FARM COMMONS

Financing A Farmland Purchase: Legal basics for traditional and non-traditional farmland purchases

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Introduction

> “What do you do if you feel like you are born to farm, but you’re not born on a farm?”

Some people feel like they are meant to be farmers. They feel a deep yearning to work the land, to collaborate with the earth and produce food. But what do you do if you feel like you are born to farm, but you’re not born on a farm? Many hopeful farmers find themselves in exactly this predicament.

It’s difficult enough to finding viable land to farm. Once that hurdle has been cleared, coming up with money to purchase land and raise capital can be another big obstacle for many farmers. In this guide, we will explore some common and less traditional financing options for farmers along with the legal considerations that accompany them.

A helpful way to think of each of the financing strategies we will discuss in the following sections is to look at each strategy as a bucket. From a legal perspective, when someone gives you money, it has to go into a specific bucket. Each bucket has its own implications, ranging from tax obligations to how you can and cannot use the money. You have to choose one bucket – the same money can’t go into more than one. If we mix up the buckets, we can’t determine which legal obligations apply to the funds. This resource is meant to help you figure out the correct bucket for your money so that you know how to manage its legal aspects properly and continue to have success in your fundraising and financing ventures.

Throughout this guide, we will be following one hypothetical farmer, April, in her pursuit to purchase farmland. Her situation will provide us with a useful example to explore the legal principles of financing farmland. It is, however, just one potential scenario. It’s important to note that much of the law depends on specific details. As those details change, the legal outcome can shift in unpredictable ways. Please use April’s story and this guide as tools to provide context and to help you understand the legal principles of farmland financing. This guide is not meant to provide hard and fast rules, nor offer specific legal guidance. An attorney is the best source for information on your unique circumstances.

Meet Farmer April. April has been working for other farmers during the past five years and is ready to start working land of her own. Luckily for April, she has a few different resources to consider. April's mother, May, has some land that was passed down through her family. April also has a rich uncle, Bob, who would like to support April and see her succeed. To top it all off, April lives in a town with a number of local banks as well as a Farm Services Agency office. A long-time member of her community, April is lucky to have a supportive network of friends, relatives, and local businesses. April is ready to learn more about her various opportunities for buying farmland, specifically the legal aspects of each option.

The financing options presented in this guide do not represent the full range of options that might be available to farmers. Be sure to do additional research and consult with an attorney to learn more.

We will use April and her supporters to help us discuss 7 different "buckets" into which April might put her funds.

These aren't the only legal options. In the interest of time and space, this resource only covers these select legal categories of funds:

1. Gifts
2. Grants and Crowdfunding
3. Loans and Mortgages
4. Seller- financing
5. Land Contracts
6. Investors
7. Partnerships

Many of the options explored in this guide are also applicable to financing situations other than purchasing farmland.

Although purchasing farmland is the focus of this guide, many of these financing strategies have a range of applications and are not restricted to land purchases. Each can be an opportunity for a farmer who is raising money to grow the business, even if he or she already has access to farmland. Continue reading to gain an understanding of the above options and how to navigate their parameters.

Gifts

A gift is a wonderful thing, and certainly a fortuitous way to finance a farmland purchase. In the eyes of the law, a gift is defined as when someone freely gives you something with no expectation of its return. This can come in the form of land, money, or other property. Seems pretty straightforward, right?

When it comes to the legal side, there are a few details to be considered for the donor and recipient. First, not to look a gift horse in the mouth, but you'll need to make sure that the money is an authentic gift, and that it does not actually belong in the loan bucket. If there's any chance your gift will need to be returned , skip ahead to the "Loans and Mortgages" section of this resource for more details on whether you have a gift or a loan.

After confirming that the funds go into the gift bucket, lets explore the tax consequences. When thinking about gifts as a financing strategy, it's important to consider the gift tax. The gift tax is exactly what it sounds like – a tax that applies to large gifts. The reasoning behind the gift tax (and its relative, estate tax) is that without it, large estates could be reduced by giving away all the property before death with no penalty. The system is set up to limit the accumulation of wealth in society and diminish wealth disparity. Whether that theory has proved to be successful or not is an issue for another type of publication!

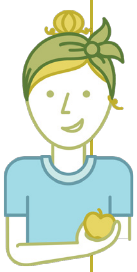
Please note: gifts are not limited to family members. Any individual can make a gift to any other individual.

There are a few details to know about the gift tax. The first is that the tax is paid by the gift-giver, not the recipient. Gifts are not considered personal income nor business income, and therefore the receiver of the gift does not owe taxes on the gift.

The second is knowing when the tax is owed. As of 2015, if an individual gives more than $14,000 in a calendar year the gift tax becomes applicable. Under $14,000 per year is tax exempt, up to a lifetime limit of $5.43 million (2015). The gift tax rate can be quite high - 40% as of 2015 – but with such a high lifetime limit, most Americans will never have to pay the gift tax.

This section gives a broad generalization of the gift law. Consult with an attorney to find out more detailed information that might apply to your situation.

Each gift donor-recipient relationship is considered separately. For example, each member of a married couple gets a separate exclusion. This means that a husband and his wife could give their daughter, for example, a combined total of $28,000 per year. If that same couple has two children, they could gift each child that amount – the gift limit is per recipient.



Let's explore this concept in context of Farmer April's situation. Uncle Bob could give April up to $14,000 in cash without worrying about taxes. Her mother could do the same with up to $14,000 worth of land. If either of these gifts were to exceed that $14,000 limit, the giver may have to pay the gift tax. If both Uncle Bob and April's mom want to make gifts in the same year, that's no problem. Remember, each gifting relationship is considered separately, so April can accept multiple gifts of up to $14,000 from different people in same year.

