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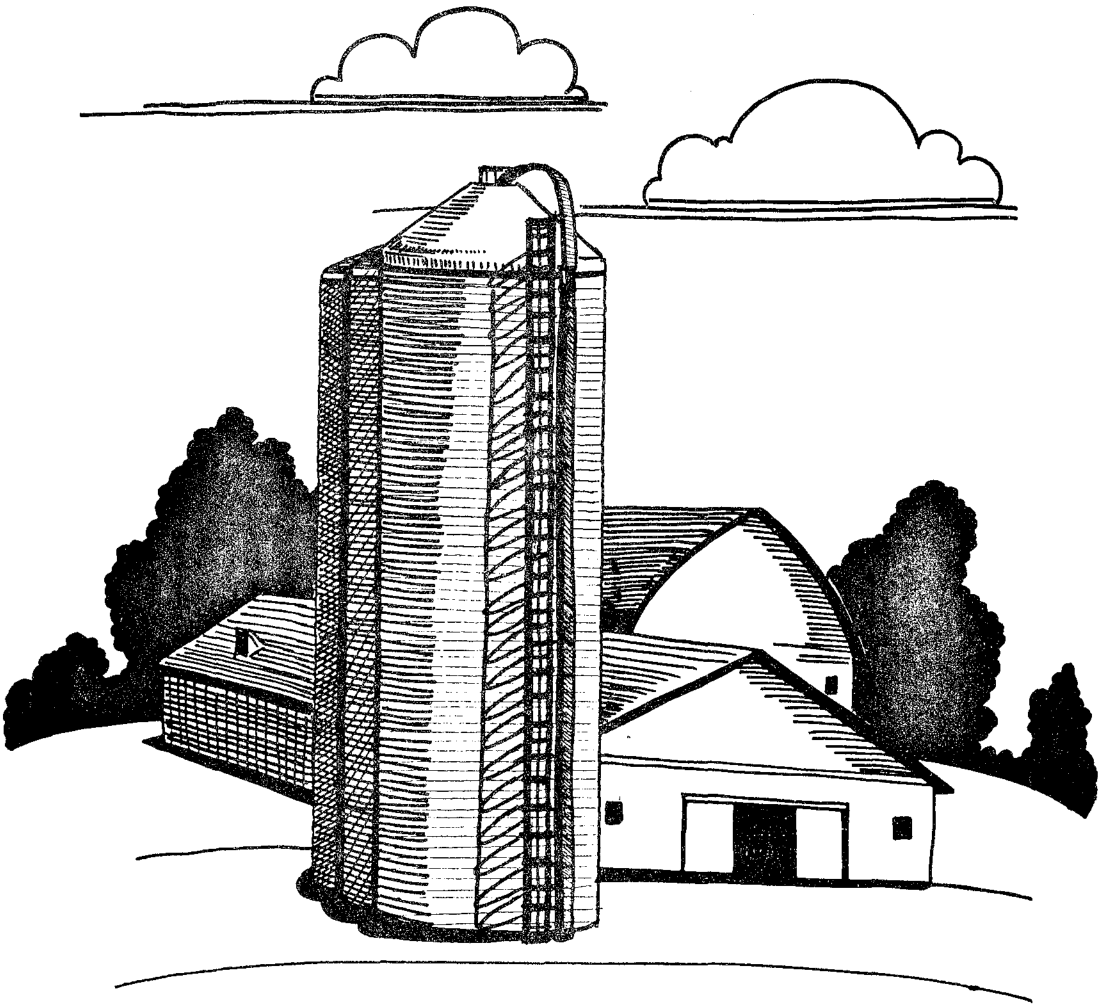
BUYING A FARM ON CONTRACT



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The purpose of this publication is to clarify some of the economic considerations which arise in the sale of a farm on contract. It is not the intention of the writers to give legal advice, nor is it their intention that this publication shall be a substitute for legal advice.

If you are buying or selling a farm business on contract, be sure to consult your attorney and have him or her write the contract for you. There is no substitute for good legal advice. Only an attorney is qualified to give you such advice.

