



MINISTRY OF AGRICULTURE, FOOD AND RURAL AFFAIRS

Lease Agreements, Farm Buildings

Table of Contents

[Introduction](#)

[Section 1. Lease Agreements](#)

- [Human Components of a Successful Lease](#)
- [Advantages and Disadvantages of Leasing Land for Agricultural Use](#)
- [A Written Lease Agreement](#)
- [Advantages of a Written Lease Agreement](#)
- [What to Consider Before Entering into a Lease Agreement](#)
- [A Lease Agreement as a Succession Planning Tool](#)

[Section 2. Tax Implications of Land Leases](#)

- [Tax Deferred Rollover to Children](#)
- [The \\$800,000 Capital Gains Exemption](#)
- [Canada Pension Plan and Registered Retirement Savings Plan](#)
- [Non-Resident Withholding Tax](#)
- [Capital Cost Allowance](#)
- [Harmonized Sales Tax \(HST\)](#)
- [Farm Property Class Tax Rate Program](#)

[Section 3. Elements of a Lease Agreement](#)

- [The Components of a Lease Agreement](#)

[Section 4. Developing a Building Lease Agreement](#)

- [Factors that Affect Rental Value](#)
- [Estimating the Landlord's Costs](#)
- [Establishing a Rental Rate](#)

[Section 5. Responsibilities of the Landlord and Tenant](#)

- [Repairs](#)
- [Water](#)
- [Manure Disposal](#)
- [Insurance](#)
- [Time and Basis of Payment](#)

[Summary](#)

Introduction

This Factsheet is one of a series on leasing agreements. Leasing and renting buildings is a common practice in rural Ontario. Farm buildings and livestock facilities often outlast their owner's need for them but are still usable. Other operators want the services of certain types of farm buildings but aren't in a position to invest in new facilities. Both parties may benefit by developing a lease arrangement. However, they must agree on the amount of the rental payment and the use and care of the property.

This Factsheet examines the major considerations in developing a lease agreement for a crop, livestock or solar project from both the landlord and tenant's points of view.

Section 1. Lease Agreements

Human Components of a Successful Lease

Any form of business agreement requires a good deal of mutual respect and trust. Leasing land is no different. To be successful, the lease arrangement must satisfy both the landlord and the tenant. Before entering into a lease, the landlord and the tenant should consider more than just price. The compatibility of the landlord and the tenant and the fairness of the lease are important aspects to consider.

Checklist of a Successful Lease

Compatibility - Can you get along and discuss differences? ___ yes ___ no

Honesty - Do you trust the person you are dealing with? Have you had business dealings together before? ___ yes ___ no

Clarity - Are the obligations of each party clearly defined in the written lease? ___ yes ___ no

Equitable Terms - Do both parties agree to the terms of the lease? ___ yes ___ no

Flexibility - Can you adjust the lease if changes occur? ___ yes ___ no

Suitability - Does the lease fit the crop and encourage good agricultural practices? ___ yes ___ no

Advantages and Disadvantages of Leasing Land for Agricultural Use

There are advantages and disadvantages to all leasing arrangements.

Advantages

Lower Capital Investment

- Capital investment is shared between landlord and tenant.
- Landlord supplies land, buildings and perhaps some of the operating expenses.
- Tenant supplies labour, machinery and usually the major portion of the operating expenses.
- Operators can increase the size of their business with limited capital investment.
- Since leasing is an alternative to ownership, it is really a means of "financing" a land base.

Increasing Financial Efficiency

- When funds are limited, it is often more profitable to spend this money on seed, fertilizer, chemicals and machinery than on buying land.
- Investing scarce funds in land may severely restrict the money available for operating capital, thus lowering the efficiency of the farm business.

Obtaining Farm Experience

- Renting enables the beginning farmer to gain needed experience in the financial operation of a farm business before committing to a long-term investment in land.
- Renting enables an operator to learn more about land in an area and allows the flexibility to change farms or leave farming.

- Renting may enable an inexperienced farmer to obtain the managerial assistance or mentorship of a more experienced landlord.

Sharing Risk

- By renting, both the landlord and the tenant can share in the risks and profits of farming. This is particularly important to a farmer with limited capital. The extent of the risk-sharing depends upon the nature of the lease agreement.

Family Arrangements

- A family business arrangement might include a lease agreement whereby someone rents land from a parent or rents land from a third party and shares the machinery investment with the parent.

Providing Retirement Income

- A retiring farmer might consider leasing all or a portion of his or her land base rather than selling.
- Ownership of land provides a hedge against inflation.
- The income from the rent provides a form of "pension" income to live on during retirement.
- A farmer approaching retirement could gradually phase out of farming by renting a portion of his or her land and farming the rest of it.

Disadvantages

Lack of Security of Tenure

- Short-term leases create uncertainty for the tenant.
- Since machinery investment is matched to the land base, the cancellation of a lease could result in having machinery over capacity and a higher cost per acre.
- Short-term leases provide more flexibility for landlords since it is possible to change tenants quickly or to sell the land. However, short-term leases can work to the detriment of the landlord since they may not encourage sustainable farming practices by the tenant.

