

Agricultural Installment Land Contracts

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Ag Law and Taxation Blog: <https://agriculturallaw.lawprofessorsblogs.com/>

March 2026

Overview

For many farmers, the "Contract for Deed" or installment contract is a vital bridge to land ownership when traditional bank financing isn't an option. However, because the seller retains legal title until the final penny is paid, the stakes are incredibly high. If the contract isn't structured with precision, a farmer risks losing both the land and years of equity over a single bad harvest.

The Core Legal Structure

In an installment contract, the buyer takes equitable title (the right to use and profit from the land), while the seller retains legal title. Procedurally, it is critical to record the contract (or a memorandum of it) with the local County Recorder. This protects the buyer against the seller using the land as collateral for new loans or selling it to someone else. Also, to ensure a smooth transition, the seller should execute a warranty deed at the start of the contract, to be held by a third-party escrow agent. Once the final payment is made, the agent releases the deed to the buyer.

Determining the Interest Rate - the AFR Standard

Selecting an interest rate for an installment land contract is not merely a matter of negotiation between the buyer and seller, the IRS has a specific rules that must be satisfied. Specifically, to be recognized as a legitimate loan for tax purposes, the contract must carry an interest rate at least equal to the Applicable Federal Rate (AFR) published monthly by the IRS.¹

Note: The One Big Beautiful Bill Act (OBBBA) creates new I.R.C. §139L which allows a “qualified lender” to exclude 25% of the interest income from the lender’s gross income if the loan is secured by agricultural real estate. This tax break is intended to encourage lower rates for farmers, but the contract must still meet the minimum AFR thresholds to avoid scrutiny.

If a seller offers a "below-market" rate of interest (lower than the AFR), the IRS may trigger the imputed interest rules under I.R.C. §483 or I.R.C. §1274. In these cases, the IRS "imputes" interest at the higher AFR rate, taxing the seller on income they never actually received. Furthermore, the buyer’s tax basis in the land may be reduced because a portion of the "principal" payments is reclassified as interest. To avoid this, the parties should always ensure the stated interest rate in the contract meets or exceeds the Long-Term AFR in effect during the month the contract is signed.

¹ For March 2026, the AFR for long-term contracts (contracts for more than nine years) is 4.72 percent. For April 2026 the long-term AFR is 4.62 percent.



Structuring Payments for Farm Cycles

Traditional monthly payments rarely align with agricultural cash flows. A well-structured contract should mirror the farm's revenue stream. There are various ways that a payment schedule can be established. Annual or semi-annual payments align payments with harvest dates (e.g., December or January).

Some sophisticated contracts include "variable payments" tied to commodity prices or crop yields. To understand how a variable payment structure works, it is helpful to compare it against a traditional fixed-rate installment. In many modern agricultural contracts, a "Price-Indexed" or "Yield-Indexed" payment protects the farmer during "bust" years while rewarding the seller during "boom" years.

Example: Fixed vs. Variable Payment Models

In the table below, assume a total annual obligation of \$50,000 at a "Base" corn price of \$4.50/bushel.

Year	Scenario	Corn Price	Calculation	Final Payment
Year 1	Standard/Fixed	\$4.50	Contract Fixed Rate	\$50,000
Year 2	Drought/Low Price	\$3.50	$\$50,000 \times (3.50 / 4.50)$	\$38,888
Year 3	High Yield/Price	\$6.00	$\$50,000 \times (6.00 / 4.50)$	\$66,666

Proper structuring of a variable payment clause. The contract must be extremely specific to avoid litigation later. Care should be taken to define the following:

1. The "Base" Metric: The contract should specify whether the USDA National Agricultural Statistics Service (NASS) average price for the county, or the closing price at a specific local elevator on a specific date (e.g., December 1st) is being used.
2. The Floor and Ceiling: To protect both parties, the contract should include a "Floor" (the minimum the seller will accept) and a "Ceiling" (the maximum the buyer will pay).
3. The "Catch-Up" Provision: Does a low payment in Year 2 mean the debt is forgiven, or does it get tacked onto the end of the contract? Most sellers prefer the "tack-on" method to ensure the full principal is eventually paid.

Note: Regardless of whether the payment is fixed or variable, the contract must include an Amortization Schedule. This is a table that breaks down every single payment into "Principal" and "Interest." The buyer can generally deduct the interest portion as a business expense. The schedule shows exactly how much of the land the buyer "owns" at any given moment. This is vital if the buyer ever needs to refinance with a traditional bank to "buy out" the seller early.

