

# GROWING ON SOLID GROUND: A FARMER'S GUIDE TO LAND TENURE

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## Growing on Solid Ground: A Farmers Guide to Land Tenure

November 2017. Fundamental to any farm or ranch is land tenure, which is the foundation of food and resource-based economies worldwide. If you're interested in contributing examples of land tenure structures for future versions of this Guide, please contact us at [info@cafarmlink.org](mailto:info@cafarmlink.org). Thank you.

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**Our mission is to link independent farmers and ranchers with the land and financing they need for a sustainable future.**

### Disclaimer:

This Guide is intended for use as educational material to assist farmers in understanding various federal and California state laws and regulations related to land tenure. It is not intended, and should not be used, as a substitute or replacement for individual legal or tax advice. Farm operators should consult a lawyer and other relevant professionals prior to leasing or purchasing land. While significant efforts have been made to ensure the accuracy of the information contained in this Guide; the content and interpretation of laws and regulations are subject to change. The effect of future legislative, administrative, and judicial developments cannot be predicted. For these reasons, the utilization of these materials by any person represents an agreement to hold harmless the authors or California FarmLink for any liability, claims, damages, or expenses that may be incurred by any person as a result of reference to or reliance on the information contained in this Guide.

# Growing on Solid Ground: A Farmer's Guide to Land Tenure

## Chapter 1: The Building Blocks of Land Tenure for Farming and Ranching

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This Guide, like farming, is about relationships. Each farm or ranch can be analyzed in terms of three interrelated elements: the land, the farming or ranching activities that take place on that land, and the financial relationship between the two. Throughout the rest of this Guide we discuss each option in terms of these three building blocks:

Land Tenure: The right to access and use the land.

Farming and Ranching: The activity of managing and working the land for gain or profit.

Rent: The economic value of the land resource to the farming or ranching activity.

In this chapter we explain how and why to think about these three elements separately. In the following chapters the models and case studies will illustrate different ways the elements can be combined to facilitate land access for farmers and ranchers.

### Agricultural Land Tenure

Agricultural land tenure is a broad concept covering the legal, political, philosophical, social, financial, and ecological relationship between the land and the business of farming or ranching. Note the distinction between the land and the agricultural activities. Land ownership may be entirely passive, whereas farming and ranching require action. An individual may own land, and also farm it, or may farm on leased land. Many farms operate on a combination of owned and leased land. Imagine two identical fields of broccoli farmed by the same farmer. One field is on land the farmer owns, and the other on leased land. Which is more profitable? It depends on the cost of owning versus leasing land.

Whether accomplished through cash, credit, exchanges of goods and services, or by gift or inheritance, the right to use the land has value independent of the economic value of activities conducted on the land. The term *land tenure* is used broadly to cover both owning and leasing, but in both cases it represents certain legal rights to access and use land.

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## Farming and Ranching

This publication addresses land tenure for the purpose of operating a farm or a ranch as a business. For tax purposes all individuals, partnerships, or corporations that cultivate, operate, or manage farms or ranches for gain or profit, either as owners or tenants, are designated as farmers.<sup>1</sup> “Gain or profit” means either building long term wealth, such as by establishing an orchard or building a packing shed, or making an annual profit, such as by profitably farming annual crops on leased land.<sup>2</sup> Most state and federal laws and programs that reference farming and ranching activities limit applicability to commercial enterprises, meaning those organized for gain or profit.<sup>3</sup>

Owning farm or ranch land may be a passive activity, but actively being in the business of farming or ranching means building wealth by creating new assets (buildings, permanent crops, irrigation infrastructure) or creating current income (or current losses) by raising and selling agricultural products.

Creating new assets builds long-term wealth and does not necessarily create current income or a current tax liability. If the assets are sold, then the proceeds are cash income, and the taxable gain or loss from the sale is treated differently than the income or loss from regular annual farming activities.<sup>4</sup>

Farm or ranch assets may be owned and operated by the same person who makes the management decisions to produce annual income from crops or livestock, or may be owned and managed for long-term investment purposes by a separate individual or legal entity and leased to the farmer or rancher. An owner of farm or ranch land can generate income by working the land or by leasing it out. Someone who leases land earns income based only on the way they manage the land to raise crops or livestock.

