may be prudent for the landlord to take the necessary steps to gain a security interest in the tenant's crops and/or livestock. That can be accomplished by the landlord making a separate filing to become a secured creditor.

Additional protection. For landlords that are concerned about the tenant defaulting on the rent payment, the following suggestions may provide additional protection in addition to those items mentioned above:

- Require the rent to be paid at the beginning of the lease period. If all of the rent is to be paid up front, the rental rate is normally reduced to account for the additional interest accrued due to the early payment;
- Use of an irrevocable letter of credit, issued by the lender on behalf of the tenant, for insuring the payment of rent;
- Have the landlord's name included as the payee on the check for grain and/or livestock. As such, the landlord will be required to sign the check before it can be negotiated.

Do changes to the lease have to be in writing? While it is possible to orally modify a written lease agreement, it's always best to make subsequent changes to a written lease in writing. This leaves little doubt, in the future, about the actual terms of the lease and can help to avoid litigation on the issue.

Does a crop-share lease form a partnership between owner and operator? The Iowa Supreme Court has found that, in the absence of evidence indicating otherwise, a traditional farm lease does not constitute a partnership.[20] This is important point. If there is not a partnership, the parties cannot be held liable for the other's debts under the theory of joint and several liability. The elements of a partnership are (1) intent by the parties to associate as partners, (2) a business, (3) earning of profits, and (4) co-ownership of profits, property and control.[21] Most boilerplate lease forms contain a provision stating there is no intention to make a partnership. That keeps the landlord/tenant relationship clear to the parties.

What other provisions should be included? The parties should add in writing any additional agreements related to the lease, and should tailor the standard form lease to cover individual requirements for their particular situation. Additional provisions should be included in the space provided at the end of the lease or in attached exhibits that are incorporated into the lease by reference.

In all situations, it is important for both the landlord and the tenant to read and understand the terms of the lease before signing. Consultation with an attorney before executing the lease may be necessary in some instances.

Easements

If a third party has an easement interest in the property that is being leased, it is important for the

parties to understand the third party's rights and not interfere with them. Certainly, any easement rights should be clearly detailed in the lease agreement.

Most easements are affirmative easements which entitle another party to limited use or enjoyment of the land upon which the easement exists.[22] A common example is the right to use a roadway across another's land. Less common are negative easements, which entitle the owner of the easement to prevent a landowner or tenant from making certain uses of the land. An example might be a negative easement owned by a neighbor which restricts the height of structures built on the farm.

Either the tenant or the landlord could be subject to litigation if a third party's easement rights are interfered with.

Liability for Injuries on the Leased Premises

In general, the tenant is responsible for injuries that occur to others on the premises or as a result of items that the tenant controls (such as livestock that escape an enclosure and cause injury). It is the tenant's responsibility to maintain the leased premises in a reasonably safe condition. The landlord is generally not liable to either the tenant or third parties for injuries that occur on the leased premises. However, a landlord may be liable if injury results due to an undisclosed danger known to the landlord but not disclosed to the tenant. Also, the landlord is responsible for dangerous conditions to persons not on the leased premises, such as a low-hanging tree branch across a public road. In addition, if the landlord retains control over a part of the premises and injury results on that part, the landlord is responsible. Likewise, if the premises are leased for the public's admission, or the landlord agrees to repair a defect on the premises and either fails to do so and injury results or the repair is made negligently resulting in injury, the landlord is liable.

Another exception to the general rule of landlord non-liability for a tenant's acts is if the landlord knows that the tenant is harming the property rights of adjacent landowners (*e.g.*, via the creation of a nuisance) and does nothing to modify the tenant's conduct or terminate the lease.[23] In that situation, the landlord can be held liable along with the tenant.[24]

In general, a licensee or invitee of the tenant has no greater claim against the landlord than does the tenant. Thus, a landlord's duty to not wantonly or willfully injure a trespasser is usually passed to the tenant who has control of the property. However, a landlord can be held liable where the landlord knew of defects that were likely to injure known trespassers.

A landlord is also usually not held responsible for injuries occurring on the leased premises caused by animals that belong to the tenant.