Grants and Crowdfunding

Crowdfunding: Raising money for a business venture from a large number of individuals, often through an internet platform.

Legally speaking, farmers who raise money through crowdfunding need to make sure they put the funds in the correct bucket and follow the right rules. Raising money through grants and crowdfunding is distinct from a gift, although on the surface it might appear similar. When an individual applies for a grant or puts together a crowdfunding campaign, he or she is raising money for a specific business purpose. Generally, this tends to be capital or operating costs for a business. A farmer might apply for a grant to put up a hoophouse to grow greens for sale to local restaurants. Or perhaps she puts together a crowdfunding campaign to build an apple press and start a cider business. In either case, the folks funding the farmer know what he or she is planning to do with the money, and the money is going towards the farmer generating income.

"Raising money through grants and crowdfunding is distinct from a gift, although on the surface it might appear similar."

A gift, in contrast, is given freely and on a personal basis. While April's Uncle Bob might truly believe in April's vision for her farm, he would not just give that $14,000 to anyone with a similar business plan! His gift is a personal expression of his affection for his niece. April is not under any obligation to actually purchase farmland with the money (looming family tension aside).

It's important to understand the distinction since you account for money generated through grants and crowdfunding differently than money given as a gift. The former are given to run a business, generate a product, or provide a service. Therefore, they are legally considered income or revenue. The money in this legal bucket has specific tax implications.

Business 101

If an individual is selling a product or providing a service, he or she is running a business. This is true even if you haven't established an LLC, or picked a name, or taken the myriad actions required to "officially" start an enterprise. At the end of the year, the taxes owed on the business are based on whether the income generated from the business exceeds the expenses, i.e. did the taxpayer make a profit?

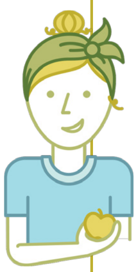
Running a business requires careful accounting and reporting of profit. This is true even if your venture is an organized nonprofit, and you may not owe taxes on your profit. Whether an enterprise is for or not for profit, the business owner must maintain accurate balance sheets and profit and loss statements to track income, expenses, and profit.

For more information on sound accounting and reporting practices, consult the "Fearless Farm Finances" guide put out by the Midwest Organic and Sustainable Education Service (MOSES) at mosesorganic.org/fearless-farm-finances.

Now that we have the basics down, you might still be wondering if you will owe taxes on money earned from a grant or crowdfunding campaign. As we discussed, a business does not owe taxes on all the revenue it takes in – taxes are only owed on the profit, or the value of the revenue over the expenses. If the business has enough expenses, they can essentially cancel out the revenue, which diminishes profits (and thus, taxes). This can get tricky, however, depending on when in the year you are receiving money from your grants or crowdfunding campaigns in relation to when the tax year ends. If you do not carefully plan your incoming revenue and outgoing expenses, you could end up in a complicated tax situation.

If you provide your crowdfunders with an honorarium of some sort, that also counts towards your expenses.

The best way to manage the accounting and reporting is to work with an accountant. While you can do it yourself, many farmers have said that money for a professional is well spent. The amount of time it takes to learn the correct procedures and monitor all the details may be more efficiently spent growing and marketing your product.



April needs to make sure that the $14,000 she is receiving from Uncle Bob is an authentic gift, and not considered a business grant. If it is the latter, the money needs to be put into the "grants and crowdfunding" bucket, which affects the business' overall tax implications. It's important that April and Bob are on the same page about this. If Bob considers the money a business grant, specifically meant for April to purchase a $20,000 tractor for her business, he would account for it on his taxes as so. In that case, the IRS might come knocking on April's door asking why she didn't report the money as revenue.

If April says, "Oh, no that money was a gift," the IRS would then go to Uncle Bob and ask why he didn't report it for gift tax purposes. You can see how a very sticky situation might develop! April and Bob need to decide together on what the money is for, and then go forward with documenting it clearly.

To determine which legal bucket Uncle Bob's money goes in, April and Bob can ask the following questions:

- Is the check written to April herself?
- Is it written in the business name?
- Is it given with the intent of being used in the business?
- Can the money be used for anything April wants?

Once April and Bob have come to a consensus on the nature of the money, they need to document it properly. If the money is a business grant, the check should be made out to April's farm, and used for business purposes. April will then report the money as revenue. If is it a gift, the money should be accompanied by a gift letter. The gift letter essentially functions as a receipt that the farmer can hold on to in case the IRS ever comes knocking. Ideally, Bob would include a gift letter along with the check. Another option would be for April, the recipient, to write Bob a thank you letter to document the gift. April should hold on to a copy of the letter as evidence of the transaction.

Whichever option April and Bob choose, they will be in good shape as long as they are honest and accurate in their reporting. Uncle Bob cannot be using a business grant to April as a strategy to pass down his estate without paying a gift tax, for example. The bottom line is that the money has to go through the IRS -- how exactly that happens will be determined by which legal bucket the funds fall into[1].

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1 If April is forming a nonprofit, the money could be a donation to the nonprofit. In that case, Uncle Bob could potentially donate a gift above $14,000 without gift tax consequences. This can be a complicated situation and is outside the scope of this resource. Farmers or donors interested in exploring that option should consult an accountant.

Loans

A loan is a familiar concept for most of us. The idea has been around for thousands of years; that is, someone gives you money now, but expects to be paid back later, usually with interest. A loan can come from a number of sources, including banks, friends, family members, customers and community organizations.

Fun Farming Fact: The first known loans were agrarian! Around 2000 BC, temple leaders in Babylonia loaned seeds to farmers, who then repaid the loan (plus interest!) after selling the finished product.

