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# Ag Decision Maker

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**A Business Newsletter for Agriculture**

Vol. 7, No. 9 www.extension.iastate.edu/agdm July 2003

## Cash Rent Acres Are Increasing

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

Slowly but surely Iowa's farm tenancy is changing. Every five year since 1982, Iowa State University has carried out a detailed survey of farmland ownership and leasing practices. Some interesting trends appear.

### Ownership Decreasing

In 1982 over half—55 percent—of Iowa's farm acres were owner-operated. However, as farmers have retired they have tended to maintain ownership of their land. For the latest survey year, 2002, only 42 percent of the farmland was operated by the owner, and the rest was leased.

Several factors encourage leasing. Giving heirs a new basis for assets passing through an estate is probably the biggest one. Selling land before death would result in a considerable amount of capital gains tax for many people, but passing the land on through inheritance wipes out most of that gain. Moreover, retired farmers are living longer. The 2002 survey showed that 37 percent of Iowa farmland is owned by persons 65 year of age or older. This compares to only 29 percent in 1982.

Increases in farmland values also make ownership more difficult. Younger operators have a hard time accumulating enough capital to purchase more acres. They can increase the size of their operation more quickly through renting land than by buying it.

### Types of Leases

For many years Iowa farmers have rented land under both cash leases and 50-50 crop share leases. However, the mix of these is shifting. In 1982 they were equally popular, each accounting for 22 percent of

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### Handbook Updates

For those of you subscribing to the *Ag Decision Maker Handbook*, the following updates are included.

**Computing a Cropland Cash Rental Rate** — C2-20 (3 pages)

**Computing a Pasture Rental Rate** — C2-23 (2 pages)

Please add these files to your handbook and remove the out-of-date material.

### *Inside . . .*



IOWA STATE UNIVERSITY
University Extension

Ag Decision Maker is compiled by: Don Hofstrand, ISU Extension farm management specialist, 641-423-0844, dhof@iastate.edu

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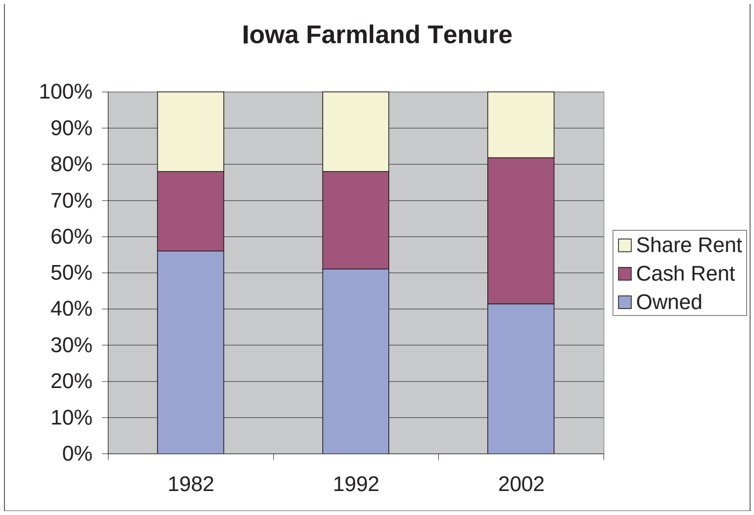
farm acres in Iowa. Over time cash leases have replaced share leases for many tenants. Today 42 percent of Iowa's farmland is rented under a cash lease, and only 15 percent under a crop share lease.

As landowners become older they are less likely to want to deal with issues such as marketing grain and paying seed and fertilizer bills. Having a fixed cash income is more important to them. Moreover, cash rent income is generally not subject to self-employment tax. Many tenants also prefer to cash rent, to simplify record keeping and to allow all their acres to be farmed as a unit.




Some owners still prefer to rent with a share lease, so they can be a material participant and possibly qualify the estate for special use valuation. Share leases also create a farm program payment limitation for both the owner and the operator, as well as share production and price risks.

## Regional Differences

Leasing is significantly less popular in the southern third of Iowa. Owner-operated and custom farmed land still accounts for more than half of the acres in the southwest, south central, southeast, and northeast crop reporting districts. On the other hand, only 26 percent of the farm acres in central Iowa are owned by the operator.

