Chapter 3

Owner-Financed Sales and Land Contracts

by Anthony Iarrapino, Esq., Staff Attorney, Conservation Law Foundation, and Elizabeth Spellman, Law Clerk, Conservation Law Foundation

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This section explores two options—owner-financed sales and installment contracts—that farmers should be aware of when they seek to buy or sell farmland without relying solely (or at all) on traditional lenders like banks. By cutting out the "middle man," owner-financed sales and installment contracts can enable buyers and sellers to be more creative in setting terms tailored to the realities of a farm start-up, lowering hurdles for new farmers and potentially increasing a seller's overall gain. A brief explanation of the basics of buying and selling land illustrates how these two options differ from the traditional mortgage scenarios, and should help you understand whether one of them might be right for you.

In the normal property sale, the average buyer cannot, on the date of sale (known as the "closing"), pay the seller's full asking price for the property. Instead, the parties contract for the sale with a "purchase and sales agreement" pursuant to which the buyer typically makes a down-payment toward the overall sale price and takes out a mortgage loan from the bank for the rest using the property as loan collateral. The bank then pays the seller a lump sum on behalf of the buyer who took out the mortgage. In exchange, the seller signs over a deed to the buyer conveying ownership of the property. At the same time, the bank requires the buyer to sign a promissory note, a contract reflecting the buyer's promise to repay the loan, and a mortgage deed creating a lien on the property. The mortgage entitles the bank to take the property from the buyer, through foreclosure, in the event that the buyer defaults on the loan. The bank records the mortgage in the land records giving notice to all of its interests in the property.

There are several reasons why a new farmer seeking to buy land and a seller seeking to help a new farmer get started may not have the desire or the ability to work with a traditional lender. A bank typically requires the buyer to "qualify" for the loan by demonstrating good credit history and a steady source of existing income that is sufficient to cover repayment of the loan principal with interest. Yet for someone just starting up in farming, it may be difficult to convince a loan officer that future revenues from the start-up farm operation will meet a bank's rigid income requirements, especially if the future farmer's credit score is not high enough.

The Risk of Foreclosure

Just like in a traditional bank mortgage, farmer-buyers should understand that if they are not able to keep up with mortgage payments owed to the seller, the seller then has the legal right to foreclose and repossess the property. After receiving a foreclosure notice, the buyer typically has a six-month redemption period during which the buyer can avoid foreclosure by making good on delinquent payments (and in some cases repaying the seller's costs of foreclosure).

Foreclosure is no picnic for the seller. During the redemption period an owner-seller could have a buyer living on his "sold" property for half a year where the owner-seller neither can use the property, nor be paid by the buyer. Unlike a bank, however, a seller offering owner financing may be willing to seek a creative resolution to avoid foreclosure. Even though both parties hope that the buyer will pay the loan on time without problems, it is best for the parties to discuss and agree upon these creative alternatives up front and to include them in the agreements they make.

A buyer's up-front and overall costs in a bank loan scenario may be increased by administrative fees that banks charge for processing the loan. Banks set interest rates at a level necessary to help recoup overhead for bank operations while also earning a profit for the bank. Time is money, too, and your deal may be one of many that a bank is working on, thus the process can move slower than the buyer and seller would like.

The Basic Owner-Financed Farm Sale

With an owner-financed sale, the process of transferring ownership (purchase and sales agreement, promissory note, mortgage deed) is the same, but there is no third-party lender involved. Instead, the buyer and seller directly negotiate the amount of time—the loan term—that the buyer will have to pay the seller the full sale price and the interest rate that the buyer will pay on the outstanding balance over that time.[17] Thus, on the closing date, instead of getting a lump sum for the entire sale price from the bank the buyer is borrowing from, the seller signs the deed over to the buyer in exchange for a promissory note and mortgage that the seller then records in the land records. Before entering any deal, a buyer needs to be sure that the seller actually owns the property and that it is not subject to another mortgage already. An attorney can provide this information to the buyer by conducting a title search in the land records where the property is located.