Source: 1001 Ideas That Changed the Way We Think, by Robert Arp.

Loans can be simple and straightforward (e.g., I give you $1 today, and tomorrow you give me $1.05) or they can be quite complex and detailed. From a legal perspective, loans are flexible and can meet a range of financing needs. As the loan becomes more complex, so do the details. That's when it's important to pay special attention to the parameters and specifications of the loan.

The right loan structure for you depends on your needs and those of the lender. The flexible nature of loans gives you latitude to come to an agreement that works for both parties. But, in order to figure out what structure is right for your situation you will need to discuss several issues with your lender and come to an agreement on how they will be handled.

This is not an exhaustive checklist by any means. You will want to think about all the possible things that could go wrong, and how you would prefer to resolve these issues. An attorney can be extremely helpful in that process. Check Farm Commons' website for more resources specific to loans.

Here is a sample of some of the legal considerations that must be discussed with a possible lender:

- When will the loan be paid back?
- How will be the loan be paid back? Installments? Lump sum?
- How does the borrower submit payment?
- What is the interest rate?
- Is there a penalty for paying it off early?
- Who exactly is responsible for paying back this loan?
- Can responsibility be transferred?

The last two items on our list regarding responsibility have us wading into more complicated legal waters. You might be wondering, why is the issue of responsibility complicated? Isn't the person borrowing the money the person responsible for paying back the loan? Well, yes, and the issue is much easier if the borrower is an individual. But, what if a farmer and her business partner are taking out the loan together for their farm business. Are both partners responsible? If so, is the responsibility split equally? Are the partners personally responsible, or does the business entity (such as the farm LLC) bear that burden?

The person who is responsible for paying off the loan is whomever is named on the agreement. Generally, if the loan is addressed and signed with your personal name on it, it's an individual loan. If the loan states your name and also your businesses name, it is addressed to you, but only so far as you are a member of your LLC. For example:

Rachel Armstrong, Member, Apple Tree Farm, LLC.

Don't assume that your personal assets will be covered from business liabilities even if your farm is an LLC.

Generally, no lender will extend you a loan under a business name if you have no business assets.

If you have attended our webinar on business entities, you might be thinking about how personal assets are protected from business liabilities with an LLC. So, if a farmer signs a loan as an LLC member, his or her personal assets are protected, right? That's a logical conclusion to come to. But, in most cases, the lender will take extra measures to ensure that he or she is going to get paid back. Often, lenders will require a personal guarantee if the borrow puts the loan under a business name. This is because lenders know that they have virtually no recourse options if the borrow doesn't pay up. By requiring a personal guarantee on the loan, the lender can go after the borrower personally if the business doesn't pay back the loan. So, if you personally guarantee a loan, it doesn't matter if you've signed as an LLC member. Your personal assets will still be available to satisfy payment.

Now that we know who is responsible for paying a loan, we have to ask if that responsibility can be transferred to someone else. For example, using our hypothetical situation, let's say that Uncle Bob decides that instead of gifting April money, he wants to loan it to her. Well, what happens if after a few years of farming, April decides that vegetable farming is really not the right career for her? She wants to move to Florida and open a juice stand. There is another farmer in town who wants to take over April's farm. Can April transfer the responsibility to make payments on the loan to this new farmer? Or perhaps April works with a local investment club. That is something that April and Bob should have worked out ahead of time.

"Like we always say, the important part of the process is the communication that goes into it, not necessarily the piece of paperwork that comes out."

Another question to discuss is if the lender can sell the loan. That means that someone new has the right to receive payments on the loan. There is no right or wrong answers to these questions, they are just issues to discuss and agree upon before a loan is made. Like we always say, the important part of the process is the communication that goes into it, not necessarily the piece of paperwork that comes out.

What happens in hard times?

It's time to discuss something that no farmer, or really anyone in general, wants to think about: what happens if hard times hit and you cannot make payment? Even though it can be uncomfortable, it's important to consider the worst-case scenario and how you and your lender will handle it. If you are in a situation where you cannot pay off your loan, dealing with unforeseen penalties and ramifications will only add insult to injury.

When it comes to a conversation with a lender, make sure to discuss what happens if you miss a payment. Is there a penalty? If there is, which is likely, make sure you know the details.

Creative Payment Options

Depending on your lender, you might be able to come up with some creative and innovative payment arrangements. In this section, we use our hypothetical farmer, April, to explore some of these possibilities.

Non-Cash Payment

April might ask her uncle if she can pay him in farm products if she can't afford to pay cash. Perhaps April raises hogs and always has delicious bacon on hand. Would that work instead of cash? At first, that seems like a ridiculous idea to Uncle Bob. But, he looks into it, and lo and behold there is no law against it. He is willing to consider the possibility. He likes bacon a lot. But, after consulting with an attorney he tells April that they have to come to a precise agreement in order for him to feel comfortable with the arrangement. They must decide the exact value of the bacon, the quantity of bacon that is acceptable, and when the payment can be made.

In other words, April cannot randomly decide one day that her bacon costs $25 per pound and show up at Uncle Bob's door with 50 pounds of bacon to serve as her loan payment for the next three months. Rather, April and her uncle must agree in advance. They decide that the bacon will be valued at no more than the average market value at the farmers' market in April's neighborhood. Payment can be made with no more than 10 pounds per month, and the remainder of the payment must be made in cash.

April and Uncle Bob make sure to put their agreement in writing. This way, even if Uncle Bob decides to become a vegetarian and has no use for bacon, April will have documentation of their agreement.

Permission for Use

Another possible payment option is for the farmer to allow the lender permission to use the property in certain ways. Maybe April has a woodlot on the property with some valuable trees. She and Uncle Bob could come agree that if April misses two payments, Uncle Bob has the right to log trees from a certain portion of the land and use those to make up the back payments.