Termination of Farm Leases

A lease can be terminated either by mutual agreement of the parties (whether via a written lease or oral agreement) or in accordance with the statutory provision for the service of notice, which required written notice to be delivered on or before September 1 to terminate the tenancy on March 1.[25] Under Iowa law, if the lease is not terminated by either of these methods, and involves an acreage of 40 acres or more, the lease automatically renews for another year on the same terms and conditions as the original lease.[26]

Note: Under the statutory definition, it is unclear whether an oral farm tenancy for an acreage under 40 acres can be terminated before March 1.[27] If not, such tenancies cannot be terminated with a mere 30 days' notice. But since such tenancies are expressly exempt from the statutory termination notice deadline,[28] it would appear that they can be terminated effective March 1 by notice given between the prior September 1 and the end of January without an automatic renewal being triggered.

The required notice. The lease may contain provisions outlining the procedure for termination of the lease. If no such specification is included in the lease agreement, the lease must be terminated according to the provisions of Iowa law. Even if a written lease provides for waiver of termination notice, notice must still be served on the other party (or the party's successor) on or before September 1.[29] If notice is served, the lease terminates the following March 1.[30]

Note: If it is mutually acceptable to all parties concerned, after formation of a lease, a

lease can be terminated or modified at any time.[31] However, if the parties mutually agree to terminate the lease, the statutory procedure for lease termination must still be followed.

Written notice may be given as follows:[32]

- By delivery of the notice on or before September 1, with acceptance of the service to be signed by the party to the lease or a successor of the party receiving the notice.

- By serving the notice, on or before September 1, personally, or if personal service has been tried and cannot be achieved, by publication, on the same conditions and in the same manner as is provided for the service of original notices, except that when the notice is served by publication no affidavit is required. Service by publication is completed on the day of the last publication.

- By mailing the notice before September 1 by certified mail. Notice served by certified mail is made and completed when the notice is enclosed in a sealed envelope, with the proper postage on the envelope, addressed to the party or a successor of the party at the last known mailing address and deposited in a mail receptacle provided by the United States postal service.

Procedures for removing the tenant. If a farm lease has been properly terminated and the tenant does not vacate the farm by March 1 of the following year, what can the landlord do?

- **Forfeiture.** Initially, if a written lease exists, the terms of the lease should be examined. Is forfeiture allowed? If forfeiture is allowed, it may occur either immediately or at some point in the future. But, if the tenant has substantially complied with the lease, forfeiture may be avoided – "equity abhors a forfeiture."[33] However, if the tenant pays rent after forfeiture has occurred, the forfeiture is not thereby negated.[34] Whether the landlord can collect for rent paid that is for a time period *after* the forfeiture depends on the terms of the lease. If the lease specifies for acceleration of rent upon default, the acceleration clause is enforceable if it results in reasonable damages to the landlord.[35] In any event, forfeiture must be conducted in the manner specified in the lease – there is no statutory procedure.[36]

- **Forcible entry and detainer.** If a farm lease has been properly terminated and the tenant does not vacate the farm by March 1 of the following year, the landlord may utilize the Iowa statutory forcible entry and detainer procedure.[37] Also, a forcible entry and detainer action is also available if the tenant does not pay rent when due, but notice to terminate has not been given. But, before such an action can be brought, three days written notice must be given to the tenant.

  Note: A forcible entry and detainer action can be held in small claims court.[38] The hearing on the matter is to be held within seven days from the date of the order and personal service on the defendant must occur at least three days before the hearing. If personal service cannot be completed after at least two attempts, the original notice can be posted on the real estate at least three days before the hearing. The two attempts to serve process can occur on the same day.[39]

- **Foreclosure sale.** A foreclosure action involving farmland that is subject to a lease can raise interesting legal issues. For example, in an 1889 Iowa Supreme Court case (that is still good law),[40] a party bought farmland at a foreclosure sale that had growing (matured) crops on the land at the time the sheriff's deed was executed. The court held that the tenant was entitled to the crop. The court indicated that the issue turned on whether the crop still required nuture from the soil at the time the sheriff's deed was executed. On that point, the evidence showed that the crop was mature at the time the deed was executed. Thus, the crop was the tenant's property and title did not pass to the buyer. The case supports the argument that a tenancy does not terminate upon foreclosure and sale. The court did not refer to the doctrine of emblements for their decision - which would indicate the tenancy

is over with the issue becoming which party is entitled to a growing crop at the time the tenancy ends. Also, the general and well-recognized rule is that the buyer of property takes subject to an existing lease and must follow state law to terminate the tenancy.

