



Montana farm leasing and current use valuations of Montana farm estates
by Theodore David Paschke

A thesis submitted in partial fulfillment of the requirements for the degree of MASTER OF SCIENCE
in Applied Economics
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Abstract:

The leasing of agricultural lands is important to Montana farming and ranching. Over 75. percent of both the State's total agricultural land and harvested cropland was leased in 1974. Those renting farms, part-owners and tenants, comprised 53.8 percent of all Montana's farm operators in 1974. Information regarding prevailing Montana farm rental practices is therefore important to aid in lease formulation for other farms. And as farm leasing is important in "current use" valuations, estate tax reducing measures allowed by the Tax Reform Act of 1976, such data are increasingly valuable.

A survey to gather such information was conducted in six counties assumed representative of Montana, dryland and irrigated farming areas. Total survey response was 21.35 percent with a usable response rate of 16.97 percent.

Data summary found share rental to be more predominant than cash rental in the study area. Those share rental agreements reported were characterized by rather standard crop- and expense-sharing patterns in both dryland and irrigated cases. What variation in sharing arrangements which did exist was largely unexplained by landlord-renter relation or by average crop yield. There was a wide range in those dryland and irrigated cash rents reported. The large deviation in such rents was largely attributed to various factors and characteristics of the farms studied. This largely precluded any conclusions regarding typical or recommended cash rents.

Analyses to test for equity of those customary crop- and expenses sharing arrangements found were conducted. Such testing showed the typical mode of irrigated share leasing discovered to be approximately equitable. Dryland share leasing deviated somewhat from an equitable division of crops in comparison to cost contributions.

The study next related survey findings regarding leasing practices and farming in the study area to estate taxation. Alternate procedures by which "current use" valuations could be secured in the study area and Montana were suggested. The study concluded considering possible effects of such valuations.

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Date September 13, 1978

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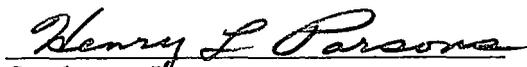
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ABSTRACT

The leasing of agricultural lands is important to Montana farming and ranching. Over 75 percent of both the State's total agricultural land and harvested cropland was leased in 1974. Those renting farms, part-owners and tenants, comprised 53.8 percent of all Montana's farm operators in 1974. Information regarding prevailing Montana farm rental practices is therefore important to aid in lease formulation for other farms. And as farm leasing is important in "current use" valuations, estate tax reducing measures allowed by the Tax Reform Act of 1976, such data are increasingly valuable.

A survey to gather such information was conducted in six counties assumed representative of Montana dryland and irrigated farming areas. Total survey response was 21.35 percent with a usable response rate of 16.97 percent.

Data summary found share rental to be more predominant than cash rental in the study area. Those share rental agreements reported were characterized by rather standard crop- and expense-sharing patterns in both dryland and irrigated cases. What variation in sharing arrangements which did exist was largely unexplained by landlord-renter relation or by average crop yield. There was a wide range in those dryland and irrigated cash rents reported. The large deviation in such rents was largely attributed to various factors and characteristics of the farms studied. This largely precluded any conclusions regarding typical or recommended cash rents.

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Chapter 1

INTRODUCTION

American farms are becoming fewer in number, larger in size, and more sophisticated in the operational techniques used. While such changes may vary from region to region and state to state, Montana agriculture has also felt this general transformational trend. Montana farms have fallen in number from about 42,000 in 1940 to about 22,500 in 1976.¹ And farm size has grown during the same period as the average farm increased in size from 1,111 to 2,665 acres. Accompanying these changes has been a rise in the value of assets employed in the typical Montanan's farm. The years from 1940 to 1974 saw the average investment in Montana farmland and farm buildings increase from \$8,373 to \$298,070.² Whatever one attributes this inflation³

¹Montana Department of Agriculture and Statistical Reporting Service-U.S.D.A., Montana Agricultural Statistics, County Statistics, (Helena, Montana, published biennially).

