



LAND LEASE ARRANGEMENTS

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INTRODUCTION

Leasing and renting land is a common practice in rural Ontario. The high capital cost of land makes leasing an attractive alternative to ownership. There are both advantages and disadvantages to leasing farmland. While reduced capital cost is an advantage, the difficulty of securing long term leases on land is a disadvantage. *Table 5* on page 7 summarizes some of the advantages and disadvantages of leasing.

This Factsheet addresses the general issues that a landlord and tenant should consider when entering into a leasing agreement. More specific information on lease types and sample agreements is available in the following Factsheets:

- Order No. 01-067, *Crop Share Lease Agreements*
- Order No. 01-069, *Flexible Cash Lease Agreements*
- Order No. 01-071, *Cash Lease Agreements for Cropland*

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SECTION 1 — THE ELEMENTS OF A LEASE AGREEMENT

THE HUMAN DYNAMICS OF A SUCCESSFUL LEASE – CAN YOU GET ALONG?

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. In Table 1 can you answer yes to the following questions?

TABLE 1. Checklist of a Successful Lease

Characteristics		YES	NO
Compatibility	Can you get along and discuss differences?		
Honesty	Do you trust the person you're dealing with? This is especially important in a crop share lease.		
Clarity	Do you both know the terms of the lease and are they in writing?		
Equitable Terms	Are you both happy with the terms?		
Flexibility	Can you adjust the lease if changes occur?		
Suitability	Does the lease fit the crop and encourage good agricultural practices?		

SHOULD THE AGREEMENT BE VERBAL OR WRITTEN?

In Ontario the majority of farm lease arrangements are simple verbal agreements. The handshake is a long-standing method of doing business in the rural community. While a verbal lease agreement is a valid contract, it has disadvantages for leases of 3 years or less. Leases longer than 3 years must be in writing to be a valid lease agreement. 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.

While these objections are valid they do not take into account the cost, frustration and relationship damage a disagreement can cause. The disadvantage of a verbal lease

becomes apparent when a disagreement occurs. At that point it is exceedingly difficult to prove what the terms were. At that point the credibility of the parties becomes the deciding factor.

A written lease can prevent, or at least, minimize the risk of this. A written agreement is not a sign of distrust — it shows that both parties want a clear understanding of the agreement they are making.

ADVANTAGES OF A WRITTEN LEASE AGREEMENT

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 and responsibilities of both parties and if a dispute occurs it 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 INFORMATION SHOULD A LEASE CONTAIN?

A written lease can be as simple or detailed as the landlord and the tenant wish. Table 2 presents the items that a lease can contain. These are categorized under 3 headings:

- **Required** — all leases must contain this information
- **Recommended** — items that every landlord and tenant should consider including in the lease agreement
- **Optional** — items that add clarity to the lease agreement and provide discussion points for the landlord and tenant as they formulate the lease agreement

REQUIRED ITEMS

Names and Addresses of the Tenant and Landlord and Spouses if required

Description of Property to Be Rented — includes the common legal description and specifies buildings or areas to be excluded.

The Term of the Lease — indicates when it starts and how long it lasts and, although not a basic requirement of a lease, this section should address the renewal of the lease if the parties wish to maintain the lease agreement for a period of years. The lease should also state when and how such a renewal will take place.

Rent Payable — what is the amount of rent, how is it calculated and when it is to be paid.

RECOMMENDED ITEMS

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 complete harvesting of the crop after 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 their ability to sell the farm and the tenants desire to continue the lease arrangement.

TABLE 2. Summary of Required, Recommended and Optional Lease Items in Written Lease Agreements

Required Items	Recommended Items	Optional Items
<ul style="list-style-type: none"> • names and addresses of tenant and landlord • description of property to be rented • term and renewal of the lease • rent payable 	<ul style="list-style-type: none"> • right of inspection and removal of crops • transfer of property • termination of the lease • the use of the land • environment matters • insurance • rights to assign or sublet the lease 	<ul style="list-style-type: none"> • arbitration of differences • production practices and management decisions • income support payments, subsidies and reimbursements • compensation for repairs to buildings, fences, and improvements • compensation for property damages • rights of first refusal • option to purchase • municipal zoning restrictions

Termination of the Lease — the lease should clearly spell out how the lease 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. (*see Termination of a Lease on page 5*)

The Use of the Land — the lease should state how the tenant is going to use the land. 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.