BUYING A FARM ON CONTRACT

A land contract is a written agreement whereby one party agrees to convey land to another party for a certain agreed price, the title to the property to pass to the buyer, and the deed to be delivered at some future date, as stipulated in the contract. This arrangement is commonly called a purchase contract, or contract of sale. When used to convey a farm, it frequently includes the sale of the personal farm property as well as the real property.

Under this agreement, the buyer contracts to purchase the farm, and begins making periodic payments on the stipulated price. He or she has the use of the farm, and the security of ownership provided by the contract. The seller retains the deed to the farm and title to the personal property. Commonly, the buyer is given title to the personal property after paying on the contract for some time, and later may be given the deed before the full purchase price is paid. In legal terminology, while paying on the contract the buyer has equitable title to the property but the seller retains legal title.

The purchase contract offers one avenue by which a beginning farmer with little capital can get possession of a going farm business. This method of transferring farm ownership has been used in all farming areas of the State, and on all types of farms. It has often been used successfully for the transfer of farm ownership from parents to a child in an equitable and businesslike manner. Its use, however, is by no means restricted to family transactions.

The sale of a farm on contract is a business transaction which should be entered into with caution by both buyer and seller. Buying a farm on contract is definitely not an easy way to farm ownership for all persons who think they would like to get started in farming. Only a limited number of farm owners wishing to sell are willing and financially able to sell on a contract. A limited number of beginning farmers are capable of paying for a farm in this way. Contract sales which can be pointed to as successful, involved efficient and productive farm units transferred on fair and reasonable terms.

Advantages and Disadvantages of Contract Sales

Some of the advantages of the contract sale cited most frequently by its users are:

1. In many instances the purchase contract is the only way in which a beginning farmer with few cash assets can obtain a farm.

2. It allows a young person to go into farming early in life, and the rigid payment schedule encourages him or her to build up an equity in the business during young and productive years.

3. It provides the framework for and encourages the adoption of flexible payment plans.

4. It provides an opportunity for a retiring farmer to retain (or make) an investment in a business over which he or she has some control.

5. It provides an opportunity to make a major sale without large income in any one year, thus minimizing income tax. The contract sale makes it possible to do this and to still protect the seller's investment. Some farm property has appreciated so much that a complete sale in any one year would produce an enormous tax liability.

The disadvantages most commonly listed by buyers and sellers who have had experience with the purchase contract are:

1. The buyer feels an insecurity of ownership because the legal title remains with the seller.

2. The buyer builds up an equity in the business which is "frozen" to a degree, for it is usually difficult or impossible to extricate that investment in the first few years the contract is in operation.

3. The seller's investment is also "frozen" because he or she is bound by the contract and cannot extricate the investment on short notice to meet unexpected needs for cash.

4. The seller often extends far more credit to the buyer than any commercial credit agency would normally authorize, and thus has a high investment risk in the early years of the contract.

5. The buyer may be committed to a very heavy payment schedule and may be too short on capital to follow good farm management practices. It is important that a fair and reasonable payment schedule be established.

TYPES OF FARM-PURCHASE CONTRACT ARRANGEMENTS

One of the major advantages of the purchase contract sale is the flexibility that can be arranged in the repayment plan. Almost any type of arrangement agreeable to both the buyer and seller is possible. Contracts vary widely in design and contractural arrangements. They can be classified according to the manner in which purchase price and payment plans are determined. The sales price can be fixed or contingent upon a future event -- like farm income. To illustrate some different plans, here is an example of a sale of a dairy farm:

Buyer and seller have agreed that the value of the property to be transferred is as follows:

Land and buildings		$150,000
Livestock		65,000
Machinery		30,000
Feed and supplies		15,000
	Total	$260,000

Rate of Interest to be charged -- 9 percent.

These are some of the plans which they may consider:

1. Fixed money purchase price and fixed payments

The buyer agrees to pay $260,000, with annual payments of $13,000 on the principal, plus interest on the unpaid balance at 9 percent. Total annual payments would be quite large at first but would decrease. The farm would be paid for in 20 years. A better alternative in most cases would be level monthly payments. Monthly payments of $2,300 per month would amortize the $260,000 loan made at 9 percent interest in just over 20 years. Other amortization plans may be given consideration. In recent years balloon payment plans have been used where the buyer's payments are based upon a 25 or 35 year amortization schedule but after 5 or 10 years the balance of the sales price is due. The buyer expects to borrow that balloon amount from a commercial lender since after 5 or 10 years he or she should be an established farmer. Many sellers would also ask the buyer to make an initial down payment.