²U.S. Department of Commerce, Bureau of the Census, 1974 Census of Agriculture, Vol. 1, Part 20 (Washington: Government Printing Office, 1977). The 1974 Census defines a farm as ". . . to include all land on which agricultural operations were conducted at any time in the census year under a day-to-day control to an individual management and from which \$1,000 or more of agricultural products were sold during the census year." (Places normally producing \$1,000 of revenue were also included.)

³The index of prices paid by farmers for all items, interest, taxes and wages rose from 36 in 1940 to 160 in 1974 (1967 = 100). This represents a change of 460 percent (169/36). Thus, the \$8,373 in 1940 corresponds to an investment of \$39,260.37 in 1967 while \$298,077 in 1974 is \$176,372.78 in "real" 1967 dollars. Thus, the effective increase in investment was \$137,103.41.

to, speculation or growth and modernization, managing the average Montana farm is a position of significant financial responsibility. This responsibility generally falls upon three types of farm operators.

Aside from full-owners, those owning and operating their own land, agricultural operators can be classified as either part-owners or tenants. Part-owners are those operating their land and renting supplemental acreage while tenants own no land, renting all the land they operate.

Those renting farms, part-owners and tenants, have long been important to Montana agriculture. They represented 56.5 percent of all farm operators in 1930, and comprised 53.8 percent in 1974. But even these figures do not show the amount of land operated by those involved in land rental. Table 1 clearly shows how much of Montana's agricultural land is rented, representing three to five times the land operated under full-ownership.

Thus, as much of Montana's farmland is leased and many of the State's farm operators are involved in farm rental, relevant questions arise regarding the contractual methods used in leasing Montana farm lands. Questions about methods of cost and return sharing in rental and how these arrangements vary with each farm rented become significant. Also, farm rental information is a cornerstone in the valuation of farm estates for estate taxation.

Table 1

All Agricultural Land and Harvested Cropland,
With Type of Operator, in Montana
for Selected Census Years

Farms and Ranches	1974	1969	1964
A) <u>All Agricultural Land:</u>	<u>Acres:</u>	<u>Acres:</u>	<u>Acres:</u>
Full-Owners	14,138,107 (23%)	11,968,129 (19%)	9,456,150 (16%)
<u>Land Rented:</u>			
Part-Owners	43,760,198 (70%)	46,306,983 (74%)	44,183,500 (75%)
Tenants	4,260,046 (7%)	4,643,135 (7%)	4,974,450 (9%)
<u>Total:</u>	<u>62,158,351</u>	<u>62,918,247</u>	<u>58,614,100</u>
B) <u>Harvested Cropland:</u>			
Full-Owners	2,035,024 (24%)	1,646,207 (21%)	1,623,750 (21%)
<u>Land Rented:</u>			
Part-Owners	5,697,443 (68%)	5,554,098 (70%)	5,154,250 (68%)
Tenants	694,415 (8%)	736,898 (9%)	853,215 (11%)
<u>Total:</u>	<u>8,426,881</u>	<u>7,937,203</u>	<u>7,631,215</u>

Source: U.S. Department of Commerce, Bureau of the Census, 1974 Census of Agriculture, Vol. I, Part 20 (Washington: Government Printing Office, 1977).

This greatly adds importance to data regarding farm leasing.

Study Objectives

This study deals with Montana farm leasing practices.

Considering the varying opinions to be discussed in the literature review regarding farm leasing theory and its application, this work largely avoids such considerations. The objectives of this study are to:

- 1) gather data so as to identify prevalent Montana farm leasing practices, analyze them from a standpoint of equity, and test whether factors such as average crop yield or landlord-renter relation affect lease determination, and
- 2) provide information necessary, if possible, for "current use" valuations of Montana farm estates. Included in this objective is study of the structure of existing "current use" legislation and its possible effects upon American agriculture.