Environment Matters — This clause addresses the issue of environmental policies and responsibilities. In the event of an environmental problem the landlord, as owner of the lands, is ultimately responsible for activities occurring on their land. The tenant, as “user” of the lands, should agree they will 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 licenses for the application of pesticides or other chemicals to be used on the property.

The tenant should also agree to bear the cost, including the costs associated with an environmental clean-up, and reimburse 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 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 (if buildings are included), are in place. For a complete coverage of Insurance issues, including environmental issues, see OMAFRA Factsheet *Farm Business Insurance*, Order No. 00-041.

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 (*see Assignment and Subletting on page 5*). In a production lease the consent of the landlord can be unreasonably withheld. In the case of a residence the landlord cannot unreasonably withhold consent.

OPTIONAL ITEMS

Resolving Differences — An arbitration clause in the written agreement describes how to deal with disagreements the tenant and landlord cannot resolve together. The most common practice is to appoint a mutually agreed upon third party to act as arbitrator.

Production Practices and Management Decisions — This clause deals with the issue of production and management decisions the landlord wants carried out by the tenant. Some of those factors could include:

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

Income Support Payments, Subsidies and 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.

Compensation for Repairs to Buildings, Fences, and Improvements — The agreement should state 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. One practice is for the landlord to let the tenant farm the improved land rent-free for a specific period of time.

Compensation for Property Damages — The party who has suffered the loss should receive any compensation that is payable. For example, if a payment is made as a result of crop damage, the tenant should receive the entire compensation in the case of cash rent. With a crop share lease, however, the compensation should be shared in the same portion as the crop is shared. Both the landlord and tenant must notify AGRICORP of the

crop sharing arrangement. Where there is capital damage to land, the landowner should receive the entire compensation.

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 present. In these cases, the landlord may be willing to include an option to the tenant to purchase the property by matching the offer the landlord receives from a third party to purchase the lands.

Option to Purchase — similar to the Right of First Refusal, the parties may include an option that allows the tenant to purchase the leased lands. This could be 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 was flooded and the tenant was 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 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 — 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 2 — TERMINATION AND OTHER LEGAL ISSUES

TERMINATION OF THE FARM LEASE

A farm lease can be terminated in a number of different situations, including:

- Termination at the end of the specified term in the lease (if a tenant remains in possession of the property after the termination date without the consent of the landlord, then the landlord can obtain a court order to have the tenant removed).

- The *surrender* of the lease by the tenant; that is, the voluntary “giving up” of the lease with the consent of the landlord.
- The *merger* of the lease where the tenant purchases the leased property from the landlord.
- The *foreclosure* of the lease in the event the landlord defaults on any mortgage on the lands, and the mortgagee begins foreclosure proceedings. This only applies if the lease was entered into **after** the registration of the mortgage in the land registry office.
- The giving of *notice* by the landlord to the tenant of the intention to terminate the lease. If the lease does not expressly state a termination date, then the landlord is required to give notice in accordance with the *Commercial Tenancies Act* (Ontario). Weekly tenants must receive one weeks’ notice; monthly tenants receive one months’ notice. [Act, s. 28]. The legislation appears to be silent on the amount of notice required for a yearly lease so it is critical the parties set out the appropriate length of notice in the written lease.
- The *court order* of a judge when the landlord or tenant has commenced an action arising from a dispute and the court orders the lease terminated. This may arise in circumstances where the tenant has failed to pay the rent in a timely basis or there has been some other alleged breach of the terms of the lease.

The tenant has certain rights in the event of termination of the lease by the actions of the landlord. In legal terms the tenant benefits from the principle known as “relief from forfeiture”. This means that where a landlord is proceeding to terminate the lease, whether for non-payment of rent or other cause, the tenant may apply to the courts to remain in possession of the premises upon such terms as the courts direct, if the termination of the lease would result in significant harm to the tenant’s enterprise. It is up to the tenant to make a substantial case for relief from forfeiture in the event that the tenant has otherwise breached the terms of the lease.

NON PAYMENT OF RENT

The *Commercial Tenancies Act* (Ontario) contains some specific issues relating to farm leases. Most of these provisions relate to the options available to a landlord when a tenant fails to pay rent. The *Act* permits the landlord to seize the goods of the tenant for the purpose of selling those goods in payment of the rent due to the landlord. This is called the remedy of distress.