2. Fixed purchase price with variable payments

The buyer agrees to pay $260,000 with interest at 9 percent. He or she agrees to make payments by assigning one-fourth of the milk check to the seller. The milk-check payments shall be applied first to pay interest and then to reduce principal. The buyer further agrees to maintain a herd of "X" number of cows. Thus the actual amount paid on principal each year will vary with the amount of milk produced and with the price of milk. This arrangement offers the buyer some protection against falling prices or against temporary losses in herd production.

3. Fixed commodity consideration and fixed payments

The buyer and seller cite the following:

- Wide fluctuations in the price of farm property are likely to occur in the next 20 years.
- The income from sale of milk must pay for the farm.
- Milk price in the year preceding sale averaged $13.00 per hundredweight.
- A $260,000 farm should sell for 20,000 hundredweight of milk at present price relationships.
- The farm produced 7,500 hundredweight of milk in the year preceding sale.

However, since the price of milk will probably continue to increase (with fluctuations) the seller is willing to sell the farm for 18,000 hundredweight of milk. The buyer agrees to pay 18,000 hundredweight of milk for the farm, and to pay this at the rate of one-fourth of the year's production. For the preceding year, the payment would have been 1,875 hundredweight of milk. The payment of milk shall be applied first to pay interest and then to reduce principal. Interest at 9 percent shall be calculated on the unpaid balance of milk, valued at $13.00 per hundredweight.

4. Variable purchase price and fixed payments or variable payments

The buyer agrees to make annual payments of $13,000 plus interest at 9 percent on the unpaid balance. As the seller is chiefly interested in an income during his lifetime, he or she suggests that the buyer guarantee to make the payments for 25 years, or as long as the seller lives, whichever is the shorter period of time. Thus the price paid will depend on the length of life of the seller. The buyer is receptive to this idea but makes a counter proposal, offering to pay 1,500 hundredweight of milk on interest and principal to the seller each year for 25 years, or as long as the seller lives, whichever is the shorter period of time.

Which Type to Use

Of the four plans listed, only 1 and 2 are commonly used. Plan 3, calling for a sale for a fixed amount of the major farm commodity, has the serious disadvantage of being complicated. It does, however, offer more protection against price fluctuations than any of the other types. Plan 4, calling for a purchase price which varies with the seller's length of life, may have merit in a few family transactions. Because it introduces an additional element of risk for the buyer (how long will the seller live?), its use is limited. Although neither plan 3 nor plan 4 is in common use, examples of each type have been found operating successsfully. Modifications of plan 3 or 4 are also possible.

Plan 2, with payments based on a share of the farm income, is widely used on dairy farms. Such a plan can be easily followed on a dairy farm because the milk check usually represents 80 to 90 percent of the gross receipts. A division of the milk check is, therefore, an easy way to divide gross receipts. However, a payment plan based on a share of the gross income can be worked out for any type of farm. The greater the variability in income from year to year, the greater is the buyer's need for a payment plan which varies with farm income.

Plan 1 has the advantage of simplicity, but offers no flexibility in payment plan.

IMPORTANT FEATURES OF THE CONTRACT

In addition to the method and rate of repayment, a sound purchase contract contains several provisions that demand the careful attention of both buyer and seller before completion of the transaction. Some of the most important are listed and discussed in the following sections.

Calculation of Interest

The contract should specify the annual interest rate on indebtedness and state how frequently interest is to be calculated. This is commonly done monthly, quarterly, semi-annually, or annually. It is to the advantage of the buyer to apply payments and calculate interest monthly, but it is much easier to calculate interest semi-annually or annually.