Lack of Efficiency, Conservation and Incentive to Make Improvements

- Short-term leases may discourage production efficiency. For example, some tenants may not use the optimum amount of fertilizer under a crop share lease unless the landlord shares in the expense of fertilizer.
- Most soil conservation practices are a long-term investment. Most tenants with a short-term lease are interested only in practices that will show results during the term of the lease.

People Problems

- As with any business venture involving two or more persons, disputes and disagreements can arise.

Availability of Credit

The tenant farmer usually has a more difficult time obtaining intermediate and long-term credit than does the owner-operator because:

- the lender may require land as security for the loan
- leased land does not build equity
- the lease is short term

Lack of Bargaining Power and Managerial Control

- There may be situations where the landlord has greater bargaining power even though the tenant is a capable manager.
- The landlord may insist on making most of the management decisions even though his or her contributions to the lease may be substantially less than the tenant's. For example, the landlord may insist on certain crops being grown that the tenant feels are not the most profitable.

Lost Opportunity for Capital Gain

- Land prices have generally increased over time, although they do decline occasionally.
- Land appreciation is an added benefit to the landowner, even though the capital gain is not realized until the property is sold.

Potential Loss of Tax Deferral or Exemption

- Leasing land can in some cases prevent the use of both the tax-deferred transfer to children and the \$800,000 capital gains exemption (the exemption increased to \$800,000 in 2014, and will be indexed for inflation starting in 2015).
- Consult an accountant.
- See [Section 2. Tax Implications of Land Leases](#)

A Written Lease Agreement

The most important thing you can do as a tenant or landlord is to put your agreement in writing. This one action would eliminate the vast majority of disagreements that occur. Even though the handshake has been a long-standing method of doing business in the rural community and a verbal lease agreement is a valid contract, it has serious disadvantages. However, many farmers and landowners are reluctant to use a written lease for several reasons:

- Tenants and landowners alike do not want to give the impression that they distrust their neighbours by requiring a written lease.
- The added time and cost to prepare a written lease may not seem justified when dealing with other farmers or community members.

The disadvantage of a verbal lease becomes apparent when a disagreement about the terms of the lease occurs, because it is exceedingly difficult to prove what the original understanding between the parties was.

Without a written agreement:

- settling a misunderstanding between the parties once the land is in use (through mediation by a third party, arbitration or litigation) can be extremely costly
- it is more difficult to protect the interests of both parties against any claims of a third or outside party to a right to the land or the crop - it is much easier to protect your interests from third-party claims by documenting the details of the agreement at the time you enter into it
- the risk of losing significant time and business goodwill is high for both landowner and the lessee

A written agreement is not a sign of distrust - it shows that both parties want to protect and clearly document the agreement they are making.

Advantages of a Written Lease Agreement

Under the Ontario Statute of Frauds, all documents that create an interest in land must be in writing. A written lease is advantageous to both the landlord and the tenant since it provides both with a record of what they have agreed to. In the case of crop share leases, where the landlord and tenant are sharing costs, this is especially important. A written lease:

- clarifies the expectations, obligations and responsibilities of both parties. If a dispute occurs, a written lease can prevent costly legal action by providing for alternatives to a court proceeding
- gives the landlord some protection in the event of an environmental liability
- provides a valuable guide to heirs if the landlord or tenant should die
- provides documentation for tax purposes

What to Consider Before Entering into a Lease Agreement

Insurance - Landowners may consider requesting proof of crop insurance, especially if the rent has not been prepaid. The tenant and landlord should also discuss insurance for protection from any potential environmental damage. If the tenant plans on storing any harvested crop on the landowner's property, there should also be insurance provisions for protection from theft or damage.

Securing the lease payment - Registering any unpaid portion of the lease payment with ServiceOntario under the Personal Property Security Registration will help protect a landowner's interest as a creditor in the event of non-payment by a tenant. Landowners may register online or by calling ServiceOntario.

A tenant may also want to have the lease registered against the title to be protected in the event that the land changes ownership. There may be very good reasons to consider the registration of the lease: for instance, any payments relating to the real estate can, in some instances, be considered "personal property" and fall within the registration provisions of the Personal Property Security Act; any interest in those payments would be subordinate to any other interest by way of a lease, so long as the lease is registered first.

Most properties in Ontario are registered under the Land Titles system, which dictates that leases for a period not exceeding 3 years do not require registration where the tenant is in actual possession of the property described in the lease. For properties under the less popular Land Registry system, the period is increased to 7 years. In the absence of registration, a subsequent purchaser of the land could take ownership without having to honour the terms of the lease.

Title search - Tenants may also perform a search on the title of the land to be leased to make sure they are entering into an agreement with the person who is the owner of the land. A title search may be done through the Ontario Land Registry Office.

A Lease Agreement as a Succession Planning Tool

A long-term lease agreement (not to be confused with a sale and leaseback arrangement) may be used as a succession planning tool. Landowners and potential farm successors thinking about alternatives to traditional financing options might want to consider a long-term leasing arrangement. Lease arrangements may include land, buildings and/or equipment. Owners and successors may choose to have multiple lease arrangements or a single inclusive lease. Leases in Ontario can be of any length of maturity, however, leases longer than 21 years must have the approval of the municipality to be valid.