The accomplishment of the first objective will provide information for comparison of individual lease agreements to prevailing arrangements. It will also aid individuals in farm lease formulation. Fulfillment of the first objective will also provide the data to achieve the second objective.

Literature Review

Much literature has been addressed to supposed agricultural leasing problems. This review is restricted to material concerning United States agriculture and especially that dealing with crop-farm leasing. First, both favorable and unfavorable opinions regarding leasing theory, economic theory concerning farm leasing, are presented. Next, the review deals with other literature showing how economics is actually applied to farm lease formulation.

Consideration of the relevance of agricultural leasing to federal estate taxes concludes the review.

Farm Leasing: In Theory and In Practice. Earl Heady's description of a "perfect lease" is representative of leasing theory literature proposing a model for farm lease structure.^{4,5} Assuming competition on the farm rental scene and using the pricing system as a means to monitor consumer preferences, Heady's model seeks to maximize social benefits. Farm profit is thus maximized. This is to be accomplished with proper leasing practices which accommodate

⁴Earl O. Heady, Economics of Agricultural Production and Resource Use (Englewood Cliffs, N.J.: Prentice-Hall, 1952), pp. 587-638.

⁵Earl O. Heady, "Economics of Farm Leasing Systems," Journal of Farm Economics, XXIX (August, 1947).

a theoretically perfect farming system. Such a system results in 1) the most efficient organization of productive resources as gauged by market prices, and 2) an equitable division of product. Heady defines efficiency as resulting in firm profit maximization. Equity is the division of proceeds in relation to the quantity and marginal productivity of resources each party contributes.

Another study of leasing theory, by Virgil Hurlburt, states those leasing conditions he feels are necessary to promote efficient and equitable operations as,⁶

Incentive Condition 1. The share of the factor of variable input must be the same as the share of output of product obtained from it.

Incentive Condition 2. The shares of all products must be the same.⁸

Incentive Condition 3. Each resource owner must receive the full share of the product earned by each unit of resource he contributes.

⁶Virgil L. Hurlburt, Farm Rental Practices and Problems in the Midwest, Agricultural Experiment Station Research Bulletin 416 (Ames, Iowa, 1954).

⁷E. O. Heady and Harald R. Jensen, Farm Management Economics (Englewood Cliffs, N.J.: Prentice-Hall), pp. 556-559 exemplify Hurlburt's comment.

⁸By "the same", Hurlburt is referring to equal percentage share of products from all farm enterprises (i.e. if renter receives 2/3 of the wheat, he must receive 2/3 of all other crops, too).

Incentive Condition 4. Each resource owner must have opportunity to receive return on investment made in one production period but not forthcoming until a subsequent period.⁹

Heady utilizes a Hicksian graphical presentation to clarify his discussion as he delves into several areas pertinent to farm rental, especially share rental. Heady contends share rental, that leasing where the renter gives the landlord a portion of the farm's produce as his rental payment, has great potential for problems in determining proper resource-use intensity, delegating individual responsibility, and in intra-firm resource allocation.

Next nonshare, cash rental is studied. It is considered the near-model leasing arrangement in allowing the operator expanded latitude of freedom and nearly total receipt of benefits accruing to his efforts. But a problem arises. The cash rental fee, being a fixed commitment, heightens operator risk and uncertainty, thus theoretically bringing suboptimal operation.

Closing, Heady proposes flexible cash agreements whereby adjustment factors to account for changing yields and prices are integrated.

⁹E. O. Heady, Economics of Agricultural Production and Resource Use (Englewood Cliffs, N.J.: Prentice-Hall, 1952), pp. 614-616 will help the reader understand Hurlburt's condition more fully.

into the cash rental plan. In alleviating some renter risk, the flexible cash lease is selected as a system most likely to promote the most efficient use of agricultural resources and equitable sharing of farm production in leasing.