As you consider your reasons and options for securing land tenure for purposes of farming it is important to understand how land tenure affects your ability to build wealth over time or to generate current income, so you can develop cash flow and business models that fit your land tenure options.

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<sup>1</sup> 26 Code of Federal Regulations (CFR) 1.61-4 (d)

<sup>2</sup> 26 CFR 1.183-2 and see also IRS Publication 225 Chapter 4. Raising crops or animals for personal use or pleasure, including to give away to charity are not business activities and thus not generally the subject of special laws and programs for farms and ranches, and not the subject of this publication.

<sup>3</sup> See for example: Cal Civ Code § 3482.5 exempting only *commercial* agricultural activities from nuisance suits. The Farm Credit programs authorized under Federal law do not require a profit motive per se, but do require applicants to be able to demonstrate a reasonable basis for the “success” of the operation. Success is not defined, but in the context of credit, if the credit is for the farm operation the expectation is that the proceeds of farm operations will be sufficient to repay the loan, with personal assets of the borrower as a guarantee, otherwise it is simply a personal loan the proceeds of which the borrower intends to use in a recreational activity.

<sup>4</sup> See generally IRS Publication 225

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### Rent

When an individual or a single family owns the land they farm there may be no perceivable distinction between the land and the farming business. When a farming business leases land the distinction between owner and operator may be quite evident or still seemingly invisible, depending on the business structures, lease agreements, and underlying human relations. Here are a few examples:

- As part of an estate plan a family forms a partnership to own the family land and a limited liability company (LLC) to farm the land. The partnership has a written lease with the LLC, and the LLC pays rent to the partnership.
  - One of the family members wants cash to move to the city. She sells her shares in the LLC farming operation but still keeps her partnership shares in the ownership of the land. She has a say over how the land is managed and receives a share of rent for the value of the use of the land, but she has no say in how the farm is managed and does not receive a share of the net profits from the farming activity.
- A retired orchard owner and a neighbor who is still actively farming enter into a crop-share agreement. The orchard owner receives a portion of the crop as rent for the use of the land and the trees. The active farmer pays all of the costs of maintaining the trees and harvesting and transporting the crop and forgoes a portion of the harvest instead of paying cash for rent.
- An individual buys farmland and farms it as a sole proprietor. The rent is invisible, but since the owner-operator is not paying out a cash-rent, the cost-savings can go towards purchasing the land (paying down the mortgage) or growing the farming business.
- An individual buys farmland and forms a farming partnership with another individual. The farming partnership leases the farmland from the partner who is both a partner and a landowner.
- An individual buys farmland and leases it to a farming business.
- A family donates their land to the local land trust and the land trust leases the land to a farmer.

### **Land Tenure Means Having Some or All of the Rights of Ownership**

As used in this Guide, land tenure means the legal rights to access and use land for farming or ranching. The right to access may be obtained by owning the land, or by being granted access to the land by the owner. Before you can understand the value of your purchase or lease, you need to understand exactly what it is you are buying or leasing.

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In physical terms ownership of land includes ownership of the surface with natural growth and fixed (generally immovable) improvements, a limited amount of air above and water below, and all the rocks and minerals below the surface, unless any elements have been separately sold and are no longer considered a part of the land.

In legal terms, ownership is usually described as a *bundle of rights*. Each of the rights in the bundle can be separated and transferred, like each of the sticks in a bundle of sticks can be taken out and also cut into smaller sticks. The *bundle of rights* in property ownership are:

- The right to use the property in any lawful manner.
- The right to possess or to exclude others.
- The right to transfer by sale, gift or through inheritance.
- The right to encumber, meaning to use as collateral for a loan, or to transfer part of the rights, or subject to the burden of future restrictions or obligations on other rights.
- The right to enjoy or destroy, subject to the restrictions of law.

Rights may be separated by type of use and transferred temporarily through a lease, or permanently by sale, gift, or inheritance. For example, a landowner can make a temporary transfer of the right to access and use a portion of the land by leasing it to a farmer, and also permanently transfer to a neighbor the right to cross a portion of the property with a utility line, and yet still retain the other rights of ownership, including the right to enjoy living on the property and the right to transfer it to children through inheritance.

When the rights to a property are separated and permanently transferred, the property is owned subject to easements. Easements are the permanent rights of others to access or use the property in the specific manner described in the easement.