Like any lease, the terms must be negotiated to the satisfaction of both parties. One of the biggest difficulties after setting the initial lease payment amount is determining what the annual increase should be. For longer-term leases, an impartial setting, such as the annualized core Consumer Price Index, which is published by Statistics Canada, may be used. It is advisable to talk to a succession planning professional to help set out some of these terms.

Section 2. Tax Implications of Land Leases

The following is for general illustrative and information purposes only and is not comprehensive, nor is it intended to be legal advice. It does not replace professional advice from a tax specialist. Remember, tax laws and qualifications for programs may be time limited or may change. It is strongly recommended that you consult with a tax specialist for up-to-date advice that is specific to your agreement.

The tax implications of entering into a lease agreement should be carefully considered.

Landlords can inadvertently disqualify themselves from being able to use two major tax provisions. The Canada Revenue Agency (CRA) does not consider many types of leasing to be farming. For example, a share crop lease, where a portion of the crop is given to the landowner as payment for the land, may not meet the

CRA's definition of farming. As a result, some leasing arrangements can disqualify landowners from using the following tax provisions:

- the ability to use a tax-deferred rollover on the transfer of land to children (called a rollover)
- the \$800,000 capital gains exemption on their land

Tax Deferred Rollover to Children

The Income Tax Act allows for the transfer of farmland to a child on a tax-deferred basis. This is accomplished by using what is called a "rollover." It allows the transfer price to be set at any value between zero (a gift) and the fair market value (FMV) of the land. In the case of a gift, the transfer value would be the adjusted cost base (ACB). Without the use of the rollover, the land would have to transfer at its FMV and all the gain would have to be reported.

To qualify for the rollover, the property must have been used principally in the business of farming prior to the transfer by the taxpayer, the taxpayer's spouse or their children who were actively and continuously involved. This means that the land's use was farming for greater than 50% of the time (as defined by the CRA). The property does not, however, have to be used in farming immediately before a transfer takes place in order to qualify for the rollover.

Landowners who want to use the rollover should monitor the percentage of time that they have leased their land and what type of leasing arrangement they are using. For example, a landowner who farmed a property for 20 years, then leased the land for 4 years could still qualify for the rollover. If, however, the leasing period was longer than the farming period, it could disqualify the use of the rollover. An exception to this is if the person leasing the property is the landowner's spouse or child actively engaged in farming.

The \$800,000 Capital Gains Exemption

Selling Farmland

The \$800,000 capital gains exemption is available to individuals on the sale of qualified farm property. Individuals who had used their entire \$100,000 personal exemption, which was eliminated in 1994, have \$700,000 remaining. The exemption is also available for partners in a partnership, since taxes are paid at the individual level. However, corporations do not have any capital gains exemption.

Qualified farm property includes:

- farm land and buildings
- shares in a family farm corporation
- an interest in a family farm partnership
- quota (referred to as eligible capital property)

Qualified farm property must meet the following definitions:

- property purchased before June 18, 1987, must be used in farming at the time of sale, or have been used in farming for any 5 years during its ownership
- property purchased after June 17, 1987, must be owned for 24 months prior to the sale, and in at least 2 years, the gross farm income must exceed net income from other sources or the property was used by a family farm partnership or corporation in a 2-year period during which time the individual, spouse, child or parent was actively involved in the farming business

In either of the above cases, property must be used in farming by:

- the individual
- the spouse, child or parent of the individual, or
- a family farm partnership or corporation of the individual, spouse, child or parent

In all cases, the qualifying individuals, whether farming as a sole proprietorship, a partnership or as a shareholder in a farming corporation, must be actively engaged in management and/or the day-to-day activities of the business.

Leasing Farmland

Leasing farmland is most likely to affect the use of the exemption on land purchased before June 18, 1987.

Land purchased before June 18, 1987, must be farmed for any 5 years or farmed in the year of sale to be considered qualified farm property and therefore eligible for the capital gains exemption. If the 5-year rule has not been met, the property must be farmed immediately before the sale.

Since leasing is not considered to be farming, according to the Canada Revenue Agency (CRA), a lease in the year of sale could disqualify the landowner from using the capital gains exemption because it was not farmed immediately before the sale. Even a share crop lease, where a portion of the crop is given to the landowner as payment for the land, does not meet the definition.

Hiring custom operators to do the cropping work may solve this problem. Alternately, a share crop lease where the landowner is sharing the cost of inputs may also meet the CRA requirements of farming. Discuss such agreements with your accountant.

Canada Pension Plan and Registered Retirement Savings Plan

Rental income from a cash lease cannot be used as a basis for contributions to the Canada Pension Plan (CPP). Farmers who lease their land and have no other CPP-eligible income source will be unable to make contributions to the plan. This may have the effect of reducing the amount of CPP pension benefits. Although rental income is not eligible for contributions to the CPP, it is considered earned income for the purpose of contributions to a Registered Retirement Savings Plan (RRSP).