Section 44 of the *Act* allows a landlord to seize and secure goods and to sell them, but cannot remove them until the sale takes place. This includes livestock and growing crops. The landlord can seize and harvest standing

crops for arrears of rent and place them in an appropriate facility until they can be sold. In this case, the tenant is granted the right to know where the crop has been taken. In the event the tenant then pays the rental arrears, together with any costs incurred by the landlord in pursuing this remedy, the tenant is entitled to receive the crops back.

Section 46 of the *Act* specifically exempts livestock on pasture from the distress remedy if there are other chattels sufficient to pay the amount owing.

Note that in the case of an insolvent tenant other creditors might have priority security agreements that rank prior to the interests of the landlord.

REGISTRATION OF THE LEASE

Ontario has a system of registering interests in land, including leasehold interests. Under Ontario law, a lease for more than 7 years *must* be registered in the land registry office where the land is located. Leases of less than 7 years *may* be registered by the registration of a Notice of Lease advising the public that the terms of the lease can be made known by contacting either of the parties. The advantage of registering a lease is that a potential purchaser of the property is deemed to have been notified of the existence of a lease, whether or not they conducted a title search.

On balance, it is prudent that all leasehold interests be registered so that public notice can be provided of the claims of both the landlord and the tenant. The cost of registering the appropriate documents in the land registry office is currently \$60.

SPOUSAL OBLIGATIONS

Farm leases are unique in that the farmland is generally used for dual purposes. One use is for business activities while the other for the family residence of the owners. The *Family Law Act* (Ontario) provides, among other things, that one spouse cannot create an interest in land, including a leasehold interest, without the consent of the other spouse if the interest impacts on the use and enjoyment of the

“family residence”. As such, if the farm lease is to include the personal residence located on the farm property, it is important that both spouses sign the lease and acknowledge their consent to the arrangements.

ASSIGNMENT AND SUBLETTING

The *Commercial Tenancies Act* states that, unless a lease provides to the contrary, assignments or subletting to a third party can occur with the consent of the landlord and that such consent cannot be arbitrarily withheld by the landlord. This requires the landlord to consent to any reasonable new party taking over the terms of the lease. Because of this legislation farm leases often contain a clause that permits the landlord to arbitrarily not consent to such an assignment.

THE LANDLORD AND TENANT RELATIONSHIP

The relationship of landlord/tenant can sometimes be confused with the relationship of joint venturer’s or partners. Because the legal obligations of these relationships are very different it is important to clarify the relationship that is intended in a lease agreement. This is especially true in the case of a crop share lease where both parties are contributing to a cropping enterprise. The lease should clearly identify the parties as having the relationship of landlord and tenant.

THE FARM EMPLOYEE TENANT

The *Tenant Protection Act*, 1997 (Ontario) deals primarily with the use of all residential units in Ontario; however, the provisions of that legislation specifically exempts living accommodations of farm employees. This means that the specific rules regarding residences in the legislation do not apply to farm workers who benefit from the use of farm residential premises as a term of their employment, whether or not the residential premises are located on farm property.

TABLE 3. Cropland Lease Comparison

Cash Rental	Flexible Cash Rent	Crop Share
<ul style="list-style-type: none"> • Tenant receives the income from all crop sales but pays the landlord a fixed dollar amount each year as the rent. • A portion of the rent may be paid in advance and the rest at harvest. • The tenant bears all the production risk. 	<ul style="list-style-type: none"> • The tenant receives all the income from crop sales but the dollar amount paid to the landlord each year varies with either the price of grain or yield of grain, or both price and yield. • Incorporates features of both the Crop Share and Cash Rent leases. • Amount of risk that is borne by the tenant and landlord depends on the type of leasing arrangement. 	<ul style="list-style-type: none"> • A division of crop sales between the landlord and the tenant. • Income is divided as the crop is sold.

TABLE 4. Landlord's Risk for Leasing Arrangements

	Type of Lease		
	Crop Share Lease	Flexible Cash Lease	Cash Lease
Production Risk			
Income affected by:			
• weather	Yes	Yes	No
• insects and disease			
• use of inputs			
• general management			
Marketing Risk			
Income affected by:			
• price variations	Yes	Yes	No
• crops grown			
• delivery opportunities			
• storage costs and losses			

SECTION 3. TYPES OF LEASES

There are 3 types of cropland leases — cash rental, flexible cash rent and crop share leases. What makes each of these leases different is how the payment for the land is calculated. Cash rental is fixed. Flexible cash rental and crop share are based on a division of revenue from the crop in a pre-determined fashion. *Table 3* compares the different cropland leases. In addition to cropland leases there are building and pasture leases.