A *conservation easement* is the permanent transfer of certain use rights to a not-for-profit or government agency which then “retires” the rights. This type of partial transfer of ownership allows a landowner to retain most of the rights of ownership but strips the property of some rights of use, typically the right to develop the property for housing. One of the consequences of separating off the right to develop the property is to limit the fair market value of the property. An urban-edge property with a conservation easement prohibiting urban development should sell for a per-acre price comparable to farmland farther from the urban center, rather than a per-acre price comparable to land about to be developed for housing or commercial purposes.

Local zoning may have a similar though more temporary effect if the local zoning authority zones the property for agricultural use only. Local law may also limit the right to use or occupy the land for farming purposes, for example if the land is zoned exclusively for residential use.

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State and Federal law may limit the right to use or destroy. For example, the Federal Endangered Species Act limits a landowner's right to destroy the habitat of endangered species, and many Midwestern states have laws limiting a landowner's right to destroy topsoil through poor farming practices.

The flexibility of property rights allows different uses to co-exist under different owners and managers. In Kern County, where the same piece of land may be used for farming and oil drilling, it is common to see oil wells in the middle of vineyards. The oil company may have purchased the right to the oil below the surface from a prior owner. The current owner may have purchased the property subject to the understanding that the oil company had the right to operate the oil rig. The farmer may have a long-term lease and an agreement to establish a vineyard and pay the landowner a portion of the proceeds from the grapes. The vines, trellises and irrigation are *leasehold improvements* owned by the farmer. The lease itself is a form of property; it has value to the leaseholder. Depending on the terms of the lease the lease and leasehold improvements may be transferred for value to another party.

Typically a farm lease says that in exchange for rent the landlord gives the tenant:

- 1) The right to use the property—but only for the purposes detailed in the lease, and usually subject to the requirement that the property be restored to its original condition at the conclusion of the lease.
- 2) The right to exclude others from the property, but subject to the landlord's right of entry as specified in the lease or in State law.
- 3) The right to transfer the lease subject to the restrictions of the lease and other restrictions in State law.

The landlord typically retains:

- 1) The right to exclude others from the property, subject to the landlord's right of entry as specified in the lease or in State law.
- 2) The right to transfer by sale, gift or through inheritance, though the transfer may be subject to the ongoing terms of the lease.
- 3) The right to encumber (meaning take out a mortgage against the land, or sell an easement relating to the use of the land) so long as the encumbrance does not interfere with the tenant's use rights.

In the American legal system property rights come from the State, and therefore the State may have the ability to restrict or limit a property owner or a tenant from fully exercising all of the rights of ownership. It is now established law that government may have a legitimate interest in

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limiting the rights of private ownership through mechanisms such as the Endangered Species Act, the Clean Water Act, similar state-level environmental acts, and through local land use and zoning laws. This does not mean all government actions to limit a property owner's rights will be legal; it means the mechanisms are generally legally valid. In specific instances government officials may abuse their discretion and overstep; but as a property owner or a leaseholder you should probably assume environmental laws and zoning restrictions are valid. You should also be aware that some rights to use land may change even after buying or leasing the land; for example, a state environmental regulation or a local zoning change could require you to change some of your farming or ranching operation.

### Owning land or a business

An individual may own property or farm without actively creating a separate business entity. When an individual owns their own business they are called a *sole proprietor*.

Two or more individuals may own property together as tenants in common or as joint tenants without forming a separate business, or they may form a partnership or a corporation for the purpose of owning land.

When two or more individuals farm together (meaning the activity of farming), for federal tax purposes and under California law (and in other states) they will be found to have formed a partnership. This will be true if the partners know it or not, and whether they have a written partnership agreement or not.

The proprietor of a sole proprietorship, and any partner in a general partnership, is both owner and manager, and is personally responsible for all of the debts and other liabilities of the business; this is called *unlimited liability*. Unlimited liability in the context of a farm partnership means all of the debts or liabilities of the farm can be enforced against any one of the individual owners, including possibly against the personal property or wages of a spouse who does not own or work on the farm.

Incorporation is a legal method for limiting personal liability. An individual or a group of individuals may incorporate as an entity by filing articles of incorporation in the state of choice. State statutes make the incorporated entity into a distinct legal *person* who may own property or conduct business, and who may sue and be sued. The separate legal status of the incorporated entity allows individuals to invest in ownership without subjecting themselves (or their spouses) to unlimited personal liability.