Rather than operating under a cash lease, a landowner could farm the property by hiring custom operators or lease the land on a crop share basis where the inputs are shared. Currently, the net income from these sources is eligible for contributions for both the CPP and RRSPs.

Non-Resident Withholding Tax

If the landlord is a non-resident of Canada, the tenant is required to withhold 25% of the rent (cash rental or crop share) and submit it to the Canada Revenue Agency (CRA). If the tenant does not remit the 25% withholding tax, the CRA will attempt to collect the tax from the landlord. If the landlord does not pay this tax, the tenant will be liable for the payment.

Capital Cost Allowance

When a landowner changes the use of the farm land, buildings or machinery, such as in renting, the Income Tax Act requires that the depreciable assets purchased before 1972 (Part XVII) be switched from the Straight Line Method of capital cost allowance to the Declining Balance Method, which is used for depreciable assets purchased after 1971 (Part XI).

In most cases, this is undesirable, since it would mean that all recaptured capital cost allowance that occurs when the class is closed out (e.g., sale of all machinery in that class) would be taxable income. The landlord could choose to not use the property and still maintain the Part XVII status, however, no deduction could be claimed in the years when it was not used. Any other use, either personal or rental, would require a change to Part XI. The landlord could choose to use his machinery or buildings as part of a custom farming arrangement and thereby maintain the farming status.

Harmonized Sales Tax (HST)

Generally speaking, a lease is taxable unless specifically exempted under Part I of Schedule V of the Excise Tax Act, which might apply in limited situations such as land destined as long-term residence. Rent that is paid by way of share of the crop is not subject to the HST. The treatment of cash rents for HST purposes may also depend on the landlord's total income. A business (including a landlord who rents property) does not have to register to collect and remit HST if its gross taxable and zero-rated sales are under \$30,000. Landlords whose only source of business income is rent, where the rental income is less than \$30,000, need not register, although they may choose to do so.

Farm Property Class Tax Rate Program

The Farm Property Class Tax Rate program enables eligible farm properties to be taxed at 25% of the municipal residential/farm tax rate. The farm residence and 1 acre of land surrounding it are taxed as part of the residential class.

To be eligible for the reduced rate, an application to the program must be filed showing that the property is used by a farming business with a valid Farm Business Registration number that has gross farm income of \$7,000 or more. Exceptions to this threshold can be made for new farming operations. For more information, contact the ministry, toll-free, at 1-877-424-1300 or visit the website at www.ontario.ca/farntax.

Section 3. Elements of a Lease Agreement

The Components of a Lease Agreement

A written lease can be as simple or detailed as the landlord and the tenant wish. The following summary presents the items that a lease can contain, categorized under three headings.

Items in Written Lease Agreements

Required Items

- names and addresses of tenant and landlord
- description of property to be rented
- term and renewal of the lease
- rent payable payment and use of utilities

Recommended Items

- right of inspection and removal of crops
- transfer of property
- termination of the lease
- use of the land
- environmental matters
- insurance
- rights to assign or sublet the lease
- resolution of differences
- restrictions of land use

Optional Items

- production practices and management decisions
- income support payments, subsidies and reimbursements
- repairs to buildings, fences and improvements
- duty to notify AGRICORP
- compensation for property damages
- rights of first refusal
- option to purchase
- municipal zoning restrictions

Required items

All leases must contain this information:

Names and addresses of the tenant and landlord - Including spouses if required.

Description of property to be rented - Includes the legal description and specifies buildings or areas to be excluded.

Term of the lease - Indicates when it starts and how long it lasts. Although not a basic requirement of a lease, this section should also address the renewal of the lease if the parties wish to maintain the lease agreement for a period of years, including when and how such a renewal will take place.

Rent payable - The amount of rent, how it is calculated and when it is to be paid. In the case of a building lease or where the renter has access to facilities, the payment and use of utilities should also be stipulated.

Recommended items

Items that every landlord and tenant should consider including in the lease agreement:

Right of inspection and removal of crops - Includes the following:

- The landlord should have the right at all times to inspect the rented property.
- The tenant should be able to complete harvesting of the crop after a reasonable time period after the termination of the lease agreement or the sale of the property. If this is not possible, the landlord will compensate the tenant for the anticipated agreed value of the crop.
- The incoming tenant, purchaser or landlord should have the right to enter on the land after harvest in the last year of the agreement to prepare the land for next year's crop.

Transfer of property - It is important that the landlord and tenant discuss their expectations in the event that the landlord sells the farm property to a new owner during the term of the lease. A fair agreement will attempt to strike a balance between the landlord's desire to not unduly restrict his or her ability to sell the farm and the tenant's desire to continue the lease arrangement.

Termination of the lease - The lease should clearly spell out how it can be terminated. This could be due to a breach of the terms of the lease or merely because the termination date of the lease has arrived.

Use of the land - The lease should state how the tenant is going to use the land. The lease should also describe any certification, regulatory or contractual constraints that the renter should be aware of, such as the land being certified as organic. The tenant should be required to adhere to normal farming practices in regard to disposal of manure. It should also be clearly stated how the land is to be left after termination of the lease. If buildings are included in the leased property, the lease should state how the buildings will be used and the rules for accessing the buildings.