Generally a cash rental arrangement would, over time, return less to the landlord than a crop share arrangement. This is because the landlord would not be sharing any of the risk associated with growing the crop and therefore not reap the returns when prices or production are higher than normal. These risks can be grouped into two categories, namely production and marketing risk. *Table 4* outlines these risks and shows which risks are shared by the landlord under the three types of lease arrangements.

There are both advantages and disadvantages of leasing arrangements. *Table 5* outlines some of these.

ESTABLISHING A RENTAL RATE

Most rental rates are established by using local market rates, which reflect the supply of and demand for rental land in a local area. Crop share and flexible cash agreements use this market rate as the basis for establishing the crop shares or flexing provisions in the agreement. In the case of crop shares a traditional 1/3 – 2/3 or 1/4 – 3/4 landlord/tenant split is common.

Despite the fact that most rental agreements are based on the local market rates a tenant and landlord should take the necessary time to calculate their costs and potential revenues. This will help them determine, most importantly, if the arrangement will be profitable. It is also useful when a good market comparison is not available.

It is important to emphasize that determining a fair cash rental rate or a crop share depends on the landlord and tenant knowing their costs. In addition, estimates for labour, depreciation, management and investment need to be taken into account.

Several approaches can be used to determine an appropriate rental rate. These methods are summarized in *Table 6*. For greater detail refer to the specific Factsheets listed on page 1. These calculations give you a place to begin your negotiations and more importantly, provide a safeguard against entering into agreements that are unprofitable.

SOURCES OF COST INFORMATION

From *Table 6* you can see how important it is to know your costs when negotiating a rental rate. Your own records are the best source of this information, however when these are not available it is important to use realistic estimates. The following sources can be of help:

- Publication 69, *Ontario Farm Management Analysis Report (OFMAP)*, published annually by OMAFRA
- Publication 60, *Crop Budgets*, updated annually these 12 crop budgets can provide you with cost estimates.
- Sample lease agreements — electronic versions of the lease agreements are available on the OMAFRA Web site at: www.gov.on.ca/OMAFRA/english/busdev
- A computer spreadsheet called “Land Leasing Tools” is available on the Business Development page of the OMAFRA Web site at: www.gov.on.ca/OMAFRA/english/busdev

TABLE 5. Leasing Advantages and Disadvantages

Advantages	Disadvantages
Lower Capital Investment <ul style="list-style-type: none">• 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.• An operator can reach a larger size of business.• It is also a means for becoming established in farming. Since leasing is an alternative to ownership, it is really a means of “financing” a land base.	Lack of Security of Tenure <ul style="list-style-type: none">• Short-term leases create uncertainty for the tenant.• Machinery investment is matched to the land base. The cancellation of a lease could leave the tenant farmer with 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 it may not encourage superior farming practices by the tenant.
Increasing Financial Efficiency <ul style="list-style-type: none">• When funds are limited it is often more profitable to spend this money on seed, fertilizer, chemicals, and machinery.• Investing scarce funds in land may severely restrict the money available for operating capital thus lowering the efficiency of the farm business.	Lack of Efficiency, Conservation and Incentive to Make Improvements <ul style="list-style-type: none">• 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.
Obtaining Farm Experience <ul style="list-style-type: none">• Renting enables the beginning farmer to gain needed experience in the financial operation of a farm business before he commits himself to a long-term investment in land.• Enables operator to learn more about land in an area and gives more flexible position to change farms or to leave farming.• Renting may enable a younger farmer to obtain the managerial assistance of an older experienced landlord.	Availability of Credit <ul style="list-style-type: none">• Tenant farmer usually has a more difficult time to obtain intermediate and long term credit than does the owner-operator because:<ul style="list-style-type: none">• the lender may require land as security for the loan• leased land does not build equity• the lease is short term.
Sharing Risk <ul style="list-style-type: none">• 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.	Lack of Bargaining Power and Managerial Control <ul style="list-style-type: none">• 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 contributions to the lease may be substantially less than the tenant’s contribution.• For example, the landlord may insist on certain crops being grown which are not the most profitable as far as the tenant is concerned.
Father-Son Arrangements <ul style="list-style-type: none">• A father-son business arrangement might include a lease agreement whereby the son rents land from the father or rents land from a third party and shares the machinery investment with the father.	People Problems <ul style="list-style-type: none">• As with any business venture involving two or more persons, disputes and disagreements can arise.
Providing Retirement Income <ul style="list-style-type: none">• A retiring farmer might consider leasing all or a portion of his 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 land and farming the rest of it.	Lost Opportunity for Capital Gain <ul style="list-style-type: none">• 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 <ul style="list-style-type: none">• Leasing land can in some cases prevent the use of both the tax-deferred transfer to children and the use of the \$500,000 capital gains exemption.• An accountant should be consulted.• See page 8 <i>Tax Implications of Leasing</i> for details

