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Low-Equity Land Transfer: The Installment Sale

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A sale of farmland where the purchase price is paid over a period of years is called an installment sale and is one type of low-equity transfer. Installment sale transfers of farmland can be advantageous to both the buyer and seller. The buyer is able to purchase a farm with a low initial capital investment. If the transaction qualifies under the tax laws for installment reporting, the seller benefits because the income tax laws allow him to spread his capital gain over a period of years. By reporting the capital gains over a longer period, the total income tax paid on the capital gains can be reduced.

The legal documents used to transfer title to the land are important. In Missouri a deed of trust is recommended. Use of a long-term land installment contract generally is not recommended in Missouri.

This guide presents a general discussion of land sale transfer methods which require an initial low-equity investment by a buyer. An attorney should be consulted about specific legal and tax problems.

Financing Alternatives for the Sale of Farmland

Various arrangements may be worked out between the seller and buyer of farmland. If the buyer has sufficient cash, he may pay the entire purchase price to the seller in return for the seller deeding the property to the buyer.

More often the sale of farmland involves some sort of financing agreement. The financing agreement may be between the buyer and the seller, or it may be between a third-party lender, such as a bank or an insurance company. Whether the seller or a third-party lender finances the buyer, the party or parties providing the financing will probably require some kind of security to ensure repayment of the loan. This security is often the land itself.

The most often used legal document by which the land is pledged as security for the debt is a mortgage. In Missouri, the deed of trust, which is essentially a mortgage, is used to secure land for debt repayment.

Traditionally, land purchase agreements have required buyers personally to furnish 40 to 60 per cent of the purchase price while obtaining the balance of the purchase price from a third-party lender. This guide discusses various aspects of land transfer arrangements where the buyer is required to pay a relatively low amount of the total purchase price initially with the remainder plus interest to be paid over a specified

period of years. Such arrangements are called "low-equity" transfers. Low-equity transfers generally require from 5 to 30 per cent of the purchase price to be paid in the year of sale with the remainder paid over a period of two or more years.

Why the Interest in Low-Equity Transfers?

Considering only capital requirements, it is easier to enter farming as a tenant than as an owner-operator. However, competition among farmers has made it increasingly difficult to find land to rent, explained partly by the trend toward ownership of larger farming units.

Some who want to enter farming are forced to do so as owner-operators even though they have few capital assets. Thus, a low-equity transfer may be the only method by which they can enter farming.

This transfer mechanism may be unattractive to some sellers. However, sellers may be interested in low-equity transfer when:

- A. they can get a tax advantage;
- B. they are related to the buyer; or
- C. they want to avoid the problems and management obligations of re-investment.

There may be circumstances when a seller does not want, or should not be faced with, the responsibility of re-investing. This could occur when he is nearing retirement and his primary interest may be a constant flow of income with a guaranteed return on his investment. He may not want to risk investing proceeds from the sale of his farm in another enterprise completely unfamiliar to him.

Many low-equity transfers occur between family members. They may desire to minimize estate and inheritance taxes or to see the family farm kept in the family.

Income Tax Advantages to the Seller

A major incentive for using a low-equity transfer comes from provisions for the installment method of reporting capital gains in the Internal Revenue Code. These provisions apply to sales of real property if no more than 30 per cent of the purchase price is received in the year of sale. These rules also apply to sale of personal property if the selling price is more than \$1,000.

If requirements for the installment method of reporting are

met, the seller is permitted to report the gain on his tax return as it is received, rather than reporting it all in the year of sale (as is ordinarily the rule). This method treats each payment received partly as a recovery of basis (cost) and partly as taxable gain. Therefore, it has become customary to define a low-equity transfer as one in which not more than 30 per cent of the purchase price is received in the year of sale.