There are a number of different types of incorporated entities. State statutes governing each of the different types of entities vary, but not greatly. The main differences between types of



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incorporated entities have to do with a now-familiar concept: the separation between ownership and management. According to Generally Accepted Accounting Principles, by state statute, and for state and federal tax purposes, there are various ways an owner may invest in and profit from ownership. Each of the different types of incorporated entities has different mandatory characteristics with respect to critical events in the life of a business: formation, management, sharing profit or loss among owners, taxation, additional capital contributions, and exiting or dissolving. Each individual business may also make individual decisions about the terms and conditions under which each owner invests in the original capitalization of the business, participates in business management, is compensated, participates in sharing profit or loss, the circumstances under which owners may or must contribute additional capital, and the circumstances and methods under which an owner may exit.



Farms and ranches are notorious for being land rich and cash poor. This means the terms of any agreement must carefully consider the circumstances under which an owner may be required to contribute additional cash, may withdraw cash, and may be cashed out of ownership either by selling her or his ownership share to the other owners or to a new owner. When these issues are not addressed, state law fills in the gaps, and often an exiting owner is in a position to drain all of the cash from the business, and force it to take on debt which it cannot sustain.

Circumstances that can cause a cash drain from the business include: death, divorce, and debilitating illness or injury, and all situations in which it is difficult

### Joint Tenancy or Tenancy in Common

The critical distinction to understand is that when land is owned through a joint tenancy or a tenancy in common the default of the relationships between co-owners is found in state law. When a separate business entity is formed then the co-owners have an opportunity to write more of their own script regarding their rights and obligations to each other. However, to the extent that people forming a business entity fail to specify the nature of their rights and obligations in the business documents, state law for that entity type will govern.

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or impossible to retroactively negotiate exit terms favorable to the continuity of the business.

In a more positive scenario, owners exiting a farming business may have ownership shares to sell to aspiring farmers. If the farming business is structured so it is separate from landownership then buying into the business may be much more affordable than buying a share of the business and the land. Chapters 2 and 3 of this book focus on the subject of land tenure through lease or ownership. In Chapter 4 we will look at some examples of how aspiring farmers buy into farm ownership, either through land purchase or through purchasing all or part of a farming business.

Additional resources to help you understand the rights and obligations of business entities are abundant, but always keep in mind that while you might prefer the information resources of one state over another, business entity formation and state taxation is determined by the law of the state or tribal nation where you operate. Two accessible entry points are through the Small Business Administration and affiliated local Small Business Development Centers. For an ag-specific overview of business entities see the National AgLaw Center's "Business Organizations: An Overview"<sup>5</sup> and Chapter Two of the Harvard Center for Health Law and Policy Innovation's "Farm & Food Law: A Guide for Lawyers in the Legal Services Food Hub Network"<sup>6</sup>. No matter how much background research you do, you should consult a Certified Public Accountant or a licensed attorney ***with expertise in business and tax law*** to analyze how different entity types will affect your personal tax situation.

### *Let's look at some examples*

The next three chapters use these building blocks in different ways. Chapter 2 takes a deeper look at leasing land. Chapter 3 includes various models of financing land purchase. Chapter 4 shows some innovative ways of combining the concepts in Chapters 1, 2 and 3, including models that separate out property rights so the farmer only has to pay for the rights she or he needs. As you read through the models and case studies and think about each of the elements of the transactions you will see that while each situation is unique the building blocks are the same. Knowing this, you will be able to think creatively about how to access land for your farming or ranching business.

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<sup>5</sup> National AgLaw Center's "Business Organizations: An Overview": <http://nationalaglawcenter.org/overview/bus-org/>

<sup>6</sup> Harvard Center for Health Law and Policy Innovation's "Farm & Food Law: A Guide for Lawyers in the Legal Services Food Hub Network" Chapter 2 [http://www.chlpi.org/wp-content/uploads/2013/12/Farm-and-Food-Law-Guide\\_June-20-2014.pdf](http://www.chlpi.org/wp-content/uploads/2013/12/Farm-and-Food-Law-Guide_June-20-2014.pdf) Note that all citations are to Massachusetts law so the guide should only be used for general education if you live in any other state.