While some like Heady and Hurlburt propose theoretical solutions to supposed agricultural leasing imperfections, others question this application of economic theory.

Elefson re-examined and tested hypotheses of leasing theory.¹⁰ He found 1) empirical evidence failed to support theoretical hypotheses and 2) there were "flaws in the theory" as it provided an inadequate rationale for real world phenomena and was unable to predict the consequences of actions taken in actual farming situations. These failings reportedly arose from 1) the fact leasing theory, like all theory, is based upon abstractions from reality, 2) the circularity of reasoning involved when a landlord's return is based upon his contribution of land as these returns in turn help determine land value, and 3) the several diverse and often highly personal considerations influencing agricultural land use.

A blunter attack upon theory's applicability to leasing comes

¹⁰Vern Elefson, "Economics of Agricultural Leasing" (Doctoral dissertation, University of Minnesota, 1965).

from John Frey.¹¹ Frey states ". . . explanatory theory needs to be grounded in reality before a study of obstacles (to economic optimization) can be made." And he adds, "It is possible in theory to derive such formulations (speaking of theoretical ideals) but suffice to say, this kind of theory may be getting far ahead of any workable understanding of the real world."

Not totally discounting the use of theory, others suggest leasing theory needs amending to take account of personal attributes and desires.

While that literature described in the preceding seems addressed to professional economists, much other material has been prepared for a non-professional audience. It is intended for those actually engaged in farm rental. This literature utilizes basic theoretical concepts regarding personal incentives and applies them to the farm level.

Of prime importance is translation of theoretical concepts of sharing risks, revenues, and costs, to the working level. This allows discussion from an economic standpoint of the relative advantages and disadvantages of various lease types.

¹¹John C. Frey, "Discussion: Obstacles to Economic Determination of Farm Rents," Rent Theory, Problems and Practices. Northcentral Regional Research Publication #139 (Columbia: University of Missouri, 1962), pp. 63-67.

Cash rental plans employ a fixed cash payment made for the use of a farm with the renter receiving all the farm's produce while paying all expenses excepting those few usually paid by the landlord, i.e. property tax. Advantages attributed to cash rental are 1) a steady income is assured the landlord with a minimum of his supervision required, 2) more independence is afforded the renter, 3) lease simplicity allows less chance for controversy, and 4) the renter receives most of the returns accruing to his managerial efforts and labor. On the other hand, the fact 1) a renter may be encouraged to exploit a farm, 2) the fixed rental fee, in transferring risk from landlord to renter, lowers the landlord's long-term income and jeopardizes the latter's security, and 3) that cash rents are difficult to adjust over time in relation to changing costs and returns, are all seen as disadvantages of cash rental. Flexibility clauses can be added to partially alleviate the last two faults mentioned.

Crop-share rental also has inherent traits of varied desirability. In 1) decreasing the renter's risk and the amount of capital he need employ, 2) allowing the landlord to accept some risk and thus raise his long-run income, and 3) allowing a good landlord input into the decision process, a share lease is seen as advantageous. Perceived disadvantages arise as 1) farm uniqueness may necessitate a special

agreement, and 2) it may be difficult to get landlord and renter to concur on operational methods, needed improvements, and delegation of responsibility.

Assessing these advantages and drawbacks, the landlord and renter are advised to select that leasing plan suited to their personal goals and objectives as well as the farm involved. An agreement, once negotiated, should be put in writing.

A conclusion common to such literature is a study of the "contributions approach" to farm leasing. This method, concentrating on equity, encourages sharing returns in relation to those assets contributed by each party. Values are imputed to the landlord's and renter's fixed assets in order to attribute a rate of return to them in compensation for investment opportunity cost. And then allowance is made for depreciation of those fixed assets contributed. Record is also kept on the full value of whatever variable inputs each party contributes.

With the preceding calculations accomplished, the landlord and renter are encouraged to divide production proceeds in proportion to their contributions.