If the farm will be used for selling products such as pick your own fruit, the lease should indicate this, and the tenant should be made aware of all the regulations governing the sale of food products, in addition to food safety requirements.

Environmental matters - This clause addresses the issue of environmental policies and responsibilities. In the event of an environmental problem, landlords, as owners of the lands, are ultimately responsible for activities occurring on their land. The tenant, as "user" of the land, should agree to adhere to appropriate and accepted farm practices and legislation relating to the environment (manure disposal, pesticide and herbicide applications, etc.). The tenant should also provide a "warranty" - a legal term meaning that this assurance can be legally relied upon - that they possess the necessary provincial licences for the application of pesticides or other chemicals to be used on the property.

Normally the tenant bears the cost, including the costs associated with an environmental clean-up, and reimburses the landlord for any costs that the landlord incurs as a result of the breach by the tenant of any environmental regulation.

Insurance - A clause regarding insurance would allow the landlord and tenant to identify who will be responsible for insurance coverage. The parties should ensure that adequate policies of insurance coverage, including occupier's liability insurance (insurance against personal injuries sustained by people coming onto the farm property) and fire insurance (especially if buildings are included), are in place.

Rights to assign or sublet the lease - The written agreement should contain a clause that prevents the tenant from subletting or assigning the lease to another individual without the written consent of the landlord. In a production lease, the consent of the landlord can be withheld at the landlord's sole discretion, without

explanation or reasonable cause (i.e., unreasonably withholding consent). In the case of a residence, the landlord cannot unreasonably withhold consent.

Resolution of differences - An arbitration or mediation clause in the written agreement describes how to deal with disagreements the tenant and landlord cannot resolve. The most common practice is to appoint a mutually agreed upon third party to act as a mediator or arbitrator.

Restrictions of land use - The lease should clearly define any areas that may have restricted use (e.g., the area directly underneath a wind turbine).

Optional Items

These items add clarity to the lease agreement and provide discussion points for the landlord and tenant as they formulate the lease agreement:

Production practices and management decisions - This clause deals with production and management decisions the landlord wants carried out by the tenant. Some of those factors could include:

- cropping decisions
- proper use of fertilizer and chemicals
- crop insurance and revenue insurance
- delivery and sale of crop

Income support payments, subsidies, reimbursements - The written agreement should clearly specify how government or marketing agency payments will be divided. This is most relevant in a crop share lease.

Repairs to buildings, fences and improvements - A clause stating who is responsible for repairing buildings, fences and other improvements, and how the expenses will be shared. A common practice is to have the tenant responsible for all minor repairs and for the landlord to reimburse the tenant for improvement costs that have a lasting benefit longer than the rental term.

Examples of major improvements that extend beyond the length or termination of the lease are:

- building and fence construction
- erosion control
- tile drainage
- clearing land

It is usually required that tenants obtain written permission from the landlord before making major improvements. It is also important to outline how the value of improvements will be determined and when compensation will be made. An example of one form of compensation to the tenant for improvements is for the landlord to let the tenant farm the improved land rent-free for a specific period of time to be agreed upon between the parties (in writing) at the time the improvement is consented to by the landowner. An annual review and agreement of the repairs and improvements needed could also be included here.

Duty to notify AGRICORP - Both the landlord and tenant must notify AGRICORP of any crop-sharing arrangement.

Compensation for property damages - This clause is especially necessary for determining responsibility for third-party and environmental damages.

Rights of first refusal - In some cases, the tenant is interested in purchasing the leased land but is either unwilling or unable to do so at the time. In these cases, the landlord may be willing to include an option whereby the landowner will notify the tenant that there is an offer to purchase from another party, allowing the tenant to bid on the purchase of the land before the landowner accepts the offer to purchase the land from the other party.

Option to purchase - The parties may include an option similar to the right of first refusal that allows the tenant to purchase the leased lands. This could be for a limited or unlimited time and for either a fixed price or

a price to be determined by some objective method such as a real estate appraisal by a certified agricultural appraiser.

Miscellaneous - The lease agreement may contain a clause that would terminate the lease if certain natural disasters occurred. For example, if the land were flooded and the tenant were unable to use the property, it would be unfair to insist the tenant continue to pay the cash rental unless the original rent charged had considered the risk of flooding. Other unforeseen circumstances include the installation of a highway, gas line, oil well sites, etc., on the rented land, creating inconvenience and additional operating costs for the tenant. In some instances, instead of terminating the lease, it may be considered desirable to renegotiate the terms of the lease or compensate the tenant for the added costs or reduced income they may incur.

Municipal zoning restrictions - The tenant enters into a farm lease with the express intention of conducting agricultural operations; it is important that the landlord provide an assurance to the tenant that the lands are properly zoned for such use. If the landlord is unwilling to provide such a warranty, the tenant should get advice from the local municipal authorities to ensure that the purpose to which the tenant wishes to put the property is permitted.