TABLE 6. Methods of Calculating a Rental Rate

Method	How is it calculated	Pros	Cons
Current Market Approach	<ul style="list-style-type: none"> The going rental rate and conditions in the area establishes the rent for the land. Each party should do their own financial projections to determine if returns will be adequate to make the leasing worthwhile. 	<ul style="list-style-type: none"> Usually method used above all others. 	<ul style="list-style-type: none"> Difficult if you can't determine local rates. There can be a large variation even within a small geographic area due to type or condition or competition for land.
Landlord's Cost Approach	<ul style="list-style-type: none"> Landlords determine how much cash rental is necessary to give desired rate of return on land investment. 	<ul style="list-style-type: none"> Can be used as a starting point for landlords. 	<ul style="list-style-type: none"> The amount is often higher than going market rate because landlord's capital gain is not included.
Crop Share Equivalent Approach	<ul style="list-style-type: none"> Used to establish a cash rental rate. Landlord estimates amount of rent received based on a normal crop share lease. Used as basis for establishing or negotiating cash rent. 	<ul style="list-style-type: none"> Both landlord and tenant can see how the cash rent figure is calculated. Useful as a starting point. 	<ul style="list-style-type: none"> Need to know costs involved. May be more difficult for the inexperienced. Must know the normal crop share arrangement.
Income Approach	<ul style="list-style-type: none"> Income and expenses for given situation are estimated and net income is calculated. Tenant or landlord set rent based on a return to labour or investment. Tenants use this approach to determine how much rent they can afford to pay. 	<ul style="list-style-type: none"> Tenant and landlord can calculate their own costs and revenue. 	<ul style="list-style-type: none"> Income and expenses are estimates, may be hard for inexperienced landlord or tenant to calculate. May not be appropriate for new crops or land rented for first time
Contribution Approach	<ul style="list-style-type: none"> Each party shares the income from the land in the same proportion as they contribute to costs. Tenants should receive a larger share if contribute more in the way of crop inputs, machinery, labour or accepts a larger risk. Landlord should receive a larger rent for more productive and higher valued land. 	<ul style="list-style-type: none"> Recognizes the risk and investment of both landlord and tenant. 	<ul style="list-style-type: none"> Can be difficult to determine or agree on costs and value of investment, or the return required on the investment. Landlord may not be familiar with crop costs.

SECTION 4 — TAX IMPLICATIONS OF LAND LEASES

The following information is intended for planning purposes only. It does not replace professional advice from a tax specialist.

While the purpose of this publication is to explain leasing arrangements, it would be incomplete if it did not touch on some of the tax issues the tenant and landlord should know.

Landlords can inadvertently disqualify themselves from being able to use two major tax provisions. This can happen because Canada Customs and Revenue Agency (CCRA) does not consider many types of leasing to be farming. Even a share crop lease, where a portion of the crop is given to the landowner as payment for the land, does not meet their definition. As a result some leasing arrangements can cause a landowner to lose the ability to use the tax provisions outlined below. These provisions are:

- the ability to use a tax deferred rollover on the transfer of land to children (called a rollover)
- the \$500,000 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, in tax language, 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). Transferring the land at any price up to the ACB would trigger no capital gain while transferring at FMV would trigger all the gain. Without the use of the rollover the land would have to transfer at its FMV and all the gain would have to be reported.

In order to qualify for the rollover the property must have been used principally in the business of farming prior to the transfer by the taxpayer, their spouse or their children who were actively and continuously involved. This means that for greater than 50% of the time the land's use was in farming. 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 have leased a farm property for a number of years and 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 and 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. The exception to this is if the person leasing the property is your spouse or child and they are actively engaged in farming.