Southwest Iowa has always been a stronghold for crop share leases. Although they have declined in importance, they still account for 31 percent of the farmland acres there. Only 17 percent of the acres surveyed in southwest Iowa were cash rented. Higher production risks in this district probably influence tenants to maintain share lease arrangements.

In central, north central, and east central Iowa the proportion of acres cash rented is close to 50 percent. These are some of the most productive areas of the state, and competition for rental acres is strong. In northeast Iowa only 6 percent of the acres are share rented. The higher number of livestock farms in this part of the state means that tenants more often want to own all of the crop, to meet feed needs.

Custom farming has increased in popularity in recent years, although it still accounts for a small proportion of the total cropland. Custom farming was most prevalent in central and west central Iowa.

Ownership, cash rents, share leases, and custom farming all have a place in Iowa, and will continue to be used. How important each one is will depend on tax laws, trends in farm type and size, and demographic patterns.

**Tenure of Iowa Farmland**

| Crop Reporting District | Owned (%) | Cash Rented (%) | Crop Share Rented (%) | Custom Farmed (%) |
|---|---|---|---|---|
| Northwest | 32 | 44 | 22 | 2 |
| North Central | 30 | 51 | 18 | 1 |
| Northeast | 52 | 42 | 6 | 0 |
| West Central | 36 | 38 | 23 | 3 |
| Central | 26 | 47 | 23 | 4 |
| East Central | 41 | 49 | 10 | 0 |
| Southwest | 48 | 17 | 31 | 4 |
| South Central | 55 | 31 | 13 | 1 |
| Southeast | 55 | 29 | 14 | 2 |

Source: Iowa State University, 2002.

# Rising Farmland Values: Some Implications for Rural America

by Nancy Novack, Associate Economist, Center for the Study of Rural America, Federal Reserve Bank of Kansas City

Land is the biggest asset on the farm balance sheet—and the largest source of farm debt. Thus, farmland values play a significant role in the financial condition of U.S. farmers. Farmland values depend heavily on the revenue that the land generates. Yet despite a depressed agricultural economy in recent years, farmland values have posted surprisingly solid gains. These gains have helped stabilize farm balance sheets during the recent income difficulties in agriculture.

While most analysts do not expect a repeat of the 1980s crash in land values, important risks in land markets merit watching. The behavior of land values going forward—whether land values remain elevated or they fall—has implications for both farmers and their communities.

## Recent Strength in Farmland Markets

Farm economy fundamentals have been weak in recent years. Commodity prices have been soft overall. Although last year's drought pushed up crop prices, the dry weather led to poor crops in many regions, leaving many farmers with much lower total revenues. Still, farmland values continued to rise. Forces beyond the profitability in agriculture appear to be driving these gains.

Across the nation, the value of farmland continued to stay strong. In quarterly surveys of agricultural credit conditions in the Federal Reserve System at the end of 2002, gains for the year in farmland values ranged from 5 percent in the Dallas District to 13 percent in the Minneapolis District. In the Kansas City District, farmland values rose 7 percent in 2002, led by areas with healthy Main Street economies and good crop yields.

For cropland, conditions in agriculture are the most direct influence on land values. When crop receipts rise, land values typically strengthen, while farm income shortfalls often lead to softer land values. In 2002, areas of severe drought saw weaker gains in farmland values. In good times or bad, however, the supply of farmland for sale may be limited in many local markets. In such cases, farmland values can rise from the fierce competition among farmers wanting to expand operations to capture economies of scale made possible by new technologies.

Direct farm effects can also be masked by other factors. Government payments boost farm income, and future payments are quickly capitalized into the value of land. Because payments are perceived as guaranteed returns, at least for the life of a farm bill, farmers bid them into the selling price of land. USDA recently estimated that roughly 25 percent of the total value of farmland reflects government payments.