Example: A contract calls for payment of one-fourth of the milk check on interest and principal and the milk plant sends checks to each party for his or her share. The contract further states that the parties will meet once a year to compute payments and interest, and that interest is to be calculated on a semi-annual basis. At the end of the first 12-month period $26,000 has been paid on an indebtedness of $260,000, with interest at 9 percent. Seller's one-fourth of the milk check for the first six months totaled $13,000.

Computation of interest and principal payments for the first six months is as follows: Interest on $260,000 at 9 percent per annum for six months = $260,000 x 9% ÷ 2 = $11,700.

Total paid -- 6 months	=	$13,000
Interest -- 6 months	=	11,700
Reduction in principal	=	$ 1,300

A reduction of $1,300 in principal took place during the first six months, so that interest is paid on only $258,700 for the second six months as follows: Interest on $258,700 at 9 percent per annum for second six months = $258,700 x 9% ÷ 2 = $11,641.50.

Total paid -- second 6 months	=	$13,000.00
Interest -- second 6 months	=	11,641.50
Reduction in principal	=	$ 1,358.50

Use of Simple Interest

Current federal income tax regulations require that a seller charge a buyer at least 9 percent simple interest (6 percent involving land sales between family members) or the IRS will impute interest at the rate of 10 percent compounded semi-annually (7 percent between family members). This regulation prevents sellers from charging low or no interest and then selling the farm at a higher price and thus converting ordinary income (interest income) to capital gain with the result of less income tax.

The previous example was based upon compound interest concepts which are normally used in farm finance. Nine percent compound interest is greater than 9 percent simple interest and thus fulfills the minimum interest requirement. For parties that wish to use the lowest possible interest charge, 9 percent simple interest should be used. Simple interest is discussed in A.E. Ext. 80-28, "Simple Interest Amortization Tables for Installment Sales".

When Does Legal Title Pass to the Buyer?

Many contracts compel the buyer to wait until the entire purchase price is paid before he or she receives legal title to any of the farm property. A more equitable arrangement is for the buyer to receive title to the personal property after he or she has reduced the principal in an amount equal to the value of the personal property. Subsequently, when he or she has further reduced the principal by an amount equal to one-third or one-half the value of the real estate, he or she may receive a deed to the real estate and give back a mortgage for the remaining indebtedness to the seller. As an example:

Land and buildings	\$150,000
Livestock, machinery, feed and supplies	110,000
Total	\$260,000

After indebtedness under the contract is reduced to \$150,000 the buyer might be given legal title to all except the land and buildings. After indebtedness on the contract is reduced to \$100,000, the buyer might be given a deed, and the seller take back a mortgage for \$100,000, with the repayment schedule remaining the same as under the original contract.

Livestock and Tool Replacement

Commonly, the buyer agrees that all livestock raised or purchased and kept on the farm shall be considered as replacements for original livestock, even though numbers may be increased over the period of the contract. The seller usually insists that a minimum number must be maintained at all times. Equipment purchased by the buyer after the contract period begins is customarily considered as the replacement equipment, and is legally the property of the seller until title to equipment is transferred. The agreement may be modified to allow the buyer to retain ownership of animals which increase herd size, and of machines which are purchased as additions rather than as replacments.

Payment of Taxes and Insurance

The buyer agrees to pay all taxes assessed after a specified date, and to keep certain insurance in force in the name of the seller. A clear understanding of the kind and amount of insurance to be kept in force is important. An easy solution is to agree that the insurance program in effect at date of contract shall be continued, unless adjustments are agreed upon between buyer and seller. It is also wise to agree on use of insurance proceeds in case of loss from fire. A fair agreement allows the buyer to use insurance proceeds to rebuild if he so desires, otherwise, insurance proceeds are used to reduce the indebtedness under the contract.

Advance Payment Provision

A contract may allow the buyer to pay off his or her indebtedness at a more rapid rate than the repayment plan specifies. The seller may want to restrict the annual amount of any advance payments so that income tax management is possible, or the seller may wish to include a prepayment penalty if the contract is paid off in order to help pay any additional income tax from a lump sum payment. It is important that the prepayment provision be included. This serves as an "escape hatch" for any buyer who feels that he or she cannot endure the terms of the contract <u>if</u> he or she can raise the money to pay off the seller.