Services

April could also offer to provide services for Bob in exchange for part of her payment. But, she needs to be sure to set quality standards and provide a timeline on which the services will be done. For example, "maintaining landscaping" is too vague and open-ended. April would need to include exactly what that maintenance entails – mowing, pruning trees, planting flowers around the front walk – and when and how often she will do those tasks.

The bottom line: Be creative, but be thorough.

The bottom line with any of the above options or anything else you come up with is this: be creative, but be thorough. Make sure to talk through all the relevant details with the lender, and make sure that you are on the same page. For example, when can alternative payments happen? What are the procedures when they occur?

The other important principle to keep in mind is: remember your tax and accounting obligations! Just because April might use something other than cash to make her payments doesn't mean that it's tax-free. She needs to follow all relevant tax laws and pick an arrangement with transparent accounting. Flexibility is not an excuse or justification for breaking tax laws.

What are those tax obligations? For the farmer (or any borrower), the interest paid on a loan is a deductible expense. The money that you give back to the lender as principal, however, is not. For the lender, the interest received is taxable income and the principal is not. The borrower and the lender need to agree on what portion of the payment is going towards the principal and how much is going towards the interest. And we are not just talking cash here! If April's bacon is serving as the interest received on the loan, that is taxable. The same goes for services and all the rest. Both the lender and the borrower need to allocate cash to the IRS for the tax obligations of all of the payment options.

There may be an opportunity for the farmer to be part of the Aggie Bond Loan Program through the state. The program offers affordable financing to farmers by making interest tax-free to the lender, allowing him or her to offer the farmer a reduced interest rate. Contact your state's department of agriculture to learn about eligibility requirements and opportunities available.

Flexibility and creativity are not as relevant when working with a bank. Generally, the borrower either signs the bank's standard form and gets the loan, or the loan isn't given. But even in that case, the questions we bring up in this section are still important. Farmers need to clearly understand all the details and stipulations of the loan arrangement they are agreeing to uphold.

Paperwork

Whether a farmer is working with a bank, a family member, or any other loan source, it is ideal to write all decisions down on paper and have all parties sign the document. There are a few reasons why this is an important step to take.

This document can go by many different names: promissory note, loan agreement, etc. Don't worry too much about the title and legal jargon, just focus on the content.

The first is to preserve the collective memory of the agreement. It's easy to forget the exact details of what you agreed on, especially if you had to go back and forth on some points before coming to a consensus. Writing down your decisions will also come in handy if a borrower transfers responsibility for payment of the loan to someone else. That new person needs to have a way to find out all the details of the loan, e.g., if the lender is accepting a non-cash form of payment, payment procedures, etc. A piece of paper with all the relevant details provides clarity and makes the process of transferring responsibility much easier.

Writing down your loan agreement:

1. Preserves the collective memory of the agreement.

2. Provides evidence of the relationship.

3. Can protect you if the agreement needs to be enforced.

Writing down your loan agreement also provides evidence of the relationship. We are mainly referring here to the IRS. Loan documentation helps prove that the money was given, in fact, as a loan, and that you are following the applicable laws. This could also apply to another potential lender who wants to see evidence that you are receiving additional funds for your purchase.

A third reason for writing down a loan agreement is something that we often don't like to think about: enforcement. It's not pleasant to think about how a relationship might change, or how a situation can go awry down the road. But, taking the steps to write down your loan agreement can protect you if necessary. Enforcing an agreement if it's not written and signed is possible, but it's very difficult.

Enforcement can go both ways. A loan agreement can be enforced against you if you don't follow through on your end of the agreement. Likewise, you could enforce the agreement against the lender, if he or she is the one who didn't follow the agreement. Exactly how and where enforcement can play out (such as small claims court or through bankruptcy process) depends on a number of factors. This resource will not delve into the nuance and details of enforcement of agreements because we are hoping that you will not reach that point. The issue is still important and farmers should consider meeting with an attorney to learn more about enforceability. By going into the loan agreement process with a strong emphasis on communication, working with someone you trust, and writing all the details down, you will be set up for success.

The Duck Test

There are some limits to the flexibility that we have been discussing. Like we mentioned at the beginning of this resource, the law likes to put things in separate buckets. It's important to keep in mind that these legal distinctions are based on reality, not just a heading on a piece of paper. In other words, if it looks like a duck, and quacks like a duck, it goes into the duck bucket and has to follow the duck rules. It doesn't matter if you have a piece of paper stating that it's really a beaver.

Let's look at a few examples of what we mean.

1. Uncle Bob gives April a no-interest loan of $50,000. Well, a loan with no interest looks like a tax avoidance scheme to the IRS. This is because the receipt of interest is taxable income. The IRS will not be pleased that they are missing out on that tax money, and may choose to assign interest to the loan and asses it against Uncle Bob when tax times comes around.
2. April's mom gives a "loan," of $50,000 but there is no written commitment to pay the loan back, or no details on how or when that payment will take place. The IRS will likely say that this is a gift, not a loan. Gift tax laws would then apply.
3. Uncle Bob gives April a loan for $50,000, and tells her that she can pay him back in ten years. Oh, and she doesn't have to worry about offering any collateral. He trusts her. Well, a longer loan (anything more than nine months to a year) with no collateral is more likely than a loan with collateral to be seen as a security and regulated as such. We will address this in further detail later on.

Full disclosure: your loan may be considered a regulated security, anyway.

Farmer Profile: When Financing Gets Personal

This story comes from a member of the Farm Commons community who wanted to share her experience in the hopes that it would help others achieve success in their farm businesses. Please note, we have changed names and identifying details in this story to protect the privacy of the farmer, but email info@farmcommons.org if you would like to learn more about this situation or be put in touch with the farmer.