Procedures for removing the tenant's property. If the tenant leaves the premises after the lease has ended, but leaves personal property behind, certain statutory procedures apply for removing the abandoned property. Under Iowa Code §555B.2, the landlord can store the property if notice is given to the county sheriff. The sheriff, upon the landlord's request, is to notify the property owner personally (if the property owner can be determined) or by publication in a newspaper of general circulation in the county where the property was abandoned (if the property cannot be determined). Once notice is provided, the property owner has six months to claim the property or the property will be sold at public auction. If the property is reclaimed, the owner must pay for any storage costs and other costs the landlord incurs with respect to removing and storing the property. If the property is sold at auction, the costs of sale are paid from the sale proceeds along with any lien on the property with the balance paid to the county treasurer. A good faith buyer of the property takes the property free of any interests in the property.

As an alternative to utilizing the sheriff, the landlord can bring an abandonment action in the district court in the county where the leased premises is located.[41] This provision applies only if there is no lien on the personal property (except for a tax lien). The action is an equitable action, and once the petition is filed, a hearing is to be held within two weeks. If a judgment of abandonment is entered, the landlord is also entitled to any monetary damages that may apply.

Agricultural Leases as Personal Services Contracts

Another issue that can arise under an oral agricultural lease involves the question of what happens when either the tenant or landlord dies during the lease term. If the landlord dies, the outcome is fairly straightforward. The landlord's heirs assume the responsibilities that the decedent had before death. If the lease is to be terminated, the heirs will have to follow the statutory notice of termination rules. Indeed, Iowa law specifies that when a landlord dies, the estate's executor takes possession of the real estate[42] and must follow the termination statutes to terminate the tenancy.[43]

If the tenant dies, however, the outcome may be different. Some courts hold that the lease is a contract for services to be performed by the tenant and no one else. Upon the tenant's death, these courts hold that the oral contract ends and no statutory notice of termination is required.[44] However, the Iowa Supreme Court ruled in 1970 that a farm lease creates an interest *in the real estate* in the tenant.[45] While the court noted that Iowa common law generally regards a farm lease as a personal services contract, the court determined that the common law rule was "materially restricted" by the statutory notice of termination provisions. Under the facts of the case, the tenant had an oral lease with the landlord and in the fall of 1968 planted 20 acres to wheat for harvest in 1969. The tenant died on November 27, 1968, after the deadline for receiving statutory notice of termination (which, at the time, was Nov. 1). The court held that the landlord's failure to give the statutory notice extended the "existing leasehold rights" that the decedent held lease through the 1969 crop year (terminable on March 1, 1970). Thus, according to the court, when the tenant died, those rights vested in his estate.

Note: The Iowa Supreme Court's reasoning is questionable. A lease creates merely a possessory interest in the tenant. It does not create any type of ownership interest. In addition, the tenant's death constitutes a surrender of the possessory interest and, thereby, a surrender of the leasehold. What the tenant's heirs succeed to are the rights that the tenant had in the wheat crop under the lease, not the right to continue to occupy the premises until receiving statutory notice of termination.

Exceptions to statutory notice. Iowa law distinguishes between "croppers" and "tenants." A person is a "cropper" and not a tenant if the landowner supplies the land and the inputs, controls the operation of the farm and pays a portion of the crop to the person raising and harvesting the crop. In that situation, the farmer has no legally enforceable interest in the crop or land involved,

only has a contract right for compensation in-kind for their labor, and is basically an employee of the landowner (i.e., a wage earner) that is hired to produce a crop.[46] Therefore, because a cropper does not have any property right in the leased premises, the cropper is not entitled to statutory notice of termination[47] - there is no interest to be terminated. Instead, a cropper's "lease" terminates upon harvest of the crop. However, farmers with crop-share leases are tenants – they are not croppers, and the statutory notice of termination requirement applies.[48]

Note: Historically, the statutory notice requirement did not apply to pasture leases. But, that is no longer the rule. Iowa law now defines "farm tenancy" as a leasehold interest in land held by a person who produces crops or provides for the care and feeding of livestock on the land, including by grazing or supplying feed to the livestock.[49]

Another exception from the statutory termination notice requirement is for leases involving less than 40 acres.[50]

These exceptions may be overcome by incorporating a notice requirement into a written lease. Iowa courts also recognize certain legal doctrines which may make notice unnecessary. These doctrines include: (1) agreement; (2) waiver and estoppel; and (3) abandonment and surrender. These doctrines are based on the conduct of the parties.