17 IRS regulations classify owner-financed situations as "installment sales" and require that the seller charge the buyer some amount of interest in an owner-financed sale, though the actual interest rate remains subject to negotiation between the buyer and seller. See IRS "Tax Topic 705: Installment Sales" for basic information or IRS Publication 537 for full details about accounting for installment sales. If you do not state interest, the IRS will state it for you, based on the rules outlined in Publication 537. State law sets a maximum limitation on the interest rate that an owner-financer may charge. In Vermont, those limitations are set forth at 9 V.S.A. § 41a.

In an owner-financed sale, the buyer and the seller have tremendous flexibility when it comes to key elements of the deal. The parties can tailor their financing plan; for example, owner-financing arrangements are often set as "balloon payments," where the farmer-buyer makes payments according to a 30-year amortization schedule and is required to hand over a lump sum of the remaining balance balloon payment at some point prior to the full thirty year term (often at the five-year mark). This assumes that the buyer will build up enough equity in the property, good credit, and a solid income stream from farm operations to attract a conventional lender to step in and enable the farmer-buyer to pay off the owner-seller in full. In this scenario, the owner-seller would not have to worry about collecting payments for the entire 30 years.

Other lower-risk strategies an owner seller might want to use include an above-market interest rate or a hefty down payment. A seller can require an offer of personal liability from the buyer, a third-party guarantee or co-signature on the agreement. Depending on a seller's individual circumstances, the heightened risk to the seller may be offset by the tax advantages the seller could realize. In an owner-financed sale, the seller pays capital gains on the principal and income tax on the interest over time as the seller receives annual installments from the buyer, rather than having all state and federal taxes taken in one big chunk in the year of the closing—as is the case in a traditional sale.

Tax Implications of Owner-Financed Sales

Owner-financed sales can involve complicated tax ramifications, and it is advisable to consult with a qualified tax accountant to understand clearly how the IRS will interpret the terms of the arrangement. For example, in many cases, unless the arrangement falls under specific exemptions, the IRS expects that some portion of the loan will be paid back in interest and taxed accordingly. If interest is not stated in the agreement, it will be imputed or implied according to IRS regulations and the going IRS' Applicable Federal Rate (AFR). Read IRS Publication 537, "Installment Sales," for more information on the AFR and tax treatment of owner-financed sales. AFR rates are based on federal short, medium and long-term interest rates, and are published monthly in the Internal Revenue Bulletins (IRBs), available at local IRS offices or online at http://www.IRS.gov. The rules for including interest hold true even when sympathetic sellers desire to make zero or low-interest loans. For tax purposes, if these transactions are to be considered loans (vs. taxable gifts or capital contributions), they must follow IRS "Below-market Loan Rules." For more information about below-market loans, see IRS Publication 550, "Investment Income," available online at http://www.IRS.gov.

Is the Land Encumbered?

Real estate is encumbered when a legal claim exists against a property that restricts its transferability. Any farmer entering into an installment contract (conventional owner-financed sale or land contract) should make sure to ask the all-important question: is the seller's land or farm encumbered in any way? In Vermont, buyers can access public records at the town office to research whether or not any mortgages or liens have been recorded specific to the property in question. The buyer should also consult with his/her attorney reviewing the agreement to confirm that the owner-seller will be able to transfer free and clear title to the buyer at the end of the payment period. Buyers should also be aware if the owner-seller is using the installment contract as a "wrap-around" to pay off a mortgage from another lender while seller is slowly selling to the buyer under the installment contract (which can be a dicey situation for both owner-seller and farmer-buyer).