Many installment contracts are amortized over 20 years but have a five or 10-year "balloon" date. This means that the buyer makes payments as if it's a 20-year loan, but at the end of year 10, the *entire remaining balance* is due



at once. With such a clause in the contract, the buyer must assure that the contract contains a "Right to Extend" clause if interest rates at that time are above a certain percentage, or if the buyer can prove you were denied a bank loan despite "Good Faith" efforts.

Essential Contract Clauses

“Safety Net” Provisions. Beyond the purchase price and interest rate, an installment land contract should contain certain technical provisions. The following are suggested as "safety net" provisions for the buyer:

- Prepayment right – this allows the buyer to pay off the loan early. Without such a provision the seller can force the buyer to stay on the interest schedule for the full term.
- A Cure Period – this provides a “grace period” for late payments. This clause is often crucial for farmers facing weather-related delays in grain checks.
- Waste and Maintenance provision – this specifies that “normal farming practices” (tilling, chemical application, etc.) don’t constitute “waste”
- Severability – this provision can be used to protect the buyer’s home. If the farm being purchased is large, this clause can allow the buyer to “pay off” the portion containing the homestead first to secure the home for the buyer to live in.

Default and Forfeiture. The biggest risk in an installment contract is forfeiture. In many jurisdictions, if a buyer defaults, the seller can cancel the contract, keep the land, and keep all previous payments. But a "Conversion to Mortgage" clause can protect the buyer. This states that once the buyer has paid a certain percentage (e.g., 20 percent or 30 percent) of the purchase price, a default must be handled through a formal judicial foreclosure rather than a quick forfeiture.

Insurance & Taxes: The contract must explicitly state who is responsible for property taxes and multi-peril crop insurance. Usually, the buyer assumes these costs to demonstrate "ownership" for tax deduction purposes.

Environmental and Mineral Rights. Farmland buyers must ensure they aren't buying a liability. The seller should warrant that there are no underground storage tanks, chemical spills, or "dead zones" on the property. Also, the contract should specify if mineral rights or other rights (e.g., wind and solar) transfer with the land. If the seller keeps mineral rights, for example, the contract must limit the seller’s ability to disrupt the surface for drilling.

Critical Questions

Moving from the "handshake deal" to a formal legal document is a high-stakes transition. Before signing an installment contract the should “peel back” the layers of the property's history and the seller’s financial standing. The following is a checklist of questions designed to uncover hidden liabilities and structural weaknesses in the deal.



- "Is there an existing mortgage on the property?" This matters because if the seller defaults on their own mortgage, the bank could foreclose on the land the buyer is paying for. For protection, the buyer needs a "Non-Disturbance Agreement" from the seller's lender.
- "Are there any active agricultural easements or conservation Reserve Program (CRP) contracts?" This is important to know because of possible restrictions on the buyer's ability to tile the land, build structures, or graze livestock. The buyer also needs to know who receives the remaining government payments.
- "Is the legal description based on a recent survey?" This is important because farm fences are notorious for not following actual property lines. Buying "40 acres more or less" is a recipe for a boundary dispute.
- "Will you allow a 'Deed in Escrow'?" This is an important question because it prevents the buyer from being stuck looking for the seller's heirs many years into the future to get the deed to the property after it's been paid for. The deed should be signed now and held by a neutral third party (like a bank or title company).
- "Can I prepay the principal without penalty?" This a provision the buyer would like to have, however, some sellers may object desiring to maintain a steady, taxable income stream.
- "What is the specific 'Cure Period' if a payment is missed?" In farming, cash is often tied up in grain bins or pending insurance claims. The buyer needs a guaranteed window (e.g., 30 or 60 days) to make up a payment before the seller can trigger forfeiture.
- "Are there any 'Life Estates' or 'First Rights of Refusal' held by family members?" Sometimes a seller's sibling or child has a legal right to match any offer. The buyer needs to ensure all family "claims" are legally waived before investing in the purchase.
- "What is the status of the Mineral and Wind Rights?" If the seller keeps the mineral rights, they might have the right, for example, to put a drill pad in the middle of crop production field.
- "Are there any abandoned wells, fuel tanks, or dump sites on the acreage?" Under environmental laws (like CERCLA), the "owner" can be held liable for cleanup costs, even if they didn't cause the pollution.
- "If I default, do I have the right to harvest the standing crop?" This is the "Doctrine of Emblements." The buyer wants it explicitly in writing that even if the contract is canceled after a crop is planted but before harvest, the buyer has the right to finish the harvest.
- "Will you provide an annual 'Stated Balance' letter?" The buyer needs this for accounting purposes and for operating loan applications to prove that the buyer is growing equity in the land.
- "Will you release the deed to 10 acres (the homestead) once I've paid 20 percent of the total contract price?" A clause allowing this ensures that even if the farm fails later, the buyer has secured the house and a small plot of land for the buyer's family.