## Chapter 2: Agricultural Leases and Crop-Share Agreements

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See also Appendix A – Understanding the Legal Terms in a Lease

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### Agricultural Leases and Crop Share Agreements

State law governs the parameters of the landlord-tenant relationship for commercial and residential leases, specifying things like when a lease must be in writing in order to be enforceable, and what the default law will be if a lease is silent on a matter that is later subject to dispute. Many states have specific provisions for agricultural leases such as a provision that a landlord has an automatic lien on the crops for the amount of rent, or provisions to protect farmers from losing land access while the crops are still growing.<sup>7</sup> This Guide addresses issues general to small-farm leases and specific to California law. The “Additional Resources” section at the end of the chapter will Guide you to other resources with both general information and information for some other states.

Agricultural leases are typically either cash-rent leases which are paid in cash, or crop-share leases meaning rent is paid in the form of the harvested crop.

A cash rent amount is usually based on an annual dollar value per acre with rent due monthly or as infrequently as once a year. A cash rent lease means the farmer must pay the agreed upon rent regardless of the success of the crops or the available market price when the crops are sold, though these terms can be made flexible in the terms of the lease if the parties agree. Cash rent income is passive income to the landlord, not subject to self-employment tax.<sup>8</sup>

A crop-share lease is a type of joint venture between the landlord and the farmer. It is not a formal partnership; the landlord and tenant are usually not liable for each other as they would be in a partnership, but both share in the unknown risk or reward related to yield and price.

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<sup>7</sup> National AgLaw Center - <http://nationalaglawcenter.org/overview/agleases/>

<sup>8</sup> This has important tax planning implications. If a group of farmers own land together and farm together will pay less tax if they form a separate farm business and pay themselves rent than if they “just start farming together.”

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Instead of receiving a cash rent the landlord receives a percent of the harvested crop. The percent amount is usually based on the local custom for the crop in question, and can be paid either in crop or as net or gross proceeds from the sale of the crop. For commodity crops where yields and prices are known and knowable this can be a great arrangement, but for specialty crops and markets it can be difficult to objectively determine if a low yield or price was due to external forces beyond the farmer's control, or due to poor farming and marketing by the farmer. Crop-share income may be active or passive depending on the landlord's participation, and thus either subject or not to self-employment tax.

Some lease agreements are hybrids, containing both a cash and a crop component.<sup>9</sup>

Federal law regarding participation in various USDA programs for landlords and tenants and for passive or active participation by landlords varies by program. For information about how a lease agreement affects the farmer's or the landlord's ability to participate in programs such as crop insurance, the Natural Resources Conservation Service (NRCS) Environmental Quality Incentives Program (EQIP), or Farm Service Agency loans, visit the local USDA office or the USDA website for the specific program.

### Land leases

In California and most states a land lease must be written if the lease term exceeds one year. A valid written lease must include:

- 1) a description of the property location
- 2) a beginning and ending date
- 3) the amount of rent
- 4) the signatures of both the landowner and tenant

In some situations multiple separate documents referencing each other may be compiled to constitute one written lease agreement.

Although only leases for terms greater than a year are required to be in writing, all leases *should* be in writing. Lease amendments should also be in writing and signed by both parties. Addendums and attachments allow changes to be made without redoing the entire lease. Keep in mind that, if you have a written lease, an oral agreement on the side will be difficult or impossible to enforce in court.

### The time period covered by the lease

California State Law provides that "in all cases of tenancy on agricultural lands" a tenant who has been allowed to remain on the land for more than 60 days after the expiration of the lease

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<sup>9</sup> For more information, see the National AgLaw Center - <http://nationalaglawcenter.org/overview/agleases/>

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term is deemed to have renewed the lease for a month-to-month tenancy under the terms of the original lease.<sup>10</sup>

California law limits the term of agricultural or horticultural leases to 51 years<sup>11</sup>.

### The purpose of the lease

A land lease does not need to specify the intended use of the land, and if it does not specify how the land is to be used then a tenant has the right to use the land in any reasonable way.<sup>12</sup> However, a lease without a clause defining use is not optimal for either party and it is recommended to include such language.