Communication and trust are big themes in this guide, as well as in Farm Commons' work in general. They are the cornerstones of any strong relationship, business or otherwise. But sometimes communication can be difficult, especially when dealing with sensitive topics. Anyone who has been in a domestic partnership knows how true that can be! When you combine romance and farm business, both the importance and sensitivity of communication rises.

No one knows that better than farmer Vicki Potter. Vicki met her partner, Jessie, when they were both in graduate school. They started dating, bonding over many mutual interests – including a shared passion for farming. They each had been farming for other people for the past few years and, after about a year, they realized that it made sense to start looking for a piece of land to farm together. After a 2-year search, they found a suitable piece of property and began their journey to finance their farmland purchase.

Financing a property purchase can be challenging, but Vicki and Jessie had one thing on their side: Vicki had inherited a small amount of money from her grandfather, just enough to put a down payment on the piece of land they had their eyes on and make their mortgage payments manageable. With that, the couple was able to secure a loan through the Farm Service Agency (FSA). FSA loans are joint loans, so they also had a commercial loan through their local farm credit bank.

The situation was made slightly more complicated by the fact that Vicki and Jessie were not legally married. Both of their names were on the deed, which was under their personal names both because their LLC wasn't set up yet and because the property was their home as much as their business. They had to decide who should be listed as the primary loan carrier on each loan, as well as what made sense from tax and asset perspectives. Eventually, Vicki was listed on the commercial loan, and Jessie on the FSA loan. Finally, they were ready to start farming.

About a year and a half went by and, while the farm was flourishing, the same couldn't be said for Vicki and Jessie's relationship. After trying to work things through, they decided it was time to go their separate ways. One small problem – what would happen to their farm and home? Very quickly, Vicki realized that they had failed to address any sort of contingency plan about what would happen if things went wrong. Some of the questions that came up were:

- What happens to the house? Who continues to live there and take care of it?
- Can one person buy out the other's stake in the business, or does the business have to be sold even if one person has the financial ability to buy out the other?
- What happens to the LLC? Does it have to be disbanded, or can one person continue to use the name and operate the farm as is?
- How do you account for each person's cash and labor contributions?

> "It would have been so much better to have [those conversations] when we were level-headed and planning - not when we had to figure them out."

In Vicki's own words:

"Through the whole process we had kind of started writing all of our documents down, but we never finalized them, and we had never addressed how the business would be dissolved if it had to be for some reason. Those are things that people don't like to think about, but it would have been really helpful if we had thought through what would happen to the LLC, how it would be divided, and what happens to the property. We hadn't outlined any of that. All those conversations are all really hard to have when you are going through a break-up at the same time. It would have been so much better to have them when we were level-headed and planning – not when we had to figure them out."

Vicki was the only one in the financial position to take on the farm, and the couple was able to settle on a sum that they were both comfortable with for Vicki to buy out Jessie. But, they still had to address how to handle the two loans that they had taken out and the accompanying mortgages. Although

Jessie was listed as the primary name on the FSA loan, both partners were actually listed. In order to transfer the loan to one person, they would have had to go through the whole application process from the beginning, which could take a very long time. Luckily, Jessie was able to pay off the remainder of the FSA loan with her savings, but she doesn't know what she would have done without that ability. She still holds the commercial loan after the lender went through a mortgage liability release process and determined that she was financially secure enough to hold the loan on her own.

Vicki says, "I was young when we started out this process, and buying a house and a piece of land in itself was really testing my learning curve. So much so that I wasn't forward thinking enough about what might happen. Luckily we didn't buy a property beyond our financial means and I had savings and support from my family. I can't imagine being in that situation without all those resources, which gave me a safety net. There are some things that I might have done really differently from day one if I had known the way things were going to turn out. So having those big conversations is really important, and then writing down what you decide is key. It worked out for us, but I don't know what I would have done if I didn't have the money to just pay off our FSA loan and buy Jessie out. It would have been much different, and I probably would have lost the property and my business."

Talking through the details of what might go wrong and how you will deal with the outcome is key in successful business planning. Even if it's uncomfortable, having this type of detailed conversation before engaging in joint financing and business ventures will save you a lot of trouble and the potential loss of your business down the road.

Mortgages

Generally, when it comes to buying land, lenders want something more than a promise to pay them back. They want some collateral. This means that if the farmer doesn't pay back the loan, the lender can take the collateral. Generally, when buying land, the land itself is the collateral. But, it could be another stated item of value. The ability of the lender to take the collateral if the farmer defaults is often memorialized in something called a "security agreement."

When we think of loaning money to buy land, we think of a mortgage. The mortgage is technically these two things bundled together: the promissory note and the security agreement. The promissory note, if you remember from our earlier discussion, is the agreement that says a lender will give you money, and you will pay back that money plus interest. The security is the additional piece that says that if you don't pay back the loan, the lender will take back the land.

It is possible that these documents remain separate, and they may go by a different name. But the principles remain the same.

A thorough security agreement will cover when the lender has the right to take the land back, as well as the procedure that he or she will follow. We have some flexibility in security procedures when drafting a straight loan agreement without a house as collateral. When it comes to homes, however, drafting a security agreement is not nearly as flexible. There are mandated foreclosure procedures that must be followed when someone's home is on the line. If your farmland is not your home, the foreclosure procedures may not apply. The bottom line is this: Read the fine print of your security agreement. If you are buying land and pledging it as collateral for the loan, and it is not your home, don't automatically assume that home foreclosure procedures apply.