A landlord can also terminate a lease without giving the statutorily required notice if the tenant breaches the lease – such as for non-payment of rent.[51] Courts require the breach must be positively established. So, it's a good idea for the landlord to notify the tenant of the conduct that is considered a breach, and the landlord's intent to terminate the lease. This may prevent the default termination from looking like an excuse for missing the notice date.

When should termination notice be given? Because there may be uncertainty as to a tenant's ability to continue to rent ground because of financial problems, a landlord may want to give notice of termination every year. This will avoid being locked into another year with a questionable tenant. A landlord will then be free to lease to another party or enter into a lease with the current tenant once that tenant can assure the landlord that rents will be paid.

Annual termination may also be advisable when land values are changing rapidly. Cancellation and renegotiation of a new lease with an updated rental amount to reflect current rental values may help the landlord (and/or the tenant) manage risk.

What is the landlord's right of entry and inspection? The lease may have a provision allowing the landlord (or someone else) to enter the property after termination of the lease to conduct tilling or fertilization after harvest. The landlord may do this even if the date of entry is prior to the termination of the lease. The landlord may also enter the property at any reasonable time for the purpose of viewing, seeding, preservation of crops, making repairs or for other reasonable purposes.

General Concerns – Economics and Risk Allocation

What is the difference between a cash lease and a crop-share lease? The primary distinction between a crop-share or cash lease involves how the lease allocates risk between the parties. On that point, here are the major concepts to keep in mind:

1. Cash rent leases allow a farm tenant to pay a specific amount of money for the use of part or all of the described farmland. Cash rent leases will vary in the amount of cash rent per acre and will also vary in the due date for payment of the rent. The tenant may pay a slightly lower rent per acre in exchange for payment of all of the cash rent up front. Typically, the risk is balanced between the parties by having the lease payments paid in installments, one installment in the spring and one or more at harvest. It will benefit both parties to have the times for payment set out in writing so there will be no conflict about when payment is due.

2. Crop-share leases allow the farm tenant to pay shares of the crop as rent. Crop-share leases and cash rent leases can also be combined to utilize both methods of payment. Crop share leases should allow the owner and the tenant/operator to share in the total farm profits in the same proportion as they contribute resources.[52] This

principle implies that if a landowner contributes 50 percent of total resources and the tenant contributes 50 percent, then profits should be shared 50/50. Typically, the allocation of government program payments is similar to the allocation of the crop profit and crop input expenses.[53] Due to the fact that the government program payments are often a significant portion of the total return from the farm operation, the lease should determine the agreement of the parties regarding the participation in government programs. Resources and profits are not always shared 50/50. This could be due to high land values or low tenant inputs and costs resulting from practices like minimum tillage and other input differences.

When should a crop-share lease be considered? While most farm leases in Iowa are cash leases, there are situations that merit at least a consideration of the utilization of a crop-share lease. The parties should consider the relative advantages and disadvantages of a crop-share lease before executing such an agreement.

Advantages of crop-share agreements:

1. Less operating capital may be tied up by the tenant due to the landowner sharing costs compared to cash rents.
2. Management may be shared between an experienced landowner and tenant, resulting in more effective decisions.
3. Allows an inexperienced landlord or tenant to take advantage of the experience of an established landlord or tenant.
4. Sales of crops may be timed for tax management and purchased inputs may be timed to shift expenses for tax purposes. This is also true to some extent with cash rent leases.
5. Risks due to low yields and/or crop prices are shared between the two parties as well as the profits from high yields or prices.

Disadvantages of crop-share agreements:

1. Landowner income will be variable because of yield and price variation as well as changes in shared input production costs.
2. Accounting for shared expenses must be maintained.
3. Marketing decisions must be made by landowner.
4. The need for tenant and landowner to discuss annual cropping practices and become involved in management on a continuing basis.
5. The lease may need to be reviewed and changed on a yearly basis because of market fluctuations and so on.

How should the crop be shared between the landowner and tenant? The crop should be shared on a percentage basis in a manner that recognizes the inputs (capital, labor, etc.) contributed by each respective party. The landlord's return is based on the land value, real estate taxes and insurance costs. If the landlord has a mortgage on the farm, the landlord will want a return sufficient to service the loan. The tenant will expect the rental rate to be within a normal rate of return on land value. The tenant's percentage return is based on his or her labor and management of the farm.