Section 4. Developing a Building Lease Agreement

Most landlords and tenants want to determine a fair or going rental rate. However, a common rental rate for a particular building or piece of equipment may not always exist. In many areas, there is no widespread market for specialized livestock buildings. The fixed location of existing structures often narrows the market to just a few prospective tenants. The factors surrounding each individual case and the bargaining position of each of the parties involved may determine the final rental rate.

Factors that Affect Rental Value

Before leasing a building, consider these factors that may affect the net income from the proposed lease arrangement:

Condition - Are the building and equipment in usable condition? Will major repairs be needed? Who will pay for repairs and maintenance? Will operating costs be unusually high? Poor feed storage may result in high spoilage, or livestock performance may suffer if equipment breaks down.

Obsolescence - Does the facility reflect current technology? Can replacement parts be easily obtained? Does it meet current environmental rules? Extra labour, management and supervision may be required with obsolete equipment.

Use - Does the building or equipment fit the tenant's current needs? A hog producer may have little use for a silo or milking parlour, for example.

Size - Do the buildings and equipment have sufficient capacity for profitable livestock production, considering the tenant's labour and feed supplies? Is the storage facility large enough for the quantity of grain or forage to be stored? Or is it too large to be utilized efficiently or to match the tenant's other equipment?

Location - How far are facilities located from the tenant's base of operations? Distant buildings are less valuable to the tenant because of the higher transportation cost and greater inconvenience involved. Security risks are higher if livestock, machinery or stored crops are located where they cannot be observed regularly.

Convenience - Is the operation of equipment simple and efficient? Can grain or livestock be unloaded and loaded easily? Does machinery contain features that increase operator safety or comfort?

Alternatives - Could the same services or facilities be obtained elsewhere? At what cost? If the owner is offering a service that is difficult to obtain in the area, a higher rental rate is likely.

Estimating the Landlord's Costs

Landlord's Costs

Landlords may be primarily interested in recovering their costs for a particular farm building or set of equipment, particularly any operating costs not paid directly by the tenant. In addition, landlords may consider proper care and maintenance of their property important. At a minimum, the rental rate should cover any added costs related to the use of the facility. These variable costs may include use-related repair and maintenance costs, utilities expenses, and additional wear and tear. These are usually called ownership or fixed costs and include depreciation due to age, interest (return on investment), property taxes, insurance, and certain repair and maintenance costs not related to use. Because these costs occur whether the asset is

rented or not, any rental amount in excess of variable costs is a net gain to the landlord, even if it pays only part of the ownership costs. Table 1 provides guidelines for estimating annual ownership costs.

Table 1. Guidelines for estimating annual ownership costs

Item	Useful Life (yr)	Repairs (% of replacement cost)
Livestock buildings	15 - 25	1% - 3%
Livestock Equipment	5 - 10	3% - 5%
Grain storage, drying	15 - 20	3% - 4%
Machinery and hay storage	20 - 25	1% - 2%

Estimating the total of the landlord's costs for the item rented may provide a starting point for negotiating a rental rate. "Estimating Landlord's Costs," below, shows an example.

Calculating a Current Value

Most ownership costs can be tied to the current value of a building or facility. The best estimate of the current value of buildings or equipment is the price that could be realized from selling on an open market, although some items are not sold commonly enough to have an established market price. Original cost is not always a very good estimate of the current value of buildings and equipment unless they are only a few years old or are being newly constructed. Current value is generally less than the original cost due to depreciation and obsolescence. Current replacement cost is a good place to begin when estimating a facility's current value. Replacement cost refers to the cost of a new implement or facility, which is of similar size to the one in question, performs a similar service and is technologically comparable. Estimating current value as a fraction of current replacement cost adjusts for both depreciation and inflation since the asset was new.

For example, a building with an estimated useful life of 20 years (see "Estimating Landlord's Costs") and that is now 13 years old would have an estimated current value equal to 35% of its replacement cost (7 years remaining, divided by 20). If the lease period is more than 1 year, use the average age of the property during the expected lease period. If the property is in particularly good or poor condition for its age or is functionally obsolete, adjust the current value up or down to reflect this. Some facilities have very specialized uses or are attached to a fixed location. This often reduces their market value and rentability. A realistic estimate of current value should take this into account. You may want to engage the services of a professional certified appraiser to value unusually complex or expensive facilities, particularly if a long-term rental agreement is being negotiated.