Getting a mortgage for farmland can be different than in other cases. Some farmers are able to buy their farm like anyone buying a personal home on a personal mortgage. They demonstrate their credit worthiness and prove they have income from a job to pay the mortgage. But, buying land for farming on your present or future income as a farmer, which is to be earned from the land you will buy with the mortgage, can be very difficult. Banks don't have evidence that you'll make money on that land and may view farming as too risky. This also applies when a farmer applies for a commercial loan. Banks generally don't have faith in farming business plans (even robust ones!).

The Farm Service Agency (FSA) is more understanding of the farmer's predicament. Their beginning farmer loan program can be a great resource for farmers looking to purchase farmland (and is often a farmer's only choice). But, the process can be quite slow, and the pace can prevent farmers from competing in a competitive and fast-moving property market.

Farmer April is continuing on her quest to finance her farmland purchase, but she is running into some problems along the way. She cannot quality for a personal home mortgage loan from a bank because she doesn't make enough money, her credit isn't strong enough, and she has no collateral (such as stocks or other property) to offer the bank. She can't get a business loan to buy the property as a commercial enterprise either. Her local bank doesn't make business loans to farmers. Like most banks, they view farming as too risky.

April can't even use the FSA beginning farmer loan program because she lives in the densely-populated Northeast, and the good properties were bought up by non-farmers long before she had a chance to get her paperwork in order. And, she doesn't have personal connections with a landowner who is willing to wait for April to arrange an FSA loan.

So, what can April do? Unfortunately, we don't have solution. April's situation is a common one, and by far the biggest barrier to entry for new farmers. April is one of the lucky ones, as she has Uncle Bob and her mom's land as possible options. But, as a community we need to continue to explore solutions to this all-too-common predicament.

"As a community we need to continue to explore solutions to this all-too-common predicament."

Seller Financing

Seller financing is a loan provided by the seller of the property to the purchaser.

Seller financing is a very general term. For the purposes of this resource, seller financing means a situation where the person who owns the land (the seller) takes on the role of the bank. The seller loans the buyer (the farmer) the amount of money required to purchase the property. The end result is that the farmer owns the property, and the seller holds the mortgage. The farmer pays the monthly payments directly to the seller.

Gone are the days when a farmer has to write and send an actual check to the seller. Most banks offer online options for transferring money directly to someone else's account and issuing a receipt of the transaction at the same time.

There are some standard legal transactions that take place during this process. When the seller passes over the deed, the buyer pays the down payment and signs the paperwork that goes along with a loan. This includes the mortgage: a promissory note to pay the seller back, and a security agreement that states that the land will be returned if the buyer does not pay. The buyer and the seller would go through essentially the same process with a bank loan, as we discussed in the section above, including all the questions about interest rates, timeframe, etc.

Why else might a farmer choose seller financing as a strategy when looking to purchase farmland? There are some practical considerations. Seller financing may be more flexible than dealing with a bank because the bank has to follow specific risk management practices and policies. It is, after all, a business, and needs to protect itself. Dealing with a seller one-on-one may provide opportunities to work our your unique situation without the burden of institutional oversight and obligations.

Seller financing is not an attractive choice for a seller who needs money upfront.

In some cases, the seller might not be interested in going this route. Seller financing would not work in the case of a seller who needs cash upfront, e.g., an individual who needs money for his or her retirement, or to purchase a house or property elsewhere. In those cases, the seller would need to be getting full payment for the land at the time of the sale. Waiting for monthly installments of the purchase price probably would not be sufficient.

Also, this probably won't work out if the seller doesn't already know and like the buyer! The process takes trust and a sense of security that the arrangement will work out over the long-term. This can be great when a farmer has already established a relationship with the seller and has a trust-worthy reputation in the community. It might be harder to find a willing seller to finance a farmland purchase without that foundation.

April's mom's land is valued at $90,000. April's mom decides to loan April that money to purchase the land with a signed promissory note that states that April will pay back her mom in monthly installments. April gives the money right back to her mom to pay for the land; April now owns the title for the land. They also execute a security agreement so that April's mom can take back the land if April doesn't pay. Once they've gone through the work of making sure they have the correct documents ready, the process is pretty easy!

Seller financing can also be used in conjunction with a bank loan. If April's bank is only willing to loan her $20,000, she could try to work out an arrangement where she finances the remainder of the purchase price ($70,000 in this case) with her mother, the seller.

Land Contracts

Installment land contract. Long-term land contract. Installment sale contract. Bond for deed. Land sale contract. Any of those terms sound familiar? They are just a variety of names for the same financing topic: a land contract.

Land contracts could be described as the concept of "rent-to-own" for farmland. It is similar to a mortgage but there is often little to no down payment required. Instead, the buyer and the seller decide on a purchase price for the land and spread the payment out over the length of a contract via monthly payments. With the potential to leave the bank out of it, this is a popular option among family members and friends. Retiring landowners who may not want a long-term mortgage may also find land contracts appealing.

"Because ownership doesn't transfer until the last payment, a farmer could lose his or her entire investment in a single bad month."

It may sound casual, but land contracts have a careful legal distinction. As with the rent-to-own concept, the buyer does not own the property until he or she makes the last and final payment. In the case of a mortgage, the buyer owns the property right away. The mortgage holder just has a right to take back that ownership if the buyer does not continue to meet the monthly payments.

This is an important distinction to make because of the vulnerability it creates for farmers. Because ownership doesn't transfer until the last payment, a farmer could lose his or her entire investment in a single bad month. In contrast, if a farmer is in a loan and security agreement and misses a payment, there is a series of foreclosure procedures that must be followed. These include opportunities to catch up on payments, or paying off the loan in full before the property transfers back to the mortgage holder.