How should the cost of shared inputs be divided between the landowner and tenant? A crop-share lease commonly allows yield increasing expenses, such as fertilizer application, to be shared by the landlord and tenant in the same percentage as the share of crop profits. Sharing a variable cost in the same percentage as the crop is shared encourages the parties to use the amount of that input which maximizes net returns to the total operation.

Farm Leases and Farm Program Benefits

The type of lease can also impact eligibility for farm program payments. In general, to qualify for farm program payments, an individual must be "actively engaged in farming." Each "person" who is actively engaged in farming is eligible for one payment limit of federal farm program payments. A tenant qualifies as actively engaged in farming through the contribution of capital, equipment, active personal labor or active personal management. Likewise, a landlord qualifies as actively engaged in farming by the contribution of the owned land if the rent or income for the operation's use of the land is based on the land's production or the operation's results (not cash rent based on a guaranteed share of the crop). In addition, the landlord's contribution must be "significant," must be "at risk," and must be commensurate with the landlord's share of the profits and losses from the farming operation.

A landlord who cash leases land is considered a landlord under the payment limitation rules and may not be considered actively engaged in farming. In this situation, only the tenant is considered eligible. Under the payment limitation rules, there are technical requirements that restrict the cash-rent tenant's eligibility to receive payments to situations in which the tenant makes a "significant contribution" of (1) active personal labor and capital, land or equipment; or (2) active personal management and equipment.

Leases in which the rental amount fluctuates with price and/or production (so called "flex" leases) can raise a question as to whether or not the lease is really a crop-share lease which therby entitles the landlord to a proportionate share of the government payments attributable to the leased land. Under Farm Service Agency (FSA) regulations,[54] a lease is a "cash lease" if it provides for only a guaranteed sum certain cash payment, or a fixed quantity of the crop (for example, cash, pounds or bushels per acre.) All other types of leases are share leases. In April 2007, FSA issued a Notice stating that if any portion of the rental payment is based on gross revenue, the lease is a share lease.[55] However, according to FSA, if a flex or variable lease pegs rental payments to a set amount of production based on future market value that is not associated with the farm's specific production, it's a cash lease.[56]

Note: Beginning with the 2009 crop year, FSA's position is that *any* arrangement entered into by a landlord and tenant will not convert what is otherwise a cash lease to a crop-share lease.

Estate and Business Planning Implications

While material participation can cause problems with respect to Social Security benefits, material participation is required for five of the last eight years before the earlier of retirement, disability or death if a special use valuation election is going to be made for the agricultural real estate included in the decedent-to-be's estate.[57] The solution, if a family member is present, may be to have a non-retired landlord not materially participate, but rent the elected land to a materially participating family member or to hire a family member as a farm manager. The solution, if a family member is not present, is to have the landlord retire at age 65 or older, materially participate during five of the eight years immediately preceding retirement, and then during retirement rent out the farm on a non-material participation crop-share or livestock-share lease.

Tax Considerations

When considering the type of farm lease to utilize, an issue that is sometimes overlooked is the impact that a particular type of lease will have on estate and business planning goals and objective for the parties involved (particularly for the landlord) as well as the income tax implications of the lease.

Self-employment tax concerns. From the landlord's perspective, rents from real estate and from personal property leased with real estate are excluded from the definition of earnings from self-employment. Likewise, income from crop-share and/or livestock-share rental arrangements for landlords who are not materially participating in the farming operation are not classified as self-employment income subject to Social Security tax. Only if the rental income is produced under a crop or livestock-share lease where the individual is materially participating under the lease does the taxpayer generate self-employment income.

Income received under a cash rental arrangement is not subject to self-employment tax, nor does such income count toward eligibility for Social Security benefits in retirement. An exception to this rule exists if the lessor leases land to an entity in which the lessor is materially participating.[58] IRS has won several cases in which they have successfully attributed the lessor's material participation in the entity to the leasing arrangement with the result that passive cash rent income is transformed into material participation income subject to self-employment tax.[59] But, in the U.S. Circuit Court of Appeals for the Eighth Circuit (which includes Iowa), if the rental income represents a fair market rate, the rental income is not subject to self-employment tax.[60]

The key concept for farm landlords attempting to qualify rental income as self-employment subject to Social Security tax is material participation. Rental income is self-employment income if it results from a material participation lease. If the lease is a material participation lease, the income is subject to SE tax. If it is not such a lease, the income is not

subject to the tax. A lease is a material participation lease if (1) it provides for material participation in the production or in the management of the production of agricultural or horticultural produces, *and* (2) there is material participation by the landlord. Both requirements must be satisfied. While not required, a written lease does make a material participation arrangement easier to establish.