If the seller has owned the land for the requisite time period, he can treat gain realized on its sale as a long-term capital gain. The prescribed holding period for long-term capital gains treatment of real estate has been six months. This holding period was increased under the Tax Reform Act of 1976 to nine months for the tax year 1977 and to 12 months for tax years after 1977. The seller will be taxed at ordinary income rates on 40 per cent of the long-term capital gains. The remaining 60 per cent is not taxed. This change from the 50 per cent exclusion rule was made by the Revenue Act of 1978 and was effective starting November 1, 1978.

Only the difference between the sale price and the seller's "basis" in the property constitutes taxable income. In its simplest form, "basis" is the price the seller gave for the farm, increased by the value of capital improvements made to the property, and decreased by the depreciation claimed (or allowable) on all depreciable items considered to be a part of the land.

For example, suppose you own a farm in which the basis is \$40,000. In 1979 you agree to sell the farm for \$100,000 and agree to accept two payments of \$10,000 and \$18,000 during 1979. The agreement calls for you to receive the remaining \$72,000 in nine annual installments of \$8,000, plus interest at 6 per cent.

Making the 30% test:

$$\frac{\text{Payment in year of sale}}{\text{Total purchase price}} = \frac{\$28,000}{\$100,000} = 28\%$$

Hence, this land sale qualifies for the installment method of reporting since less than 30 per cent of the sale price was to be received in the year of sale. This means you will not be taxed on the entire \$60,000 capital gain in 1979 which would otherwise result if the installment reporting method were not used.

Since 40 per cent of each payment received of the sale price is actually a return of your investment (basis), only 60 per cent of each payment will represent taxable capital gain income. Since a total of \$28,000 was received in 1979, this means that you would receive a taxable gain of \$16,800 ($28,000 \times 60$ per cent) for 1979.

If you owned the farm for the requisite time period to qualify for long-term capital gain treatment, 60% of the 1979 payments will represent long-term capital gains. You will be taxed at ordinary rates on only 40 per cent of this gain. Thus, you will report \$6,720 from this transaction on your income tax return for 1979. The remaining portion of the long-term capital gain is tax free. However, any interest payments you receive will be treated as ordinary income when received and not as capital gains.

In future years when you receive \$8,000 per year, you will realize a gain of \$4,800 (60 per cent of \$8,000). The taxable gain (treated as ordinary income) will be 40 per cent of the gain of \$4,800 (\$1,920) and is taxed at ordinary rates. The remaining 60 per cent of the gain (\$2,880) is not taxed. Computation to figure taxable income:

Sale price	\$100,000
Less adjusted basis	40,000
Total taxable gain	\$ 60,000

$$\text{Taxable portion of each payment} = \frac{\text{Taxable gain}}{\text{Sale price}} = \frac{\$60,000}{\$100,000} = 60\%$$

Table 1
Ten-Year Return of Basis and Gain

(1) Year	(2) Payment	(3) Unreturned Basis	(4) Return of Basis (40%)	(5) Gain (60%)
1	\$ 28,000	\$40,000	\$11,200	\$16,800
2	8,000	28,800	3,200	4,800
3	8,000	25,600	3,200	4,800
4	8,000	22,400	3,200	4,800
5	8,000	19,200	3,200	4,800
6	8,000	16,000	3,200	4,800
7	8,000	12,800	3,200	4,800
8	8,000	9,600	3,200	4,800
9	8,000	6,400	3,200	4,800
10	8,000	3,200	3,200	4,800
Totals	\$100,000	0	\$40,000	\$60,000

Sellers who have a low basis in their farm and a large mortgage may face a problem qualifying for the installment method of reporting. If the excess of the mortgage over the seller's basis combined with the payments received in the year of sale is more than 30 per cent of the sale price, the seller would not qualify for installment reporting.

The installment reporting method is an elective provision. The seller must indicate his choice on the tax return in the year of sale.