Estimating Landlord's Costs

1. Current replacement cost: \$40,000
2. Total useful life: 20 year
3. Average age during lease period: 13 year
4. Years of life remaining (line 2 - line 3)(adjusted for condition): 7 year
5. Average value (line 1 x line 4 ÷ line 2): \$14,000
6. Interest rate on financing: 7.0%
7. Depreciation rate per year: 5.0%
8. Total depreciation amount (line 1 ÷ line 2): \$2,000
9. Cost of capital (average): 4.0%
10. Opportunity cost (line 9 x line 5): \$560
11. Insurance and taxes rate: 1%
12. Insurance and tax cost (line 5 x line 11): \$140
13. Total Fixed Costs (line 8 + line 10 + line 12): \$2,700

Variable Costs (if paid by owner)

14. Repairs (% of replacement cost) rate: 2%
15. Total amount of repairs cost (line 1 x line 14): \$800
16. Total variable costs (line 15): \$800
17. Total annual ownership cost (line 13 + line 16): \$3,500
18. Cost per month (line 17 ÷ 12 months): \$292
19. Total cash costs (line 17 - line 8 - line 10): \$940
20. Cash Costs per Month (line 19 ÷ 12 months): \$78

Calculating Fixed Costs

Depreciation - The annual depreciation for equipment or facilities depends on the remaining useful life. For example, items with a 10-year remaining life depreciate at an average rate of 10% of their remaining value annually. Remember that you are estimating loss of value due to use and obsolescence, not depreciation for income tax purposes.

The full investment cost of many items can be depreciated on the tax return at a much faster rate than their useful value declines. Facilities that have aged well beyond their useful life may be considered to have no depreciation expense.

Interest - The interest rate for intermediate-term loans and the rate of return from other fixed investments can be used to estimate a cost of capital. Multiply this rate by the current value of the facilities to find an annual interest cost.

Insurance and Taxes - These are most accurately estimated by consulting with your municipality and your insurer.

Calculating Variable Costs

Repairs and Maintenance - Repair and maintenance costs generally increase as a building or other structure ages. Repair costs can be estimated as a percent of new replacement value, to allow for changes in the costs of parts and labour. "[Estimating Landlord's Costs](#)," previous page, shows some suggested percentages for estimating repair costs for various types of rental items. For older or well-used items, you may choose to use the high end of the ranges shown.

A more satisfactory method may be to keep a record of actual repair and maintenance costs incurred by the landlord during the lease period. Some tenants may be able to reduce repair costs by providing some or all of the necessary labour.

Other Operating Costs - Other operating costs such as water, fuel and oil, electricity or gas should be borne by the tenant, either directly or indirectly through the overall rental charge. The most accurate method is to actually measure consumption of fuel or other energy, perhaps through a separate meter. If electrical use cannot be metered separately, an estimate of its cost can be made based on the size of lights and motors involved and their hours of use.

A partial budget format may be used to evaluate the cost benefit to the tenant of renting the facility. The tenant would compare the estimated added income and reduced expenses to any reduced income and added costs (see the sample evaluation below).

Sample Evaluation of Tenant's Value in Renting a Hay Storage Building

Line 1 - tenant expects added income because stored hay will result in better quality feed.

Line 2 - annual ownership of a building would be \$3,500. (See Line 17 of [Estimating Landlord's Costs](#))

Line 3 - income would not be reduced by renting the building.

Line 4 - cost of travel to the location to store and retrieve feed.

1. Added income from using the building: \$1,000
2. Reduced costs from not having to own the building: \$3,500
3. Reduced or lost income that could be earned by investment in another building or asset: -

4. Added cost from using the building, not including the rent: \$600
5. Added Value in Renting [(line 1 + line 2 - (lines 3 + 4))]: \$3,900

Establishing a Rental Rate

In the end, a rental rate is negotiated between the landlord and tenant. Landlords and tenants may use a combination of the methods below to arrive at the final price.

Total Costs of Landlord

The total of all ownership and operating costs may be used to estimate a rental charge for the whole year or a portion of the year. If a structure or piece of equipment is rented for less than a full year, the annual ownership cost estimates would likely be reduced proportionately. Alternatively, the total can be divided by a typical annual production level to estimate a charge per unit of production or use such as the cost per pig finished.

Keep in mind that many structures may not attract sufficient rent to pay for all ownership and operating costs due to their fixed location or a low demand for their services. Rental rates should, in general, at least cover operating costs and added wear to make it worthwhile for the landlord to enter into a lease. When selecting or negotiating with a potential tenant, characteristics such as reliability, experience, honesty, financial condition, availability, possession of skills and equipment for making repairs or improvements, and likely longevity may be considered.

A lower rental charge may be acceptable in exchange for strong performance in these other areas.

Commercial Rates

In some cases, the same service being offered by the landlord may be available from a commercial source at an established price. Commercial rates may serve as an unbiased reference that reflect current costs, and supply and demand conditions.

Property rental agents may help to determine an appropriate rental rate for a farm home or other building. Some commercial livestock companies may pay standard rates for the use of feeding facilities. An advantage of using commercial custom rates as a guide to rental charges is that they reflect average per unit costs at an efficient level of use.

Farm Records

A third approach to setting a fair rental value is to find out how much it costs other farming operations to own and operate the same facilities. Benchmark data, if available, may provide detailed cost data. If possible, use data for the same enterprise and size of operation as for the facilities under consideration. Try to include all the ownership and operating costs that the landlord of the facilities would normally pay. Keep in mind that records may not include interest (opportunity) costs on the landlord's own capital.

Many private production record services also provide group summaries with detailed enterprise cost data. Generally only members or users of the service have access to this information.