Agricultural program payments that are received under a crop-share or livestock-share lease are considered to be SE income for Social Security purposes if the landlord materially participates under the lease.

Note: Managing earned income in retirement years can be important, and may have an impact on the leasing arrangement. Persons age 65-70 can receive an unlimited amount of income without loss of Social Security benefits. For persons under full retirement age (presently age 66), however, the earnings limit in 2011 is $14,160. For excess amounts, benefits are reduced $1 dollar for every $2 over the limit. Thus, for retired farm landlords under full retirement age, they may not be able to receive full Social Security benefits if they are materially participating under a lease.

Income tax considerations. There are several important income tax concepts to keep in mind when leasing farm land.

- ***USDA cost sharing payments.*** Under certain federal farm programs, especially those programs designed to provide environmental benefits, the USDA shares in part of the expense associated with complying with the program. If certain requirements are satisfied, a farmer that receives cost-share payments can exclude them from income. Crop-share and livestock-share landlords are eligible to exclude cost-share payments from income.

- ***Soil and water conservation expenses.*** Taxpayers engaged in farming can deduct soil and water conservation expenses in the year incurred under a one-time election, rather than capitalizing the expenditures. One of those requirements is that the taxpayer be engaged in the business of farming. A farm operator or landowner receiving rental income under a crop-share or livestock-share lease satisfies the test. But, a landlord collecting rental income on a cash rent basis is not eligible to deduct soil and water conservation expenses on the associated real estate. The landlord must materially participate in the farming operation.

- ***Fertilizer and lime.*** A taxpayer can deduct fertilizer and lime costs by making an election on the tax return, if the taxpayer is in the trade or business of farming. For farm landlords, the lease must be a crop-share or livestock-share lease. A landlord under a cash rent lease cannot deduct the cost of fertilizer and lime. A farm landlord must be materially participating under the lease.

- ***Interest.*** Most farm interest is fully deductible as business interest. Crop-share and livestock-share leases with substantial involvement in decisionmaking by the landlord are deemed to be "businesses" for this purpose.

- ***Farm income averaging.*** Income averaging is available for farmers and fishermen, and allows current farm income to be averaged over three prior base years. The provision is available by election (by filing Schedule J) and provides the benefit of applying lower income tax rates from the prior base years.

Iowa income tax issues. Effective January 1, 2007, there is an important provision in Iowa law that is intended to create an incentive for landlords to lease land to individuals with relatively low net worth.

- ***"Beginning farmer" tax credit.*** Beginning in 2007, a credit against Iowa income tax is available for landlords who lease agricultural assets to a "beginning farmer."[61] This provision can have the potential to entirely eliminate Iowa tax for individuals that lease farm property to a beginning farmer for several years. Under the provision, the lease must be from two to five years and must be with a tenant who has a net worth of less than $343,000 (eff. Jan 1, 2012). It is not necessary that the tenant be a first-time farmer, but the tenant must be at least 18 and can be either a family member or non-family member of the landlord. The amount of tax credit for the landlord depends on the type of

the lease. The credit is five percent of the gross amount received under a cash lease, and 15 percent of the gross amount received under a crop or livestock-share lease. If the landlord does not have enough income to fully utilize the credit in any given year, the unused amount can be carried forward for up to five years. The credit cannot be transferred to any other person, but it can be transferred to the taxpayer's estate or trust upon the taxpayer's death.[62]

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[1] McEowen & Harl, *Principles of Agricultural Law*, p. 7-6, Agricultural Law Press, Eugene, OR, Rel. 28, Jan. 2011.

[2] *Id.* at 2-3.

[3] *Id.*

[4] Iowa Code §622.32(4). The Iowa statute of frauds is a rule of evidence and not one of substantive law. Thus, the statute provides a defense, and the party asserting it must raise it by answer or by objection to evidence at trial. See, Harriott v. Tronvold, 671 N.W.2d 417 (Iowa 2003).