Unstated Interest Rule: A Hidden Trap

Meeting the 30 per cent rule is an absolute requirement to qualify for the installment method of reporting. If more than 30 per cent of the sale price is received in the year of sale, the installment method of reporting is not available. One way the 30 per cent maximum may be exceeded is because of the "unstated interest" rule. This rule can be a problem when the installment sale is between family members because little, if any, interest may be required under the agreement.

Under the unstated interest rule, if the sale agreement requires less than 6 per cent interest, on the installment payments of the sale price, the Internal Revenue Service (IRS) will imply the contract requires 7 per cent interest (compounded semi-annually) and discount the stated sale price when determining whether the 30 per cent rule has been violated.

That is, if less than 6 per cent interest had been stated in the original example, the IRS would say that the stated purchase price of \$100,000 must be adjusted downward to reflect the amount of interest one would have paid in a normal, arms-length business transaction.

If no interest had been charged in the original example, the 30 per cent rule would have been violated. If the 7 per cent (IRS imposed) interest rate compounded semi-annually is used to calculate the present value of \$8,000 per year for the next nine years, the nine-year sum is \$51,848, rather than \$72,000. Added to the \$28,000 received in the year of sale, this would lead the IRS to conclude that \$79,848 was the actual sale price.

Stated another way, if the unstated interest rule is applied, the actual purchase price is considered to be the contract price discounted (reduced) by the amount allowed for unstated interest.

Since the \$28,000 received initially is more than 30 per cent of the discounted purchase price (i.e., it is 35 per cent of

\$79,848), the seller is not entitled to receive installment tax treatment. Hence, the seller must report the entire capital gain of \$60,000 on his tax return in the year of sale, even though he will receive payments in that year of only \$28,000.

It is important that sellers understand the unstated interest rule. The contract should call for at least 6 per cent interest or the payments received in the year of sale should be adjusted downward to stay within the 30 per cent rule.

Not only may the unstated interest rule cause a seller to lose the benefits of installment reporting, but it also can trigger interest income. This unexpected interest income can increase the seller's total tax liability significantly.

The likelihood of violating the "unstated interest" rule and thus losing the installment reporting option is especially great when the sale is between family members. Under these circumstances the related buyer and seller may be able to agree that little or no interest will be charged on the balance of the sale price. This temptation should be avoided. The potential for an unintentional violation of the unstated interest rule again highlights the importance of seeking the advice of an attorney when selling land.

The Buyer: Pros and Cons of Low-Equity Transfers

Installment sales provide certain advantages to the buyer. The low down payment is certainly one of the major advantages. This often enables a young farmer to purchase land at an earlier time than he would be able to buy it under the more traditional land financing arrangements. The earlier ability to purchase land means the buyer will receive the benefits of any appreciation in land values after the date of purchase.

Another potential advantage for the buyer is a lower interest charge than would be available under conventional financing arrangements. Since the installment sale is often between family members, an interest rate lower than the prevailing market rate is often agreed upon by the parties. The relatively low capital outlay and a favorable interest rate on the unpaid portion of the purchase price often make an installment sale transfer very appealing to a prospective land buyer.

The above advantages can be outweighed by potential disadvantages. Just as the buyer will realize benefits of increasing land prices, he also bears the risk of a drop in land values. An installment sale buyer may find dropping land values quite discomfoting as he makes installment payments based upon the earlier inflated land values. In years of low productivity, the fixed payments may be particularly burdensome.

Allocation of the Purchase Price for Tax Purposes

Allocation of the purchase price among the various items of farm property to be sold may have considerable effect on the tax liability of the buyer and the seller. The sale agreement should contain provisions allocating the purchase price between land, residence, timber, growing crops, farm buildings, tenant houses, fences, tile drains, wells, orchards and other assets.

In general, the seller tends to benefit when more of the purchase price is allocated to assets subject to capital gain taxes and those that have not been depreciated substantially, such as the residence.

