Alternative Ways to Buy the Farm

A traditional way to buy farmland is to purchase the land from the seller for cash, financing the purchase with either cash that the farmer has on hand or a third party mortgage loan. However, farmers new to the business or those without significant savings may not have enough cash on hand or may not qualify for traditional mortgage financing.

This Guide explores the following alternative ways to purchase farmland:

- Seller-financed land acquisition
- Purchase by installments
- Lease with an option to purchase

Seller-Financed Land Acquisition

In a seller-financed purchase, the buyer makes payments directly to the landowner. Like conventional land sales, the farmland owner ("Seller") and the buyer ("Buyer") agree to a purchase price and terms for the sale of the farmland. At the closing of the sale, Buyer takes title to the farmland and agrees to make payments directly to Seller for a specified period of time (rather than paying the full purchase price to Seller when the sale is made), and Seller takes a mortgage on the farmland. Seller reserves the right to foreclose and repossess the farmland if Buyer fails to make the agreed payments.

Many times, these types of transactions are between family members or between parties that know each other well. The temptation will be to keep the terms informal. However, to avoid future disagreements and ensure that everyone understands what they are committing to, it is HIGHLY advised that the written agreement be as detailed and complete as possible.

Land Acquisition Process

Conduct Due Diligence: Because Buyer will become the owner of the farmland, Buyer should do the same due diligence as it would do if it were buying the farmland with third-party financing and should obtain a title policy ensuring its title to the farmland.

Negotiate a Sales Contract: Buyer and Seller will need to negotiate the terms of the land sale contract. Depending on the relationship with the parties (*e.g.,* close business associates or family members versus other third parties), many of the terms of the land sale contract will be the same as those in a traditional sale contract with third-party financing. Be as thorough as possible to make sure all parties are on the same page and there are no future disagreements.

Some terms that will need to be negotiated are:

- Portion of purchase price that must be paid in cash at closing and portion that will be financed by Seller.
- Payment schedule for Seller financing, including interest rate, length of payment term and whether a "balloon" payment will be due at the end of the payment term (in other words, whether a disproportionate amount of the principal of the loan is paid at the end of the loan term, rather than over the life of the loan). Typically, Seller financing is for terms of 5 years or less. At that point, the Buyer may have sufficient credit history and equity in the land to qualify for a traditional mortgage.
- Any extension rights in the event Buyer does not have funds to repay the balloon payment at the end of the scheduled payment term. An extension would typically require payment of a fee to Seller.
- Conditions under which Seller may foreclose on the farmland.
- Process for Seller foreclosure (which must comply with state law requirements).
- Whether Seller may transfer its right to repayment to a third party, including a bank or third-party investor.
- Confirmation that no mortgage currently encumbers the farmland. In a third party-financed sale, the existence of a mortgage on the property is rarely an issue, as the proceeds of the sale are used to pay off the mortgage. However, the down payment made by the Buyer may not be sufficient to pay off Seller's mortgage, which would leave the property encumbered with the pre-existing mortgage.
- Allocation of responsibility for payment of ownership costs such as insurance and real property taxes, as well as responsibility for maintaining and repairing any improvements on the farmland.

The land sale contract should be in writing to ensure it is enforceable.

Execute a Promissory Note: In addition to the land sale contract, Buyer will sign a promissory note in favor of Seller, which verifies the loan that the Seller has made to the Buyer for the acquisition of the land.

Advantages of a Seller-Financed Purchase

For the Buyer:

- Eliminates the need for substantial cash for the purchase price or third-party financing.
- Seller may be more flexible as to the creditworthiness of a buyer than a bank would be.
- May result in a quicker closing and lower closing costs due to there not being a third-party lender involved.
- Seller may provide more flexible payment terms than a third-party lender, especially if there is a pre-existing relationship between Buyer and Seller.

For the Seller:

- May result in tax advantages for Seller, as Seller may defer recognition of capital gains.
- May provide a larger pool of potential buyers of the farmland.

Disadvantages of a Seller-Financed Purchase

For the Buyer:

- Seller may demand a higher interest rate than a third-party lender.
- The term of the Seller financing is typically less than 5 years (rather than the 15-30 year term typical of third party mortgage financing). This means that Buyer will need to find alternative financing if unable to pay off the loan in that time.
- Seller will likely require the right to assign its right to payment to a third-party, such as a bank; in that case, Buyer will be dealing with a third party.
- Buyer will still be required to post a substantial down payment at closing.
- If Buyer misses a payment to Seller, Seller may commence foreclosure proceedings and, ultimately, foreclose on the farmland if Buyer does not pay all past-due amounts.

For the Seller:

- Seller will not receive payment in full of the purchase price upon the closing of the sale and may not receive payment in full for many years.
- Seller risks Buyer defaulting and must enforce remedies if Buyer does not make payments on a timely basis.

- Seller must enforce the provisions of the mortgage documents over the financing term, including Buyer's obligations to maintain/repair the farmland.

Land Installment Contracts

Land installment contracts are different than seller-financed land acquisitions. In a land installment contract, Seller retains title to the farmland, and Buyer makes payments to Seller over time. At the end of the payment term, title to the farmland is transferred to Buyer. If Buyer misses a payment, Seller may cancel the contract and retain the farmland. This structure offers less protection to Buyer than a seller-financed land acquisition, in which Buyer takes title to the farmland and Seller may only foreclose by following state foreclosure laws.