[5] *See, e.g.,* Kolkman v. Roth, 656 N.W.2d 148 (Iowa 2003)(where tenant farmer, operating under oral lease and where landlord made assurances that tenant could farm until tenant retired, made substantial improvements to the farm, promissory estoppel available as exception to statute of frauds; farmer submitted substantial evidence of detrimental reliance and established the elements of estoppel; landlord also allowed tenant to make improvements in reliance on oral statements, thus establishing the partial performance exception).

[6] Iowa Code §562.1A.

[7] Iowa Constitution, Article I, §24.

[8] *See, e.g.,* Khan v. Heritage Property Management, 584 N.W.2d 725 (Iowa Ct. App. 1998).

[9] Iowa Code§ 558.44 (In Iowa, recordation is mandatory for any conveyance of leasehold interest in farmland over five years). The lease or conveyance must be recorded no later than 180 days after the conveyance is completed.

[10] *Id.* The tenant is responsible for recording the lease.

[11] Absent a provision to the contrary in a written lease, the party that either owns the land or supervises its use has the duty to control noxious weeds. So while both the tenant and the landlord are responsible for noxious weed during the lease term, the tenant usually has exclusive supervision of the land.

[12] *See, e.g.,* Meeker v. Shull, 235 Iowa 701, 17 N.W.2d 514 (1944)(tenant's plowing was excessive and constituted a failure to farm in a good farm-like manner which breached a written lease provision specifically prohibiting tenant from plowing pasture without landlord's consent); McElwee v. DeVault, 255 Iowa 30, 120 N.W.2d 451 (1963)(tenant's omissions contravened express provisions of written farm lease); Thompson v. Mattox, No. 4-511/03-1650, 2005 Iowa App. LEXIS 125 (Iowa Ct. App. Feb. 24, 2005)(while tenant has a duty to use proper farming techniques, landlord has no general right to control and supervise tenant's farming practices absent express provision in written farm lease).

[13] *See, e.g.,* Keller v. Bolding, 2004 N.D. 80, 678 N.W.2d 578 (2004).

[14] No. 2-133/11-0658, 2012 Iowa App. LEXIS 854 (Iowa Ct. App. Oct. 17, 2012).

[15] Iowa Code §570.1.

[16] Meyer v. Hawkeye Bank & Trust Co., 423 N.W.2d 186 (Iowa 1988).

[17] See Iowa Code §§554.9308(2) and 554.9310.

[18] Iowa Code §570.1(2)(b).

[19] Iowa Code §570.1(2). See also Agriliance, L.L.C. v. Runnells Grain Elevator, Inc., 272 F. Supp. 2d 800 (S.D. Iowa 2003).

[20] Chariton Feed and Grain, Inc. v. Harder, 369 N.W.2d 277 (Iowa 1985).

[21] McEowen and Harl, *Principles of Agricultural Law*, p. 9-13, Agricultural Law Press, Eugene, OR, Rel. 28, Jan. 2011.

[22] McEowen & Harl, *Principles of Agricultural Law*, p. 7-9, Agricultural Law Press, Eugene, OR, Rel. 28, Jan. 2011.

[23] Tetzlaff v. Camp, *et al.*, 715 N.W.2d 256 (Iowa 2006)(landlord may be held liable for alleged nuisance caused by tenant's hog manure spreading activity under Section 837 of the Restatement Second of Torts; landlord knew of tenant's manure spreading activity, and of neighbor's complaints; trial court's grant of summary judgment for landlord reversed, but on remand trial court jury determined that tenant's activity did not constitute a nuisance).

[24] *Id.*

[25] Iowa Code §§ 562.5-562.7.

[26] Iowa Code §562.6. However, a tenancy will not continue due to lack of termination notice if there is a default in the performance of the existing rental agreement. *Id.*

[27] Iowa Code § 526.5.

[28] Iowa Code §562.6.

[29] *See, e.g.,* Schmitz v. Sondag, 334 N.W.2d 362 (Iowa Ct. App. 1983).

[30] Iowa Code §§562.6,562.7.

[31] Denton v. Moser, 241 N.W.2d 28 (Iowa 1976).

[32] Iowa Code §562.7.

[33] *See, e.g.,* Bentler v. Poulson, 258 Iowa 1008, 141 N.W.2d 551 (1966)(non-farm lease; breaches of which landlord complained were insignificant and equities not in landlord's favor).