On the other hand, the buyer benefits if more of the purchase price is allocated to assets that are depreciable and

possibly eligible for the investment credit. These assets include farm buildings, silos, fences and wells. A buyer will also prefer to allocate more of the purchase price to growing crops because this allocation can be deducted from ordinary income as a deductible expense instead of capitalizing the investment. The seller does not benefit from allocating the sale price to growing crops because he would be required to report the allocation as ordinary income rather than capital gain.

The allocation of the purchase price among the different types of property included in the transfer agreement may be especially important to the seller. If the sale agreement does not set forth an agreed-upon allocation, the IRS may force the seller to accept the buyer's allocation. Being bound by the buyer's allocation will often result in the seller having less capital gains income and more ordinary income. Through careful pre-sale negotiations with the help of their accountants and attorneys, the parties should be able to agree in writing to an allocation that is fair to both.

Some Non-Tax Legal Considerations

The income tax benefits of installment reporting are available whether the legal instrument used to make the low-equity land transfer is a long-term land contract or a deed of trust. In Missouri the deed of trust generally should be selected over the long-term land contract.

In deed of trust arrangements, the seller will first convey the property to the buyer, thereby transferring legal title to the property. The buyer will sign a note or notes evidencing his promise to pay the unpaid portion of the purchase price. This agreement to pay will be secured by using the land as collateral. It is at this point that the debt-securing instrument enters the transaction.

The debt-securing instrument most often used in Missouri is the deed of trust. This deed of trust is a transfer of legal title from the buyer to a third person, the trustee. The trustee is said to hold the property "in trust" for the seller as security for the payments by the buyer. In the deed of trust, the trustee is given the power to sell (foreclose) the land at public sale if the buyer does not make timely payments to the seller. If and when the buyer pays the full amount of the purchase price, the notes are cancelled, the deed of trust is released, and the buyer has an unencumbered title to the land.

A possible substitute for the deed of trust as a land sale financing device is the installment or long-term land contract. Under the long-term land contract, the buyer is allowed possession of the land and agrees to make installment payments over a period of years until the agreed purchase price is paid. The seller normally retains legal title to the land until the final payment is made, at which time he will execute a deed to the land to the buyer.

In Missouri the deed of trust arrangement generally is preferred over the long-term land contract. The deed of trust has long been used in Missouri, and most of the potential legal questions arising under a deed of trust arrangement have been answered by either the state legislature or the courts. The relative rights and responsibilities of both the buyer and seller for a deed of trust are well established in the law.

The long-term installment contract is not used widely in Missouri, and the relative rights and responsibilities of the buyer and the seller are not as firmly fixed in the law. Use of a long-term land contract may increase the likelihood of a costly legal battle between the buyer and seller. A long-term land contract should be used only where both parties carefully have considered the generally more desirable deed of trust arrangement, and then only upon the advice of their attorneys.

Summary

Installment sale transfers of farms offer a way for young farmers to start their own farm operations. A purchaser may raise enough capital for the down payment and then pay off the balance of the purchase price with the income generated by the farm operation. By using an installment sale, the seller may reduce the federal income tax substantially on the capital gains income realized from the sale of his farm.

Generally, the deed of trust should be used as the financing instrument to achieve a low-equity transfer of farmland in Missouri. With a deed of trust arrangement, the buyer's and seller's rights and obligations are well defined in both statutes and court decisions.

Additional tax information about installment sale transfers can be obtained from IRS Publication No. 537, "Installment and Deferred Payment Sales."

The decision to sell a farm to a relative may be motivated by a desire to keep the farm in the family. This transfer may be part of an overall estate plan. If so, UMC Manual 68, "Estate Planning for Missouri Families," is available at your local University of Missouri Extension Center and may be helpful.

The information in this guide is only a brief discussion of some of the tax and legal implications of a low-equity transfer of farmland. The best choice in an individual situation is dependent upon many factors. A land sale transaction should not be undertaken without the benefit of professional tax and legal advice.