Disadvantages of a Land Installment Contract

Land installment contracts often shift the risks commonly associated with land ownership to Buyer (including the obligation to maintain the property, make repairs and pay property taxes), but Buyer does not own the land until all of its payments are made, putting Buyer at risk of having its investment in the farmland wiped out based on a missed payment. Given these risks, consider whether a land installment contract is an appropriate mechanism to acquire farmland in your circumstances.

Lease with Option to Purchase, Including A Right of First Refusal

In a lease with an option to purchase, the young farmer ("Tenant") leases the farmland from the landowner ("Landlord"). The lease includes an option for Tenant to purchase the land from Landlord. The option to purchase may arise at a specified time (e.g., 5 years after lease commencement), or upon the Landlord's desire to sell farmland at any time during the lease term.

An alternative type of Tenant option to purchase the farmland from Landlord is referred to a "right of first refusal". A lease with a right of first refusal will require Landlord to notify Tenant of a potential sale and will include the terms by which Tenant may exercise its right to purchase the farmland.

Lease Terms

The lease typically includes standard lease terms, such as the term of the lease and rent. In addition, the lease would include either: (1) an option for Tenant to purchase the farmland from the Landlord at a pre-agreed price at a pre-agreed time (or time period) or (2) a right of Tenant to purchase the land in the event that Landlord wishes to sell the farmland (a "right of first refusal"). These Tenant rights must be clearly specified in the lease. **The lease should be in writing to ensure it is enforceable.**

Option to Purchase. Key issues to be negotiated for an option to purchase are:

- Timing of exercise of the option – e.g., throughout the lease term; within a certain number of years after lease commencement; or only when Landlord wishes to sell the farmland.

- Purchase price of farmland upon exercise of the option – for example, pre-agreed purchase price (perhaps adjusted annually by inflation); or purchase price based on fair market value at the time of the exercise of the option.

- Whether seller financing will be provided upon exercise of the option.

- Whether lease payments paid by Tenant are applied against the purchase price that Tenant would be required to pay to purchase the farmland.

- Whether or not Landlord may sell the land to a third party during the option period.

- Confirmation that no mortgage on the farmland exists that would not permit the exercise of Tenant's option to purchase. See, discussion above for seller-financed purchases.

- Whether a lease down-payment will be required (a lease down-payment would typically be less than a down-payment on an outright purchase of the farmland).

- A variation on a lease with an option to purchase is a "lease to own." In a "lease to own" transaction, Tenant is obligated to purchase the farmland at the end of the lease term.

Right of First Refusal. A right of first refusal gives Tenant the option to purchase the farmland before Landlord enters into an agreement to sell the farmland to someone else. Key issues to be negotiated for a right of first refusal or right of first offer are:

- Timing of Landlord's notice of potential sale.

- Period of time in which Tenant has to determine whether to purchase the farmland and close on the sale after Landlord provides notice of a sale.

- Purchase price – generally, in a right of first refusal, this would be the price at which a third party has offered to purchase the farmland. In a right of first offer, there are many ways to determine the purchase price, including through an appraisal process.

- Whether lease payments paid by Tenant are credited against the purchase price.

Advantages of a Lease with an Option to Purchase/Right of First Refusal

For the Tenant:

- Allows Tenant to occupy the farmland without needing to make an immediate decision about whether to purchase the land. Tenant may save up money for the purchase price during the lease period.

- Gives Tenant flexibility to decide at a later time whether or not to purchase the farmland.

- Tenant may be able to negotiate a fixed purchase price for its option, which would protect Tenant against increases in market value during the option term.

For the Landlord:

- Landlord may have a wider range of potential tenants if it is willing to grant future options to purchase, rather than selling the property outright or entering into a straight lease.

- Landlord will receive rent during the option period.

Disadvantages of a Lease with an Option to Purchase/Right of First Refusal

For the Tenant:

- It may be difficult and time-consuming to negotiate the terms of the option to purchase or right of first refusal, particularly the purchase price.

- The rent payments Tenant pays prior to acquiring the farmland may not be credited against the ultimate purchase price of the farmland, increasing the overall cost of the purchase.

- Tenant does not own the land from the outset and must comply with the lease terms until it ultimately purchases the farmland. In addition, there is a risk in making improvements to the soil and property if you don't own it.

- Landlord will likely be permitted to terminate the lease if Tenant does not exercise its option to purchase or right of first refusal and Landlord wishes to sell the farmland, resulting in a need for Tenant to find new farmland.

For the Landlord:

- It may be difficult and time-consuming to negotiate the terms of the option to purchase or right of first refusal, particularly the purchase price.

- Tenant may elect not to exercise its option to purchase/right of first refusal, with the result that Landlord will continue to own the farmland and will have to find another buyer if it wants to sell.

- If Landlord agrees to a specified purchase price with Tenant, it will not be able to sell the farmland to a third party if it receives an offer with a higher purchase price.

- Landlord will continue to be a landlord and will not obtain the quick cash that a sale of the farmland would generate.

Tax Considerations

Consult with your tax advisor to understand the tax implications of a lease with an option to purchase or right of first refusal. The tax consequences will vary depending on how the transaction is structured.

SUMMARY

Alternatives for land acquisition give options to farmers who do not want to or cannot use traditional third-party financing. However, such agreements are often more complicated; time and care should be devoted to think through the details of the agreement and put them in writing.

This guide was generously prepared by Goodwin Proctor LLP.

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