As noted above, most states have special protections for farm tenants to ensure they do not lose growing crops due to an untimely termination of the lease. However, note that California law does not clearly define the term *agricultural lands* for the purpose of these protections. If the lease is unclear as to the intended use of the land, or if the lease is for both agricultural and non-agricultural purposes, then these protections may not apply or may be limited. Most legal definitions of agricultural activities are limited to the raising of crops and livestock for sale in the condition in which they are normally saleable in the local market—meaning in a relatively whole and unprocessed way. Thus value-added production, tourism, and education will not generally be considered as agricultural activities.

A residence may be intimately tied to an agricultural operation—or not. California law for residential rentals is very different than the law for commercial rentals, and includes a provision for non-commercial “personal agriculture<sup>13</sup>.” In light of this, farmers planning to farm small acreage on property that is not in an agricultural area should not assume that the regular protections of “agricultural leases” would automatically apply.

The law for residential rental real estate is quite different from the law for commercial rental real estate (including agricultural lands). In situations involving both a residence and farm land the farmer and the landlord may both be best-served by writing two separate lease agreements, one for the residence and one for the farm land.<sup>14</sup> Another alternative, where the residence is intimately tied to the farm operation, is to make it explicit in the lease that the residence is leased as a part of the farm lease. Even then state statute on residential real estate may prevail over the terms of the lease, or you may find that the lease is primarily agricultural

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<sup>10</sup> Cal Code Civ. Proc. § 1161(2)

<sup>11</sup> Cal Civ. Code § 717

<sup>12</sup> Cal Civ. Code § 1997.210

<sup>13</sup> Cal Civ. Code § 1940.10

<sup>14</sup> Note that where the farm is organized as a corporation and the tenant is an employee all of the costs of the residence may be deductible to the farming corporation as farming expenses. See for example *J. Grant Farms, Inc. v. Commissioner*, 1985 Tax Ct. Memo LEXIS 456 (T.C. 1985)

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and residential protections apply. The key point here as elsewhere is that it is better to decide up-front which script you want to follow, because if you don't you may not like the script that will be written for you.

### Short-Term Leases

Beginning on new ground with a short-term lease of one to three years is advisable as a first step for many. This gives the farmer flexibility to experiment with new crops and locations without a long-term commitment and allows both parties to get to know each other and decide if a longer-term arrangement would be beneficial. Many annual commodity, grain or forage crop growers as well as rangeland grazers may prefer the flexibility of short-term leases. On the other hand it is difficult to make long-term business plans or personal decisions with a short-term lease.

Additionally, it is not advisable to invest in permanent improvements to a property on short-term tenure, both for the security of your investment and because lenders may not find it an acceptable risk. Likewise, government cost-share programs offered through the USDA Natural Resource Conservation Service typically require the tenant to show a multiple-year lease.

### Long-term leases

Long-term leases, or *development leases* of ten, twenty or more years are much less common. A long-term lease is important if the farmer plans to invest in substantial land improvements such as planting an orchard, or vineyard, or building a packing shed. Since the farmer will be improving the property, the lease must be long enough for the farmer to recoup the investment. At the end of the lease, the tenant is generally required to remove or abandon the leasehold improvements.

Long-term leases can be renewable and inheritable, allowing a farm family multi-generational use and an opportunity to leave something of value to their heirs. However, leasing land you do not own reduces net income without contributing to a long-term accumulation of wealth in the property. In contrast, since rental income is not subject to self-employment tax, forming a business to lease land you own (from yourself) will reduce taxes without reducing actual income.

Most development leases are negotiated attorney to attorney. Realtors with listing agreements often broker leases in longer-term crops and earn a commission. FarmLink program coordinators can also assist in lease development and negotiation; reach out to us with questions. See <http://www.californiafarmlink.org/contact-us>.

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### Landlord's Lien

Under the Uniform Commercial Code (U.C.C.), adopted in all fifty states, a landlord may have a security interest in crops (including livestock and supplies) grown on leased land. This is called an *agricultural lien*. An agricultural lien is a legal interest in farm products to secure payment of rent for land (or other goods and services) provided in connection with a farming operation.<sup>15</sup> This means in some cases if you are delinquent in rent and sell your crops to another business (e.g., through a broker, wholesaler, or to a restaurant or store) your landlord may have the right to receive your payment.