Income Tax Aspects of Installment Sales

In general, gain or loss must be recognized at the time of sale. However, under the installment method, a seller can defer tax and recognize gain for any particular tax year in proportion to the amount of installments received.² This allows the seller to spread the income tax liability over the entire term. Installment contracts are also beneficial because the periodic payments can be available to the seller for retirement income, a security interest may be retained in the property and the buyer has control and beneficial enjoyment of the property. However, if the seller outlives the term of the contract, income problems could result if the payments were being used for living expenses.

Installment reporting of gain is automatic for eligible property.³ An election not to have installment reporting apply must be made on or before the due date (including extensions of time) for filing the income tax return for the year in which the sale occurs.⁴ Once an election is made, it can only be revoked with the consent of the IRS. In addition, installment reporting only applies to gain and not to loss upon sale of real property.

When real property is sold on an installment basis, part of each payment received represents gain and part represents a nontaxable return of the taxpayer's basis in the property. The amount of principal reported as income for any year is determined by the "gross profit percentage" which is based upon the gross profit on the entire transaction and the total contract price. "Gross profit" is the selling price less the adjusted income tax basis.⁵ The selling price is computed without a reduction for any existing mortgage and/or selling expenses. The "total contract price" is the amount to be paid by the buyer and does not include a mortgage except to the extent the mortgage exceeds the income tax basis.⁶ The remaining amount of each principal payment is a nontaxable return of basis. Interest received is taxable as ordinary income.

The reporting of gain from an installment sale of real property involves a four-step process. The first step is to subtract the seller's adjusted basis in the property from the selling price. This yields the "gross profit." In making this computation, expenses of sale are added to the basis of the property. The total contract price is computed next. The total contract price is the amount the buyer pays less indebtedness. The indebtedness must be "qualifying indebtedness" that is functionally related to the property. Debt incident to the sale, such as legal fees, does not count. The "gross profit percentage" is determined next by dividing the gross profit by the total contract price. The fourth step is to multiply each payment received by the gross profit percentage, with the result being the amount of gain to be reported for the year. The following example illustrates this four-step procedure.

Example:

Wilbur Jones is retiring from farming, but has no heirs interested in continuing the operation. As a result, Wilbur decides to sell his farm to Tom Tiller in 2012 for \$1,325,000. Wilbur agrees to sell the farm on an installment basis, and agrees to take annual payments of \$66,250 for twenty years with no down payment. Wilbur's basis in the farm is \$360,000, and he owns the farm debt-free. The computational process for reporting gain is as follows:

² I.R.C. § 453.

³ I.R.C. § 453(d)(1).

⁴ I.R.C. § 453(d)(2).

⁵ Treas. Reg. § 1.453-1(b)(2)(v) (1994).

⁶ Treas. Reg. § 1.453-1(b)(2)(iii) (1994).



Step 1 (calculate gross profit)

Selling price.....	\$1,325,000
Less: Basis.....	(360,000)
Expenses of sale.....	(26,500)
Gross profit	\$938,500

Step 2 (determine the total contract price)

Selling price.....	\$1,325,000
Less: Qualifying indebtedness.....	0.00
Total contract price.....	\$1,325,000

Step 3 (compute the gross profit percentage)

<u>Gross profit</u>	
Total contract price	
= <u>\$938,500</u>	
\$1,325,000	
= .7083	

Step 4 (calculate amount of each payment received reportable as gain)

Amount received in 2012.....	\$66,250.00
Gross profit percentage.....	x .7083
Amount reportable as gain	\$46,924.88
Amount representing nontaxable return of basis	\$19,325.12

Note: The OBBBA creates new I.R.C. §1062 which allows a farmer to pay the income tax resulting from a farmland sale to another farmer in four equal annual installments rather than all at once in the year of the sale.

Conclusion

The agricultural installment land contract remains a sophisticated tool for transitioning farm assets, but its success depends entirely on the technical integrity of the written agreement. For the buyer, the contract must provide a "safety net" through cure periods, prepayment rights, and protections against forfeiture to ensure that a lifetime of equity is not wiped out by a single season of hardship. For the seller, the installment method offers a powerful tax-mitigation strategy under I.R.C. §453, allowing for the deferral of gain and the avoidance of a significant "tax spike" in the year of sale. However, as the rules regarding AFR compliance, imputed interest, and the new provisions of the OBBBA demonstrate, there is no room for a "handshake deal." By addressing critical questions regarding title, mineral rights, and amortization upfront, both parties can transform a high-stakes transition into a secure, mutually beneficial bridge to the next generation of land ownership.

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