Financing the Farm

A law bulletin series on legal arrangements for farm financing

September 2019

Installment Contracts

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The name itself suggests the unique feature of an installment contract: repayment of a loan to purchase goods occurs over time in installments, rather than all at once. Installment contracts can enable a farmer to finance large purchases over a period of time. This bulletin highlights important rules and tax considerations that a beginning farmer should understand before entering into an installment contract.

What is an installment contract?

An **installment contract** is a legally binding agreement where the buyer's payments, the seller's performance, or both are spread out over a specified period of time. Rather than a transaction happening all at once, installment contracts intentionally give parties more time to perform their contractual obligations. The contract establishes the time period.

When do farmers use an installment contract?

Installment contracts are common in agriculture. Farmers use these types of contracts to buy and sell land and goods such as equipment, grains, produce and livestock. Consider a few examples. First, a farmer buys 10 acres of land for $70,000 under a ten-year installment contract, often called a "land contract" or a "contract for deed." The terms of the contract require the farmer to pay $7,000 annually, plus interest. At the end of the agreement, the farmer receives the title to the land. Or, a farmer buys a new tractor from a supplier and enters into a contract that allows for annual payments over a five-year period. The seller maintains a secured interest in the equipment until payment is complete. Farmers might also sell goods under an installment contract. For example, a farmer agrees to provide a grocery with 500 bushels of apples each year for five years. Although the written contract covers five years, the farmer delivers the apples in installments and the grocery pays for each separate delivery.

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How does an installment contract work?

An installment contract should be in writing and should clearly state what each party must do under the contract. For the buyer, this usually means explaining on which dates or how frequently payment is due, how much is due, and whether the buyer must pay interest. For the seller, this usually means explaining when it must deliver its goods or perform its services.

Each party should sign the contract. If a security interest is taken until the buyer pays off the installment contract, separate documents may be necessary. For more information, refer to our law bulletin on *Security Agreements*.

A properly executed installment contract is legally enforceable in a court of law. Sometimes an installment contract does not address every situation, right, or obligation that could arise under the contract, however. In this event, legal default rules will apply to the contract. The **Uniform Commercial Code (UCC)** provides the default rules for sales of goods under an installment contract, which the law defines as an agreement "which requires or authorizes the delivery of goods in separate lots." The UCC does not apply to sales of land under an installment contract.

If an installment contract is for the performance of a service, the **common law** of the state will supply the default rules. The common law refers to the body of court decisions on a legal issue. A farmer may need to refer to an attorney to understand the laws, obligations and legal remedies that apply to a particular installment contract situation.

Installment contracts for land purchases

An installment contract is a frequent tool used for the private financing of a land sale from a seller to a buyer. This type of "land contract" or "contract for deed" allow the parties to avoid third party lenders. However, both parties should understand the legal implications of this type of installment contract. The title to the property being sold remains with the seller until the buyer has paid the entire purchase price and interest.

An installment contract for a land sale therefore should address important issues such as which party is responsible for property insurance and property taxes throughout the duration of the contract. The contract should also clarify what happens if the buyer falls behind in payments or defaults on the contract. Often, an installment contract for land provides that a buyer loses all payments and rights to the property upon a default. A farmer purchasing land under an installment contract must be aware of these legal implications, which differ from purchasing land through a mortgage situation. See our law bulletin on *Mortgages* in this series for more information.

Tax implications of installment contracts

Installment sales can raise complex tax questions, based upon how the Internal Revenue Service (IRS) treats a use of an installment contract. In most cases, each installment is reportable on the seller's tax return in the year that the installment is paid. Referred to as the **installment method**, this is the default rule for when the IRS requires a seller to report income from an installment sale.

To illustrate, a landowner enters into an installment contract with a neighbor for the sale of real estate. The payment will be made in six equal installments, with two installments due each year. Assuming that the neighbor pays as required, the landowner will have to report two installments on this year's tax return, two installments on the following year's tax return, and the final two installments on the tax return for year three.

However, there are a few situations in which the default installment method does not apply, either by choice or by rule. In these situations, a seller must report the entire purchase price in the year the contract is agreed to.

The first situation is when a taxpayer chooses to **elect out** of using the installment method and pay all income or gain in the year when the contract is entered into, even if installments will be paid in later years. Income from interest received under the contract will still be due in the year that the interest is paid.

In a second situation, the IRS does not allow taxpayers to use the installment method for **depreciation recapture**. If an asset has been depreciated, the IRS requires the seller to report all depreciation recapture as income in the year of the sale, even if the seller will not receive all the payments in the year of the sale. This can lead to a high tax bill as a result of an installment sale. However, the taxpayer may report any gain greater than the recapture under the installment method.

Third, taxpayers may not use the installment method when selling **depreciable property to a related party**. In this case, the IRS requires the seller to report all payments that are to be received under the agreement in the year of the sale, even if some payments are not due until later years. However, the IRS does provide an exception that would allow a seller to use the installment method if the seller can prove that the sale will not result in a significant tax deferral benefit.

Beyond these situations, there are special rules for like-kind exchanges, single sales of several assets, sales of a business, disposition of an installment obligation, repossession, and more. With so many special tax rules, a seller in an installment contract may want to talk with an accountant and attorney before entering into an installment contract.

Installment contracts with family members

A farmer might want to consider selling land, equipment or livestock to the next generation of family members under an installment contract. This arrangement allows the younger generation to spread out the purchase of high value assets over time and provides a continuous source of revenue for the seller. As we explain above, though, a seller may face significant taxes in year one when selling fully depreciated assets or selling to family members under an installment contract.

There are also tax ramifications for a family member who purchases property under an installment contract. If a buyer would have inherited the property, the buyer would have received a stepped up tax basis in the property. However, a buyer purchasing land or goods under an installment contract does not receive the stepped up tax basis for the property.

Comparison to a lease

Installment contracts and leases are similar in that payment occurs over a period of time. However, an installment contract transfers ownership of the land or good permanently, while a lease transfers possession, control, and use of the land or good only for the term of the lease.

The taxation of an installment sale under the installment method looks very similar to the taxation of a lease. However, when the installment method of taxation is not used or cannot be used, income generated under the installment contract may result in a large up-front tax burden.

Comparison to lease-to-own

A lease-to-own agreement falls somewhere between a lease and an installment contract. The initial rights under a lease-to-own mirror a lease: the lessee only has the right to possess, control, and use the property while the lessee continues to pay. Once the lease term ends, the lessee is expected to take ownership of the property, just like in an installment contract.

The taxation of lease-to-own agreements looks at two phases: the lease and the purchase. The lease phase is taxed just like a lease and income is due in the year the lease payments are made. The purchase phase is then taxed like a purchase. When depreciable property is involved, the asset will have depreciated in value over the course of the lease, which results in fewer taxes being due.

Pros and cons of installment contracts

We hope this law bulletin illustrates that there are both pros and cons to installment contracts. An installment contract allows a farmer to purchase high value goods over a period of time, allows a seller to privately finance a sale to a farmer or family member, and accommodates the sale of cyclical farm goods. But installment contracts can have harsh results when used to purchase land, a seller may have to report the entire purchase price of a sale in the year the parties entered into the contract, and a buyer who would have inherited the property loses its stepped up tax basis. Consulting with an attorney and accountant to understand these implications may be necessary.

Other titles in the *Financing the Farm* law bulletin series

To continue to learn more about common legal documents for farm financing arrangements, see our law bulletins on *Mortgages, Promissory Notes, Leasing Arrangements*, and *Secured Transactions*.

References and Resources

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