The above, indirectly utilizing theoretical postulates of equity, appeals to common sense but is not totally void of problems. It can easily be seen there is ample room for disagreement whenever

two parties must agree on "fair" asset value and returns merited.¹²

Agricultural Leasing and Federal Estate Taxes. As the magnitude of finances commonly invested and utilized in a farm or ranch increases, federal estate tax considerations become more important. In studying federal estate taxation one must first consider that property subject to the tax, the gross estate. This includes all property such as stocks, bonds, checking accounts, farmland, or any other assets owned by the decedent at the time of his death.

For example, assume a farmer dies leaving his heirs the estate depicted in Table 2.

¹²Publications representative of the literature pertaining to the actual application of economic concepts to the working farm leasing level as last described are:

- A) Marshall Harris, Your Crop-Share-Cash Farm Lease, U.S.D.A. Miscellaneous Publication #838 (Washington: Government Printing Office, 1961).
- B) Marshall Harris, Your Cash Farm Lease, U.S.D.A. Miscellaneous Publication #826 (Washington: Government Printing Office, 1961).
- C) Walter E. Chryst and John F. Timmons, Adjusting Farm Rents to Changes in Prices, Costs, and Production, Special Report #9 Agricultural Experiment Station (Ames: Iowa State College, 1955).
- D) Philip A. Henderson, Is Your Lease Fair?, U.S.D.A. Northcentral Regional Publication 9 (University of Wisconsin).

Table 2

A Hypothetical Gross Farm Estate
and the Resultant Estate Tax Due

<u>Asset</u>	<u>Value Subject to Estate Tax</u>
A) 500 shares XYZ Corp. @ \$10/share	\$ 5,000
B) Checking account, \$3,000 balance	3,000
C) Automobile, \$4,300 market value	4,300
D) Farm machinery, \$60,000 market value	60,000
E) 320 acres farmland, 2 machine sheds, dwelling, \$480,000 market value	480,000
<u>Gross Estate:</u>	<u>\$552,300*</u>

ESTATE TAX DUE: \$175,151.

*It is assumed the Marital Deduction is not secured.

In this case all assets in the decedent's estate are valued at market value for estate taxation.

Some believe this valuation scheme assigns real farm property (land, buildings, and some other fixed farm improvements) a heightened value incommensurate with its value as a producing agricultural entity, this caused by inflation resulting from factors such as nonagricultural

development and expectations of price appreciation. Such factors, in raising the land's taxable value, consequently increase estate taxes. This in turn is seen to accentuate the fact estate taxes complicate transfer of agricultural estates, inhibiting continual family operation of a farm or even sometimes precluding it by necessitating farm sale to simply meet the estate tax obligation.

The Tax Reform Act of 1976 includes provisions to partially overcome this. Farm real property can now be valued for estate purposes on the basis of "current use" -- its use in an enterprise producing and marketing agricultural produce. While complex in specifying rules governing "current use" valuations, the law allows two methods for the valuation.

The easiest of the two procedures involves a capitalization process whereby gross cash rental fees less property taxes are divided by the effective interest rate on all new Federal Land Bank loans. To use this procedure, the law requires the gross cash rental rate be from ". . . comparable land used for farming purposes and located in the locality. . .,"¹³ of the estate being valued.

Returning to the gross farm estate in Table 2, assume a farm comparable to it would have generated a net cash rental revenue

¹³Internal Revenue Code § 2032A(e)(7)(A).

(total gross cash rental return less property taxes) of \$24,000. Further assume the effective Federal Land Bank loan rate was nine and one-half percent. Table 3 shows the effect upon the federal estate taxes due by the decedent's heirs should the farmland, buildings, and dwellings be valued using "current use" procedures.