If that setup doesn't seem fair to you, you're not alone. The legislatures and courts agree, and decided that steps needed to be taken to give those on a land contract the protection of foreclosure. **There are three basic ways they've modified the traditional framework on a land contract:**

1. Some states allow a pay-off period when the farmer (or any other land contract holder) has an opportunity to make up a missed payment or pay off the remaining land contract in full. This gives the farmer time to apply for a bank loan or find other funds to pay the contract off.

2. A court might also choose to interpret the contract as a lease, not a land contract. In that case, if the monthly payment was more than the rental value, the landowner would have to pay the farmer back for the excessive rent that he or she collected over the course of the contract. The farmer loses only as much as he would have if he or she had been renting the land all along.
3. Other states might treat a land contract like a mortgage and follow full official notice and court procedures for beginning the foreclosure process. In that scenario, the purchaser has the opportunity for pay off the loan, and if not, the property is sold through judicial action. If someone buys the property for more than the farmer owes, the farmer would then receive the extra money. If the property sells for less than the farmers owes, the lender can still go after the farmer for the remainder of the sum.

As with our other financing arrangements, documentation of the agreement is key when it comes to successful land contracts. Drafting a good land contract document takes into consideration all of the same things we think about with a loan, plus the issues we would think about with a lease. For example, who pays the insurance and taxes? And how are you planning to deal with improvements to the property if the farmer defaults? If a farmer defaults on his or her payments on year six of a land contract, and has installed five hoophouses during the course of the contract, is it fair for the landowner to kick the farmer off the property but keep the hoophouses? The farmer and landowner need to decide in advance how this would be handled. Perhaps the landowner will pay the farmer for the increased value of the land now that the structures are there, or maybe the farmer can take the hoophouses off the property when he or she goes. Neither option is more "correct"; it's just up to the personal preference of the farmer and the landowner.

Visit Farm Commons' website for more resources and information on drafting effective land contracts.

Similarly to seller financing, a land contract will work best for a landowner who doesn't need the money immediately. A land contract is often structured with a balloon payment. That means that a big payoff is expected a few years into the contract. The assumption is that the buyer will establish better credit, a real income stream from their business, and will be competitive for a traditional bank loan or mortgage. But, there is a risk for the landowner if that doesn't happen. If profitability doesn't materialize, the farmer may not be able to afford the balloon payment. If that landowner is relying

A balloon payment is an oversize payment due at the end of a mortgage.

on that payout, he or she could end up in a bad financial situation.

For example, perhaps a farmer enters into a land contract with his grandmother. The grandmother doesn't need cash right away to buy another house, and she doesn't want to sign a 30-year mortgage (because she doesn't expect to be around that long!). But, there are some expenses she has coming up in the next five years that she needs to pay off. The balloon structure could work out well for both parties in this case, allowing the farmer to start working on the land while establishing good credit, and then paying off the contract in time to meet his grandmother's cash flow needs. But, the situation carries some risk for the grandmother. If the payments on the land contract are not reported, they will not get counted towards the farmer's credit score and he still may not be eligible for a bank loan. Or perhaps the farm hasn't produced as much income as he expected. In that case he will not be able to afford the balloon payment when the time comes around, and his grandmother will not receive her expected cash. In cases like this, a balloon payment can lead to the loss of the property if it's not renegotiated.

Visit www.fsa.usda.gov to learn more about the land contract gaurantee program and find out if you are eligible.

The Farm Service Agency (FSA) actually has a land contract guarantee program. Through the program, if a farmer misses a payment, the FSA will step in and pay the landowner. The farmer then pays the FSA back. Farmers might want to consider joining the program if they are working with a seller who is concerned that the farmer might not be able to make payment.

Land Contracts or Seller Financing?

To review, in this guide we are referring to seller financing as when a landowner loans a farmer the money to purchase his or property, accompanied by a promissory note. The farmer then pays off the loan in installments. This looks very similar to a land contract – the farmer owns the title to the land and gives monthly payments. So which is preferable, from a legal perspective?

Choosing between the two financing structures will depend on what state you are in. In some states, land contracts and seller financing might be treated the same: if payments are missed, the farmer would go through the foreclosure process. In other states, however, land contracts are not treated as mortgages, and the farmer runs the risk of losing the entire investment if he or she misses a single payment. In those states, seller-financing might be more advantageous to the farmer.

Should Farmer April choose seller financing or a land contract? It depends on what the landowner (her mom) needs. What is her tax situation and income source? Is she in a financial position to execute a seller-financed sale and become the mortgage holder?

If April's mom needs the money now, neither of these options would be a good fit. In that case, a traditional bank loan would likely be the best choice.

If Mom is flexible, what is April's preference? She should consider her state's handling of land contracts, and what protections are available. If she decides to go that route, she should look into balloon payments and decide if she is prepared to take the steps to get a bank loan in the coming years.

Investors

Raising money for a business through investors is sometimes called "equity financing".

Investors are people who give you money now in return for a share of the profit in the future. They are not directly involved in business decision-making for the farm. If an investor directly participates in decision-making for the farm, he or she is generally a partner. See the next section for more details on that concept.

Investors can be friends, family, or even strangers. While most online crowdfunding falls into either the business income or gifts bucket, in certain cases people who contribute to your business through a crowdfunding platform can be considered investors, too.

Generally, an opportunity where you promise someone a portion of future profit in exchange for money now may be classified as securities. Money that goes into this bucket may be heavily regulated at the state and federal level. Although securities are already a very nuanced and state-specific area of law, it threatens to become even more complex with the growing crowdfunding environment. In addition to being tricky to navigate, the penalties for violating securities laws are quite severe. Farm Commons cannot yet comfortably address the details of these shifting laws. Check back at farmcommons.org for updates.