[34] *See, e.g.,* McElwee v. DeVault, 255 Iowa 30, 120 N.W.2d 451 (1963)(rent paid on November 15, 1961, was for crop year ending March 1, 1962 and lease was

terminated effective March 1, 1962; landlord entitled to receive this rent amount in any event).

[35] *See, e.g.,* Aurora Business Park Associates, L.P. v. Albert, 548 N.W.2d 153 (1996).

[36] Also, an existing lease may not necessarily be terminated when the landlord, who is also the buyer of the land under an installment contract, defaults and a forfeiture action is filed by the seller. In *Myers v. Leedy, 915 N.E.2d 133 (Ind. Ct. App. 2009),* the court, in a case of first impression, the court ruled that the lease was not terminated in such a situation. Importantly, the court noted that the tenant had not been made a party to the forfeiture action and the seller had actual knowledge that the tenant was in possession of the property. Even though the tenant had constructive notice of the seller's forfeiture suit under Indiana law, the seller failed to prove that the tenant had actual knowledge of the suit.

[37] Iowa Code §648.1(2).

[38] Iowa Code §§648.5; 602.6405.

[39] Iowa Code §631.4(2)(c).

[40] Richards v. Knight, 78 Iowa 69 (1889).

[41] Iowa Code §555B.3.

[42] Iowa Code §633.351.

[43] Giltner v. Estate of Giltner, No. 8-537/07-2117, 2008 Iowa App. LEXIS 1280 (Iowa Ct. App. Dec. 31, 2008), *citing In re* Franzkowiak's Estate, 290 N.W.2d 1 (Iowa 1980).

[44] *See, e.g.,* Ames v. Sayler, 267 Ill. App. 3d 672, 642 N.E.2d 1340 (1994).

[45] Read, *et al*. v. Estate of Mincks, 176 N.W.2d 192 (Iowa 1970).

[46] See Henney v. Lambert, 237 Iowa 146, 21 N.W.2d 301 (1946). See also Dopheide v. Schoeppner, 163 N.W.2d 360 (Iowa 1968)(an agreement between the parties to divide a crop is not, by itself, determinative of whether the parties are landlord and tenant or whether the farmer is a cropper; status to be determined by facts and circumstances).

[47] Iowa Code §562.5.

[48] A recent case involving the distinction between a cropper and a tenant is *Hoffman v. Estate of Siler, 306 S.W.3d 584 (Mo. Ct. App. 2010).* Under the facts of the case, the landlord died and the personal representative of his estate terminated the existing farm lease with the tenant without giving the required 60-days notice under Missouri law. The personal representative argued that the tenant was a cropper who was not entitled to notice, but the court disagreed. The court noted that the tenant effectively possessed and controlled the tillable land. In addition, the tenant supplied his own equipment, made all of the farming decisions, performed unpaid maintenance unrelated to farming on both the tilled and untilled ground, and made application for government farm program payments and dealt directly with conservation agents. Accordingly, the relationship that the tenant had with the deceased landlord was that of a tenant rather than a mere cropper.

[49] Iowa Code § 562.1A.

[50] *Id.*

[51] McEowen, *Principles of Agricultural Law*, p. 7-6, McEowen, P.L.C., Rel. 31, Aug. 2012.

[52] *Id*. p. 7-6.

[53] *Id.* at 7-7.

[54] 7 C.F.R. §1412.504(a)(2).

[55] Notice DCP-172 (Apr. 2, 2007).

[56] *Id.*

[57] I.R.C. §2032A. A special use valuation election permits the agricultural real estate contained in a decedent's estate to be valued for federal estate tax purposes at its value for agricultural purposes rather than at fair market value. The election is an important consideration when agricultural land values are rising and the date of death value may cause the estate to incur federal estate taxes. For deaths in 2009, the maximum value reduction that can be achieved by making the election is $1,000,000.

[58] Mizell v. Com'r, T.C. Memo. 1995-571.

[59] Bot v. Com'r, T.C. Memo. 1999-256; Hennen v. Com'r, T.C. Memo. 1999-306; McNamara v. Com'r, T.C. Memo. 1999-333.

[60] McNamara v. Com'r, 236 F.3d 410 (8th Cir. 2000). The IRS has issued a nonacquiescence in the McNamara opinion. AOD CC-2003-003 (Oct. 20, 2003).

[61] Iowa Code §175.37.

[62] For further details concerning the beginning tax credit, see http://www.calt.iastate.edu/beginning.html.