Table 3

A Hypothetical Gross Farm Estate and the Estate Tax
Due With Real Farm Assets Valued Using
"Current Use" Procedures

<u>Assets</u>	<u>Value Subject to Estate Tax</u>
A) 500 shares XYZ Corp. @ \$10/share	\$ 5,000
B) Checking account, \$3,000 balance	3,000
C) Automobile, \$4,300 market value	4,300
D) Farm machinery, \$60,000 market value	60,000
E) 320 acres farmland, 2 machine sheds, dwelling, "current use" value using cash rent capitalization is <u>\$24,000</u>	<u>252,631.58</u>
<u>Gross Estate:</u>	<u>\$324,931.58*</u>
<u>ESTATE TAX DUE: \$96,276.74</u>	

*It is assumed the Marital Deduction is not secured.

A "current use" valuation of the real farm property in this hypothetical case would reduce the gross estate significantly. This would, of course, reduce the estate tax burden due by the decedent's heirs, the reduction being \$78,874.26 in this example.

Of key importance in this "current use" valuation of the hypothetical farm in this case was data regarding gross cash rental fees for comparable farms. When such gross cash rental rate data are not available, or where the estate's executor so chooses, the Code allows an alternative valuation plan, a multiple factor approach. This second method values the decedent's real property by:

- A) capitalization of income which the property would be expected to generate as a farm under prudent management, considering normal cropping patterns, and soil and land attributes,
- B) capitalization of fair rental value,
- C) assessed land values in states allowing valuation considering productive value as a farm,
- D) comparable sales where urban and metropolitan areas do not exert a significant influence on land value, and

E) any factor fairly valuing the property.¹⁴

While different than the simple cash rental capitalization process, the multiple factor approach can be used to accomplish a similar end. Either of the two methods can be used to reduce a gross farm or ranch estate's value by as much as \$500,000. Thus, such reductions provide potentially huge estate tax reductions.

Of clear importance to both valuation procedures, especially that first described, is information regarding farm rental.^{15,16,17,18}

¹⁴ Internal Revenue Code § 2032A(e)(8).

¹⁵ Neil E. Harl, Farm Estate and Business Planning (Skokie, Illinois: Agri-Business Publications), pp. 26-53.

¹⁶ Jon D. Wheeler, "The Special Use Valuation Procedure, The Estate Tax Payment Rules for Estates with Closely-Held Business, and the Miscellaneous Estate and Gift Tax Provisions of the Tax Reform Act of 1976" (Helena, Montana: Galusha, Higgins, and Galusha), pp. 1-12. (Mimeographed).

¹⁷ Michael D. Boehlje and Neil E. Harl, "Use Valuation Under the 1976 Tax Reform Act: Problems and Implications" (Ames, Iowa: Iowa State University) pp. 1-44. (Mimeographed).

¹⁸ An added note: Current use valuations can be secured in nonfarm estates where the decedent's estate was run as what the tax law terms a "closely-held" business. This work chooses to center on those "current use" valuations of farm estates.

Chapter 2

METHODOLOGY

Montana Farm Leasing Survey

Selection of Study Area. Six Montana counties were chosen as the study area to gather the desired data (see Figure 3). Selection criteria included consideration of geographical dispersion and farm type. Richland and Yellowstone Counties were selected as being representative of intensive irrigated crop farming (sugar beets, beans, corn, hay, small grains) while including some nonirrigated dryland farming. Three counties clustered in the State's northcentral region - Hill, Chouteau, and Fergus - were picked to represent dryland wheat and small grain production. Sheridan County provided an area of dryland durum, spring wheat, and other small grain production. All counties would provide a look at dryland pasture leasing.¹⁹

Sample Base. Consultation with state and county Agricultural Stabilization and Conservation officials provided the main sample base list of farm renters in the survey area. The list provided the names of those tenants and part-owners participating in current

¹⁹Montana Department of Agriculture and Statistical Reporting Service-U.S.D.A., Montana Agricultural Statistics, County Statistics, (Helena, Montana, published biennially) provides information regarding Montana cropping practices.