It's important to make sure you know the securities laws that may apply to your situation before beginning to work with investors.

Figuring out if securities laws apply to you requires the time and money to do a detailed analysis. If you are considering going the investor route, it's important that you seek guidance BEFORE you start talking to potential investors. Securities laws can come into play before you even ask anyone for money! Work with someone you trust, whether that's with an attorney or through a reputable online crowdfunding provider, who can help you understand the rules of your state.

Partnerships

Earlier, we mentioned that a partner is different from an investor. In this section, we will explore that difference, as well as delve much deeper into the world of partnerships as a financing strategy.

A partner is someone who makes an investment and gets ownership in return. In this context, ownership means the ability to make decisions about how the business operates. A co-owner is someone who can control the business in some way. It can be difficult to distinguish a partner from an investor, but the ability to make decisions is often a key determinant. If a person has some authority, the funding is more likely to belong in the partnerships bucket.

To learn more about choosing a business entity, see Farm Commons' webinar, "Farm Sole Propietorships, LLCs, S Corps, C Corps and Coops: Which? Why? How?"

If a farmer is considering taking on a partner, he or she will need to pick a business entity. There are many options, but the most popular choices will likely be an LLC or S Corporation. These entities are quite easy to form by filing a few formation documents with the state. Formation documents are generally called Articles of Organization (for an LLC) and Articles of Incorporation (for a corporation).

Once the farmer and the partner decide on the structure that they would like to form, they will need to draft the organizational documents. These are the documents that influence the internal operations of the entity. For an LLC, the document is called an operating agreement; corporations have bylaws and shareholder agreements. In some cases, like with an LLC, writing these documents might not be a required step. Whether required or not, these documents are incredibly important for the overall sustainability of your business and prevention of disagreements down the road.

Through the process of writing an organizational document, a farmer and his or her potential partner will talk through many important questions, including (but not by any means limited to):

- What is each partner contributing to the business, financially?
- How will you make big decisions?
  - E.g., if you want to take on debt, does everyone in the partnership have to agree? Just a majority? Does one particular person have the ability to make that decision?

- What are you planning to do with the profits and losses? Are they split along ownership lines?
- What if someone decides he or she wants to leave the business? How and when will his or her ownership be bought out?
- Is there a process for bringing new owners into the business?
- Do you want to write any additional policies or procedures, such as job descriptions or quality standards?

Check the Farm Commons website for more information on how to write an operating agreement, including checklists and models designed for farm businesses.

You then take all these decisions and write them into an agreement. You can start the process with plain language responses to the questions above and a signed statement that you all agree. At that point, Farm Commons highly recommends that you have your draft reviewed by an attorney.

Model Operating Agreements

Let's talk for a moment about the utility of model documents. You might have already figured out that you can go to an online search engine and type in something like "operating agreement for an LLC" and quickly be presented with a multitude of model documents. Models can be good for ideas, but the best document will be the one that relates to your situation. Operating agreements, and legal documents in general, are finely tuned machines. Each piece builds off of another, and the different sections fit together in a very specific way. What that means is that it is not easy to just tweak a model document to suit your needs. Changing one part can inadvertently ripple throughout the document and make it so that the agreement contradicts itself or just plain doesn't make sense anymore. If you work off of a model agreement, it's especially important to have attorney check your adaptation for consistency and accuracy.

After you've written your operating agreement, it's a good practice to revisit it annually to make sure that everything is still working out and all parties are still happy with the decisions. As we all know, businesses and life in general change from year to year. By reviewing your agreement, you are taking a proactive step towards coming up with solutions to any problems and strengthening the foundation of your farm business.

Be careful when limiting the decision-making power of your investors to avoid crossing into securities territory.

Remember, if your investor doesn't have authentic decision-making power in the enterprise, you may be accidentally crossing into the territory of a security. This is a heavily regulated issue, as we discussed above. If you are in any way limiting the control of the people that you are calling your partners, we strongly recommend that you seek the help of an attorney.

Farmer April can't commit to paying interest on a loan with either her mom or Uncle Bob. April is looking for other options to reward her mom and uncle for their commitment to her business. April looks into investment relationships- should she give Uncle Bob or Mom ownership or a share of the profit instead? If they decide to go down this path, there are a few ways it could go.

Perhaps April's mom and uncle are quite business savvy, and they both want to be part of the business on a deeper level than just financial backing. Great! Starting a farm business is challenging on multiple fronts, and Farmer April can use all the help she can get.

One option would be to make Mom and Uncle Bob each business partners. Let's explore co-ownership. Uncle Bob and Mom have the most cash. They are each willing to contribute $20,000 to the enterprise. April has no cash to spare, and contributes her labor as her contribution for ownership. This structure is perfectly acceptable, as long as April is mindful of the tax implications of the labor she is contributing. April's receipt of ownership is taxable income to her, and she will need to pay cash to the IRS.

If the April receives ownership valued at $20,000 also, then the trio owns the business in equal proportions. So, the profit and loss will also generally be divided in thirds. April, Uncle Bob, and Mom would need to discuss this issue. April, Mom and Bob should also sit down to identify roles and decision-making authority. Because these aspects are important for their legal implications, the team would ideally write and sign organizational documents to memorialize their agreement.

Conclusion

If you've reached the end of this guide, you are well on your way to understanding basic finance strategies. Ultimately, the structure you settle on will depend on many factors unique to your situation. But remember, whatever choice you make will come with its own set of laws, rules, and limitations. By being thorough in your research of the legal "bucket" you are exploring, you wiill greatly increase your chances of having a successful financing experience and achieving your overarching goal: getting your hands in dirt that you can call your own.

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