Good Husbandry Clause

Many contracts contain clauses which admonish the buyer to be a "good" farmer, or to keep "good" cows, or to keep the property in "good" condition. It would be difficult or impossible to get a legal interpretation of such value phrases if disagreement should arise between buyer and seller. It is advisable to be specific when possible, and to avoid the use of clauses which could lead to confusion and disagreement.

INCOME TAX TREATMENT

An accountant or attorney who does tax work should be consulted to determine the income and estate tax consequences of any contract sale. The following is a brief summary of the tax treatment.

For the Seller

Income from the sale is only reported the year that payments are received. The interest component of each payment will be reported as ordinary income. The principal component will be broken up into taxable gain and recovery of basis. Recovery of basis is not taxed. Taxable gain may qualify for capital gain treatment or may be treated as ordinary income depending upon the types of property sold. Special computations are required if the current mortgage is paid off, or assumed by the buyer, or if the seller's mortgage is more than the tax basis of the property sold. There may also be recapture of investment credit. Since the value of the contract is an asset in the seller's estate should he or she die, the estate planning implications should be explored.

For the buyer

The interest payments during a year would be an expense deductions for that year. Principal payments are not deductible. However, the purchase price of the farm becomes the tax basis and the buyer can depreciate any depreciable property and claim investment tax credit on qualified assets, even though legal title may not pass for a number of years.

DETERMINING THE RATE OF PAYMENT

It is to the advantage of both seller and buyer to establish a payment schedule which will:

1. Allow the buyer to provide for his or her family.

2. Allow the buyer to make necessary adjustments in farm operation to keep the business operating at a profitable level.

3. Reduce the indebtedness at a steady and reasonable rate.

Any person who buys a farm on contract with little or no down payment is going to be operating on a thin margin. Careful analysis of the business is needed to set up a payment plan to accomplish the above objectives. Unfortunately, payment plans are often set by custom rather than by careful analysis of the potential income of the business and of the many demands upon it. For instance, it has long been customary for the seller to demand one-third of the milk check as payment on interest and principal in a dairy-farm contract sale. Under present operating conditions and existing price relationships, dairy-farm operators are often finding it impossible to pay one-third of the check on interest and principal of indebtedness. A more reasonable guide is from one-fifth to one-fourth of the check, but an analysis of the business should be made in each case before the commitment is made.

Young men or women are often too eager to commit themselves to a repayment schedule which proves to be impossible to meet. The natural urge to get the farm paid for quickly can cause the buyer to overcommit himself or herself. It is seldom reasonable to expect to be able to pay for a farm business in less than 15 to 20 years. A buyer should be wary of a repayment schedule which will pay off the contract in less than 15 years. An analysis of the farm business will show whether it is reasonable to expect to pay off in a shorter period of time.

WRITING THE CONTRACT

The contract in final form must be written by an attorney. Prospective buyers and seller might agree on the major points to be covered by the contract before consulting their attorneys. A contract in outline form is included in this publication. Study of this contract outline will give prospective buyers and sellers a better understanding of the major points that should be covered in their contract.

DAIRY FARM PURCHASE CONTRACT

Articles of agreement, made this _______ day of ____________, 19____, by and between ____ (husband and wife), residing in the town of ________________________, ____________ County, New York, owner of the first part, and ______________________________ ______________________________ (husband and wife), residing in the town of ________________________, ____________________ County, New York, purchasers of the second part, in the manner following:

The said parties of the first part, in consideration of the convenants and agreements herein expressed, hereby agree to sell unto the said parties of the second part, and the said parties of the second part agree to purchase from the said parties of the first part, all that tract or parcel of land, situated in the town of ________________________, County of ________________, and State of New York, being part of Lot No. ______, in Township No. ______, and bounded as follows, to wit:

(Described)

Said real estate value at ____ dollars ($________________).

Also all personal property on or about the premises described above, or in connection therewith, which includes the livestock, farm machinery and equipment, and feed and supplies as listed in detail in Schedule A attached, said personal property valued at ____________________________________ dollars ($______________).