Government payments, however, do not explain all of the gains in many places. Because rural America is a recreational retreat for many people, nonfarm demand has become an important component in the value of farmland. Recreation and development demand has boosted farmland values in areas that offer scenic amenities. Nearly half of all respondents in the Kansas City District listed hunting, fishing, and recreation as major factors in the recent run-up in farmland values. A third of the respondents listed residential and development as additional reasons for land purchases.

In recent years, low interest rates have also reduced borrowing costs and boosted the buying power of both farm and nonfarm borrowers. Interest rates on farm real estate loans in the Kansas City District have fallen more than 2.5 percent on average over the last two years. There are also some indications that investors have redirected money from poorly performing stock markets toward less volatile land investments.

## What are the Risks in the Current Farmland Markets?

Despite the recent strength, several factors pose risks to land values in the period ahead. The future of farm policy and government payments is perhaps the biggest risk to farmland values. Deficits have returned to the federal budget, putting farm spending under more scrutiny. For example, the drought assistance package that recently passed Congress had to be offset by

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reductions in other farm bill spending. As the USDA study suggests, cutbacks in government payments to farmers could have potentially big implications for farmland values.

Fluctuations in farm income also pose risks to farmland values. If drought conditions persist in 2003, farm income could dip in many regions and weakness in farmland values could become more widespread. Even if production and farm income rebound in 2003, as current forecasts suggest, government payments would fall as a result, dampening the overall rise in farm income.

Finally, historically low long-term interest rates could rise when the national economy stabilizes. Higher borrowing costs would eliminate some of the support low interest rates have provided farmland values.

## Some Implications for the Rural Economy

Rising farmland values create mixed impacts for rural areas. Strong farmland values have created significant equity for land owners. This equity is an additional source of collateral for new or existing farm loans and has enabled some borrowers to restructure their farm debt in the face of low prices and production losses. Farmland also serves as a retirement plan for American farmers, and rising land values contribute to their return on investment.

Farmland values have a huge bearing on the fiscal condition of many local governments throughout the nation. Property taxes are a critical source of revenue for many communities. In addition to supporting infrastructure, such as roads, property taxes represent about one-fourth of all public school funding. If farmland values decline, local governments could be left searching for revenue streams to replace lost tax receipts on farmland.

While farm lenders and local governments clearly benefit from rising land values, there are some negative implications. Ultimately, higher land values drive up production costs and reduce the competitiveness of U.S. producers. South American producers are already able to produce soybeans for substantially less than U.S. farmers, an advantage gained mainly due to differences in land costs. Higher costs of owning and renting land have made it difficult for the next generation of farmers to enter the farming business. It is also becoming more difficult for farm buyers to finance land purchases with farm earnings alone, and farmers increasingly rely on nonfarm income to support their farm operations. Three-fourths of respondents on one Kansas City survey indicated that the majority of their farm borrowers used off-farm income to support their farm operations.

Farmland values are influenced by farm and nonfarm factors. While rising land values are beneficial for farm equity and local tax bases, they also boost production costs, reducing the ability of rural industries to compete on cheap land costs. Ultimately, farmland values will be one of the keys that determine the future competitiveness of rural areas.

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# Developments in CRP Payment Reporting*

by Neil E. Harl· Charles F. Curtiss Distinguished Professor in Agriculture and professor of Economics

With more than 35,000,000 acres currently enrolled in the Conservation Reserve Program (CRP), any change in the income tax or self-employment tax treatment of CRP payments is of widespread interest and concern. A Chief Counsel's letter ruling has injected uncertainty and concern as to how CRP payments are to be reported for self-employment tax purposes.

## The 2003 Ruling

The Chief Counsel's ruling, CCA Ltr. Rul. 200325002, involved two fact situations—

·In one, the taxpayer, who was engaged in the trade or business of farming, bid land into the Conservation Reserve Program. The payments were reported on Schedule E with no self-employment paid. The ruling states that the payments should have been reported on Schedule F with the 15.3 percent self-employment tax paid.

·In the other situation, the taxpayer, who was not engaged in the trade or business of farming, acquired land that had already been bid into the Conservation Reserve Program. The taxpayer reported the payments on Form 4835, the form for reporting income and expenses by non-material participation landlords, under a share lease. The ruling states that the payments should have been reported on a Schedule F and the self-employment tax paid.