Buyers and sellers in the owner-financed transaction can be creative and flexible when it comes to dealing with situations where the buyer has temporary problems making payments. Consider the opportunities where, for example, the property has a woodlot. The parties can agree that the owner-financer is allowed to log the property in the event that the buyer falls behind on payments, taking enough timber to cover the amount of the delinquent payments until the buyer catches up with cash payments. The same arrangement could work with other farm products. This is just one example of the flexibility buyers and sellers can enjoy when financing a property transfer without a bank. The key is making sure that the parties clearly spell out any special terms like this to avoid misunderstandings after the deal is done. The parties should be able to negotiate without the aid of lawyers, but once you come to terms, it is wise for each party to consult a lawyer with experience in real estate to ensure that the terms of the final agreement are enforceable and clearly reflected in writing.

Sellers can either be the primary financer or they can team up with another lender to offer financing that enables the farmer-buyer to meet the total purchase price. This can be especially beneficial to new farmers in cases where conventional lenders are willing to write a loan for only a portion of the purchase price. The owner-seller provides financing for the balance, based on terms that are defined by the owner-seller and the farmer-buyer. The farmer-buyer makes two separate regular loan repayments; one to the conventional lender and the other to the owner-seller, each of which would record a mortgage lien on the property.[18]

18 Farmers can also get creative to finance land where the property is not entirely owner or bank-financed. For example, farms can finance part of their land by partnering with their future customers through the various financing mechanisms outlined in this guide. Farmers can consider giving several seasons' worth of CSA shares (see Chapter 9: The Multi-year CSA) or specifying an amount of food to be used to pay back part of the principal and/or interest on a loan from a community member over several years (see Chapter 5: The Promissory Note). Farmers should be aware of the implications of the financing arrangement for triggering securities regulations (see Chapters 1 and 2, Federal Securities Laws and State Securities Laws), especially in cases where the farmer solicits financing for the land purchase from the general public.

An owner-seller will not generally need a license from the state to sell and finance the property as long as the loan is primarily for an agricultural property, and personal, family, or household use does not supersede agricultural use (e.g., a hobby farm where the buyer is purchasing the land to serve primarily as a residence). Otherwise, the seller may need a mortgage loan originator license.[19]

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Another Variation of an Owner-Financed Farm Sale: The Land Contract

In cases where a seller is reluctant to fully finance a start-up farmer with a low credit score and/or little track record in the business of farming, a land contract with what amounts to a lease-to-own arrangement, aka an "installment contract"[20] may provide the seller with more comfort in taking a risk. Unlike an owner-financed sale, the seller in a land contract does not give the buyer a deed conveying an ownership interest in the property to the buyer until the full price is paid. Thus, unless the land contract agreement specifies otherwise, the buyer will not be allowed to borrow against the property by taking out a second mortgage to finance farm operations, and the buyer will not be able to sell the property to a third party. Owner-sellers might feel more comfortable knowing that they retain legal ownership while the land is "under contract" and the buyer is making payments.

Land contracts allow for a great deal of flexibility and creativity in setting the terms of payment. They allow both the farmer-buyer and owner-seller to avoid the hassle and expense of most closing costs common in conventional mortgage transactions. As noted above, land contracts give sellers more control than normal owner-financed sales. For all these reasons, land contracts are often the preferred mechanism for transferring ownership of agricultural property from senior to junior generation within the farm family.

Land contracts can be considered as conventional purchase and sales agreements with a greatly extended time period before closing—instead of signing a purchase and sales contract and then taking 30-45 days to close the deal, land contract deals can take as long as 30 years. Five to ten years is a more common time frame, with a regular payment schedule concluded by a balloon payment. The assumption is that in five to ten years, the farmer-buyer will have enough time to improve his/her balance sheet and credit to come up with traditional financing to make the lump-sum payment that finishes the deal with the seller.