While record data from other farms may not accurately reflect costs for a particular set of facilities, they at least indicate typical opportunity costs for the tenant of not owning his or her own buildings and equipment. These three approaches may provide a starting point for negotiating an acceptable rental rate. The actual rent agreed on will probably fall somewhere among these values, depending on each person's bargaining position and the supply and demand for similar property in the area.

Section 5. Responsibilities of the Landlord and Tenant

Several areas of responsibility should be discussed and agreed on before the leasing period begins. How these are handled may affect the amount of rent that is paid for the facilities.

Repairs

Most buildings and equipment will need some maintenance and repairs eventually. At the beginning of the lease, the tenant and landlord should jointly inspect the rental property to be sure everything is in satisfactory working order. In general, it is the landlord's responsibility to have the facilities in good condition when the lease begins. Some leases may contain a 30-day trial period during which the landlord agrees to repair any part of the facility that is not performing satisfactorily. This is especially important when equipment has not been used recently.

Next, the landlord and tenant need to agree on how future repairs and maintenance costs will be handled. Lubrication, sharpening, adjustments to controls and replacement of fasteners, controls and small equipment are usually the tenant's responsibility. This ensures that such repairs are done quickly and also motivates the tenant not to abuse equipment. When major building components need to be fixed or replaced, the landlord generally pays the cost. When possible, the tenant may provide labour and expertise to perform the repairs.

Either party may provide portable items such as feeders and waterers, heaters, gates and panels, skid loaders and feed grinders. Naturally, the rental rate will be higher if the landlord provides such items. The lease agreement should list who will supply specific items. In any case, the owner of such equipment usually pays major repair costs. Some leases allow the tenant to charge repairs up to a maximum dollar amount without prior approval, but the landlord must approve amounts over this limit before they are carried out. Another possible lease provision is to allow a third-party arbitrator to decide if major repair costs are caused by normal wear and tear or by tenant misuse of the buildings and equipment.

Water

An adequate supply of water is essential for livestock facilities. Determine the source of the water and condition of pumps and waterlines at the beginning of the lease. Include the value of the water system when estimating a fair rental rate. Repairs and maintenance may be handled as described in the previous section.

If the water supply becomes inadequate due to drought or other problems, the lease should state which party is responsible for obtaining supplemental water. When the problem is due to natural causes, some tenants and landlords divide the cost of obtaining extra water. This may include reimbursing the tenant for hauling costs. Or, the landlord may pay the cost of the water while the tenant transports it.

If water is supplied by a utility, such as a rural water system, the variable cost is usually borne by the tenant. If the cost or use cannot be metered directly, some other method of measuring monthly consumption must be determined.

Manure Disposal

Manure collection and disposal is becoming an increasingly important issue in livestock production. It is the landlord's responsibility to see that leased facilities meet all applicable laws and zoning regulations related to livestock wastes. Responsibilities of the landlord and tenant under municipal nutrient management bylaws or the Nutrient Management Act, 2002, must be clearly outlined within the lease agreement. The question of who removes manure and to whose land it is applied is best answered according to practical considerations, and included as part of any nutrient management plans. Who has the proper equipment and who has cropland that can utilize the manure are good places to start. Distance of cropland from the livestock facility is also a factor.

If the same party both disposes of the manure and benefits from it, then it is possible that no payment needs to be considered. However, if the tenant applies the manure on the landlord's land, for example, then the tenant may receive payment for performing this service or have the rental charge for the facility reduced accordingly. Times and locations for spreading must also be set. For detailed information on custom rates by provincial region, see the [OMAFRA Factsheet Guide To Custom Farmwork and Short-Term Equipment Rental](#).

Insurance

Generally, each party is responsible for insuring his or her own property. This means the landlord would carry comprehensive insurance on buildings, equipment, fences and other property, as well as general liability insurance. These costs are built into the rental charges. The tenant would need to insure livestock, feed and his or her own equipment.

Time and Basis of Payment

The date that rental payments are due, in general, should coincide with the periods in which the tenant receives cash income. Annual or semi-annual payments are common, although, for a continuous livestock production facility, monthly payments may be reasonable. If a facility is used for only part of a year, annual rental charges may be reduced accordingly.

Some rental rates for buildings and equipment are based on the actual level of usage rather than a fixed annual amount. For example, a swine finishing facility may be rented for a set rate per head finished, or a machine shed may be rented for so much per square foot of space used. In these cases, the landlord and tenant would need to agree on how the level of usage will be determined.

Summary

Building lease arrangements provide both the landlord and the tenant with the opportunity to utilize their assets in the most effective way possible. Good communication and the development of a written lease allow each party to benefit from the arrangement.

This Factsheet was authored by Business Management Unit Staff, OMAFRA, Guelph. Portions of this Factsheet were taken from the North Central Regional Extension Publication No. 214 entitled Rental Arrangements for Farm Buildings and Livestock Facilities, by William Edwards, Iowa State University, and Fred Benson, formerly University of Minnesota. The authors would like to gratefully acknowledge their permission to do so. The authors would also like to thank Tom Blonde, M.Sc. (Agr.), C.A. of Collins Barrow, Elora, for his help in reviewing and editing this Factsheet.

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