Thus, in both fact situations, the landowner's activities were considered to amount to material participation. The ruling concludes that CRP payments are income from farming and are not considered rental income.

## Earlier Authority

The first authority on handling CRP payments, aside from some letters, was a private letter ruling issued in 1988. In the facts of that ruling a retired landowner had bid farmland into the CRP after first terminating the lease with a tenant. The ruling stated that the landowner's activities did not constitute material participation and no self-employment tax was due. That ruling appears to be inconsistent with the 2003 ruling which implies that even retired landowners would have self-employment income to report from CRP payments.

A 1996 Tax Court case, *Ray v. Commissioner*, involved a taxpayer engaged in farming who had purchased farmland which had been bid into the CRP program. The court found that there was a "direct nexus" between the CRP land and the farming business. Therefore, the CRP payments were subject to self-employment tax. That case left open the possibility that CRP land held as an investment and not part of a farming business or bearing a direct nexus to a farming operation would not be subject to self-employment tax. A 1998 Tax Court case, *Hasbrouck v. Commissioner*, harmonizes with the *Ray* decision in that participation in the CRP program and receipt of CRP payments did not establish that the taxpayers were actively engaged in the trade or business of farming. The 2003 ruling, by contrast, holds that personal effort in discharging the obligations under a CRP contract essentially amounted to material participation.

Another 1998 Tax Court case, *Wuebker v. Commissioner*, held that CRP payments are rental payments and are not subject to self-employment tax. However, that case was reversed by the Sixth Circuit Court of Appeals in 2000.

The language in the 2003 ruling clearly implies that landowner participation in other land idling programs would be subject to the same treatment. That could well include the Conservation Reserve Enhancement Program, the Wetlands Reserve Program, the Emergency Conservation Program, the Emergency Watershed Protection Program, the Conservation Security Program, and the Grasslands Reserve Program.

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*Developments in CRP Payment Reporting, continued from page 5*

## What lies ahead

The 2003 Chief Counsel's letter ruling will likely provide momentum for the drive to make all CRP payments exempt from self-employment tax. The first proposals were introduced in 2000 with another introduced in 2001 and the latest introduced in 2003. To date, none has passed. The current proposal, S. 665, failed to make it into the 2003 tax bill that was signed on May 28, 2003.

In the meantime, it's likely that there will be more litigation over the issue. It's a long way from being settled.

# *Ag Decision Maker* goes electronic

Like the print version, this decision-oriented agricultural business Internet site is designed for farmers, lenders, farm managers, agriculture instructors and others. It provides up-to-date information from agricultural economics at Iowa State University and other Midwest universities and institutions.

The Internet site is located at http://www.extension.iastate.edu/agdm. The new online version offers a number of interactive tools not available in the print publication. To stay current, you can request to be notified each month by email of new information that is being posted on the web site. The Internet version is free. Four types of information are offered on the site:

## Newsletter articles

This section is updated monthly and provides analysis and insight into many of the issues facing modern agriculture. Also newsletter articles published during the last three years are available.

## Decision files

More than 160 Decision Files provide information and analysis for finding solutions to many of the decisions facing farmers and agribusinesses. Each decision file can be printed or read from your computer screen.

## Decision aids

Many of the decision files have decision aids (spreadsheets) for on-line computation. Just enter your figures into the spreadsheet to analyze your individual situation and save the analysis as a file on your computer.

## Teaching activities

Many of the decision files have teaching activities for use in high school classrooms. Students can complete the teaching activity from information provided in the decision files and save or print the document and provide it to their instructor. Teachers can access a restricted area of the site to get answer keys.

The monthly print publication will still be available for a fee. Those interested in subscribing to the print publication should contact Trece Lonneman at (641) 923-2856 or via e-mail at trece@iastate.edu.



Issued in furtherance of Cooperative Extension work, Acts of May 8 and June 30, 1914, in cooperation with the U.S. Department of Agriculture. Stanley R. Johnson, director, Cooperative Extension Service, Iowa State University of Science and Technology, Ames, Iowa.