Lower risk for the seller, in some cases, means higher risk for the buyer. In traditional land contract arrangements, when a buyer defaults, there is typically a forfeiture provision whereby the buyer loses the property and all the payments they have made. He or she is not likely to be entitled to the legal protections of the foreclosure process. If the buyer resides on the premises, the seller will have to use eviction procedures pursuant to state law. If the buyer does not reside at the premises, the seller can likely pursue an ejection action against the tenant. The seller can take back the property without going through the foreclosure process because there is no mortgage involved, and under the terms of the contract, the buyer loses possession of the property. A buyer generally cannot recover principal paid to the seller, unless the contract specifies otherwise. Instead, the buyer may forfeit past principal payments upon breach of the contract (essentially, those past payments may be viewed

19 8 V.S.A. § 2201(a)(3) describes these licenses, and subpart (e) of the same section outlines exemptions for the license requirement. A Vermont Superior Court case in 2011 elucidated the terminology of "in the business of." Based on the statute and the recent case, it would be rare for an owner-seller to need a lender license when selling to a farmer-buyer, assuming the seller is not involved with money-lending aside from the owner-financed deal.

20 The USDA Farm Service Agency's definition of a land contract is "an installment contract drawn between a buyer and a seller for the sale of real property, in which complete fee title ownership of the property is not transferred until all payments under the contract have been made." From the January 2012 FSA Fact Sheet on the Land Contract Guarantee Program. Accessed online 2/14/12 at http://www.fsa.usda.gov/Internet/FSA_File/lc_guarantee_program.pdf .

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as lease payments compensating the owner for the buyer's past use of the property as a farm and residence).[21] Here again, it is up to the parties to anticipate these possibilities and to tailor the agreement to their expectations and needs before signing on the dotted line.

Farmer-buyers often intend to make changes or improvements to the property as the farm gets up and running, before making all the required payments under an owner-financed sale or a land contract. It is important for the parties to determine the fate of these improvements in case the agreement goes sour, either from the buyer's default or the seller's breach of contract. For example, the contract can include a formula that indicates how much the owner-seller should pay the buyer for improvements made prior to default. In other cases, the seller might not want to be responsible for compensating the buyer for improvements, justification being that the seller assumes risk by permitting the farmer to access and alter the land while the seller still owns it, still pays the taxes, still is ultimately responsible for environmental laws breached, etc. In any case, it is common practice in crafting land contract agreements for parties to agree that the buyer must seek the seller's permission before making any major improvements to the land or buildings on the property during the contract period. Remember: the buyer does not actually own the property until the seller receives all payments required under the land contract!

Payment of property taxes and insurance are key considerations for both parties. The buyer will want to be sure that the seller is not behind on taxes. A buyer can obtain tax status information at the town office where the property is located. Insurance is another important issue; the farmer-buyer should ask the owner-seller or his/her agent about the seller's insurance policies on the property. This information will give the farmer-buyer a sense of what kinds of prominent risks might exist in owning the property and how and at what cost insurance might mitigate these risks. The parties will also want to agree on who will pay insurance and taxes during the payment period of the installment contract.

There are many templates found and sold online for developing installment sale agreements. While the parties can do much of the preliminary work on their own, including negotiating key terms, there is no substitute for the expertise of an attorney or an accountant familiar with these types of transactions.

Buyers and sellers have been using owner-financed sales and land contract sales to transfer property without third-party lenders for decades. With creativity, careful attention, and timely assistance of professionals such as attorneys and accountants, these alternative financing agreements can help a start-up farmer clear the biggest barrier to entry in agriculture: access to farmland.[22]

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21 Some courts have imposed a more equitable parting of the ways, and have ordered the return of some of the buyers payments. Dow, Heikkila v. Carver, 378 N.W.2d 214 (S.D.1985), and Prentice v. Classen, 355 N.W.2d 352 (S.D.1984).

22 USDA FSA opened nationally in 2012 the Land Contract Guarantee Program. According to FSA, "guarantees will be offered to the owner of a farm who wishes to sell real estate through a land contract to a beginning farmer or a farmer who is a member of a socially disadvantaged group." For more information, contact your local USDA service center FSA office or see the FSA one-page fact sheet on the program online at: http://www.fsa.usda.gov/Internet/FSA_File/lc_guarantee_program.pdf Accessed online 1/26/2012.