The parties of the second part agree to pay said sum to parties of the first part as follows:

The sum of ______________________ dollars upon the execution of this agreement, receipt of which is hereby acknowledged, and the balance of ________________________ dollars is to be paid by _________________ percent of the milk check each month. First parties share of the milk check shall be applied first to pay interest at ________________________ percent on all sums unpaid, and the balance is to be applied on the principal purchase price hereof.

The parties are to meet the first of _______________________ each year, compute payments and interest, and apply the same, that has been received by first parties, upon the contract. Interest is to be computed semi-annually from __________________1st, 19__, at ____________________ percent.

Said parties of the second part agree to keep and maintain upon said farm a dairy of at least _____________ cows of milking age, replacing all cows sold or lost, with others raised on the farm or purchased elsewhere, and to keep said dairy of good average cows.

The milk from the dairy is to be delivered by second parties to a milk station during the year. The milk receipts shall be divided at the milk station, and second parties shall instruct the milk station operator to make payment for ______________ percent of the value of the milk to parties of the first part.

Second parties agree to pay all taxes that may be assessed against said premises and payable after ________________________, 19___.

It is agreed between the parties that the title to all personal property now on said premises, and that put upon said premises as replacements there of, shall be and remain in the parties of the first part, until second parties have paid the sum of _____________ dollars upon said principal purchase price, at which time the title and ownership to said personal property shall be transferred to second parties. This transfer shall be evidenced by a bill of sale to be given parties of the second part by parties of the first part.

It is agreed that when the sum of _______________ dollars of principal has been paid, first parties shall execute and deliver to second parties a good and sufficient warranty deed conveying said premises free and clear of all items and encumbrances; thereupon parties of the second part shall immediately execute a mortgage of said real estate back to parties of the first part for an amount equal to the total remaining unpaid on the principal purchase price. Said mortgage shall specify a repayment schedule identical to that agreed upon in this contract.

It is further agree that if parties of the second part raise or purchase more cows than are necessary to replace the required ____________ milk cows, they shall have the right to retain or sell said additional cows and to retain the proceeds of said sale.

It is further agreed that if the parties of the second part purchase and place on the premises farm machinery and equipment in addition to, but not in replacement of present farm machinery and equipment, the title to same shall remain with parties of second part.

It is agreed that no green or growing timber shall be cut on the farm except for repairs and use on the farm, without first parties written consent.

It is further agreed that second parties shall carry on and work said farm as a dairy farm, and properly plant and harvest all crops, properly care for said dairy and carry out the terms of this contract in a good farmlike manner and as required by good husbandry.

Second parties agree to keep the buildings upon said premises, and the dairy, insured in the amount of insurance now thereon, and pay the premiums therefor until payment is made in full of this contract. In the event any of the within described property shall be damaged or destroyed, the second parties shall have option as to whether or not they desire to rebuild or repair, and if they so desire, the insurance proceeds may be applied towards such rebuilding or repairing, any additional amount necessary to be paid by the parties of the second part. In the event second parties decide not to rebuild or repair, the entire insurance proceeds shall be paid to first parties and applied on the indebtedness.

Upon default by second parties in making the payments of principal or interest as herein provided, keeping the buildings and dairy upon said premises insured, or paying the taxes, keeping a proper dairy upon the premises, or properly harvesting and storing the crops, the first parties may, upon thirty days notice to second parties, or either of them, declare the entire balance of the unpaid purchase price due and payable immediately, and may foreclose this contract as in the foreclosure of a mortgage, in such proceeding be entitled to the appointment of a receiver without notice to the second parties.

It is further agreed that second parties have the privilege of making payments upon the purchase price aforesaid in amounts of $100 or more, other than those provided for herein, at any time.

And it is agreed that the stipulations aforesaid are to apply to and bind the heirs, executors, administrators and assigns of the respective parties, and is made and executed in duplicate.

In witness whereof, the said parties have hereunto set their hands and seals the day and year first above written.

WITNESSES:	SIGNED:
____________________	____________________
____________________	____________________
	____________________
	____________________

DO NOT ADOPT THIS OR ANY OTHER CONTRACT FOR THE SALE OF A FARM WITHOUT THE ASSISTANCE OF A LAWYER.