PRESERVING THE \$500,000 CAPITAL GAINS EXEMPTION

The \$500,000 Capital Gains Exemption is available to individuals on the sale of *qualified farm property*. An individual who had used their entire \$100,000 personal exemption, which was eliminated in 1994, has \$400,000 remaining. (*If you used this election see the section "Have you used your \$100,000 Exemption".*) The exemption is also available for partners in a partnership, since taxes are paid at the individual level. 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 must be used in farming by:

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

for property purchased **prior to June 18, 1987** it:

- must be used in farming at the time of sale **or**
- have been used in farming for any 5 years during its ownership

for property purchased **after June 17, 1987** it:

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

What Affect Does Leasing Farmland Have on Your Use of The \$500,000 Capital Gains Exemption?

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 then the property must be farmed immediately before the sale. Since leasing is not considered to be farming according to Canada Customs and Revenue Agency (CCRA) a lease in the year of sale could disqualify you from using the capital gain 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 their definition. Hiring custom operators to do the cropping work in the year before the sale since that is considered to be farming could solve this problem. Alternately a share crop lease where the landowner is sharing the cost of inputs may also meet the CCRA requirements of farming. You should discuss such agreements with your accountant.

Have You Used Your \$100,000 Capital Gain Exemption?

The \$100,000 capital gain exemption was part of the \$500,000 exemption. The 1994 budget eliminated the exemption but allowed an election to increase the adjusted cost base of property by up to \$100,000, but not exceeding the February 1994 value. **If you elected to use the \$100,000 exemption to increase the ACB, you are deemed to have disposed of the property in 1994 and you must meet the post June 1987 rules for qualified farm property on a future sale.**

CANADA PENSION PLAN AND REGISTERED RETIREMENT SAVINGS PLAN

Rental income cannot be used as a basis for contributions to the Canada Pension Plan. Farmers who lease their land and have no employment or self-employment income will be unable to make contributions to the plan. This will have the effect of reducing their Canada Pension Plan pension at the time it commences. Although rental income is not eligible for contributions to the Canada Pension Plan, it is earned income for the purpose of contributions to a Registered Retirement Savings Plan. Rather than a cash lease the land a landowner could farm the property by hiring custom operators or lease the land on a crop share basis where the inputs are shared. The net income from these sources is eligible for contributions for both the Canada Pension Plan and Registered Retirement Savings Plans.

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 Canada Customs and Revenue Agency (CCRA). When the tenant does not remit the 25% withholding tax, CCRA 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 land owner changes the use of their 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 not to 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.

GOODS AND SERVICE TAX (GST)

Rent that is paid by way of share of the crop is not subject to the goods and service tax. The treatment of cash rents for GST purposes depends on whether the landlord is registered with the Canada Customs and Revenue Agency (CCRA) to collect and remit the GST. A business (including a landlord who rents property) will not have to register if it's taxable and zero-rated sales are under \$30,000. A landlord whose only source of business income is rent and the amount is less than \$30,000 need not register. *Table 7* shows the possible resulting scenarios.

FARMLAND PROPERTY TAX PROGRAM

The Farmland Property Tax program enables eligible farm properties to be taxed at 25% of the municipal residential/ farm tax rate. The farm residence and one acre

of land surrounding it are taxed as part of the residential class.

To be eligible for the reduced rate a property must be part of a farming business with gross farm income of \$7,000 or more and must have a valid Farm Business Registration number. An application to the program must be filed. For more information contact AGRICORP toll free at 1-866-327-3678 or visit the Web site at www.farmbusreg.com.

SUMMARY

Leasing land will continue to be an important method of controlling land without having the capital costs of ownership. Developing clear leasing arrangements is a benefit to both the landlord and the tenant.

This publication is intended as general information and not as specific advice concerning individual situations. Although it outlines some of the legal and tax considerations of leasing arrangements it should not be considered as either an interpretation or complete coverage of the *Income Tax Act* or the various law effecting land rental arrangements. The Government of Ontario assumes no responsibility towards persons using it as such. All land rental arrangements should be discussed with your farm management advisor, accountant, or lawyer before they are signed.

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TABLE 7. Payment of GST

Scenario	GST	Result
Landlord is not a GST registrant.	Not required to charge the tax on the rent.	Landlord is unable to recover GST paid on taxable goods and services but may claim the full amount (including GST) as allowed for business expense deductions for income tax purposes.
Landlord is a GST registrant.	GST must be charged on cash rentals and landlord must remit the GST collected.	Tenant is able to claim an Input Tax Credit on the tax paid.

FOR YOUR NOTES

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