### Tenant's Duties

Regardless of the written terms of the lease, the tenant has a duty to ensure the land and improvements are maintained according to the reasonable expectations of the landowner that they not decline in market value<sup>16</sup>.

A written lease should specify the minimum expectations for good farming practices with a clause such as:

“Tenant will cultivate the Property in a timely, diligent, thorough, and farmer-like manner in accordance with good farming practices. Tenant will take care to not cause waste or damage to the Property or create a nuisance. Tenant is responsible for weeding, managing pests, preventing soil degradation, and irrigating responsibly.”

If a landlord expects the tenant farmer to farm to higher standards, or if the tenant farmer plans to use farming methods substantially different from those prevailing in the county or neighboring counties, it is important to specify expectations in the lease. If you farm without the use of pesticides or herbicides, but do not have the farm certified as organic under the USDA National Organic Program (NOP), and you leave the land infested with weeds or plant pathogens, the landlord may hold you liable for damages to the land unless your farming practices have been approved in the terms of the lease<sup>17</sup>.

For additional information on incorporating sustainable farming practices into the terms of a lease, see the Drake University Ag Law Center Sustainable Agricultural Land Tenure Initiative<sup>18</sup>.

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<sup>15</sup> U.C.C. § 9-109(a)(5) and Cal U Com. Code § 9102 (a)(5) and for an in depth discussion see Keith G. Meyer *Current Article 9 Issues and Agricultural Credit* 10 Drake J. Agric. L. 105 (2005).

<sup>16</sup> “[W]aste is conduct (including in this word both acts of commission and of omission) on the part of the person in possession of land which is actionable at the behest of, and for protection of the [598] reasonable expectations of, another owner of an interest in the same land.” (5 Powell on Real Property (1974) § 636, pp. 5-6.)” Cited in *Cornelison v. Kornbluth*, 15 Cal. 3d 590, 597-598 (Cal. 1975).

<sup>17</sup> If you are farming under an approved organic plan you would be able to argue that you followed recognized good agricultural practices, but otherwise it might be argued that you failed to follow any generally recognized and reasonable method of protecting the land.

<sup>18</sup> Drake University Ag Law Center Sustainable Agricultural Land Tenure Initiative: <http://sustainablefarmlease.org/>

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California FarmLink has also developed innovative lease clauses related to sustainable agriculture and conservation practices.

### Other important lease terms

See Appendix A for a detailed discussion of the important terms of a lease. A few critical issues to consider are:

- What happens to leasehold improvements at the end of the lease?
- Who is responsible for maintenance of critical infrastructure such as the irrigation pump/well and road access?
- Does the farmer (tenant) have unlimited access to the land, or does the landlord place restrictions on where and when the tenant can access the land?
- If the landlord lives on or near the property you should consider agreements regarding ongoing communication and dispute resolution.

If the landlord also has an active farming operation and you plan to use the landlord's crew or equipment you should have a separate agreement for those services, or include them in the lease agreement. The lease may specify that it is subject to the side agreements for use of crew and equipment.

### Liability and Insurance

The tenant farming business is liable for damages caused to the landlord and others and should thus carry commercial liability insurance. The landlord should require such insurance and require the tenant to name the landowner as secondary insured. When acquiring a commercial liability policy be sure to specify all commercial activities, including both farming (the production of crops and livestock), and related non-farming activities such as value-added processing, tourism, and education, as discussed above.

Landlords should be aware that a general homeowner's policy will not cover things that happen on or because of the tenant farm. The National AgLaw Center's Landowner Liability Reading Room has additional information.<sup>19</sup>

### Lease with "First Right of Refusal" to Purchase and Option to Purchase

Some leases include a *first right of refusal* or an *option to purchase* clause. A first right of refusal gives the holder the first opportunity to purchase the property when it is offered for sale. An option to purchase clause usually specifies a price, a percentage of fair market value, or that the option to purchase is at the *fair market value* price to be determined by an appraisal.

All the terms of the purchase should be negotiated at the time of incorporating an option to purchase clause into a lease. The timeframe for triggering the option is to be clearly defined as

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<sup>19</sup> National AgLaw Center <http://nationalaglawcenter.org/research-by-topic/landowner-liability/>



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well as the terms for executing the option. However, including an option to purchase in a lease is not enough, it should be accompanied by a separate purchase agreement either developed simultaneously, or shortly thereafter to ensure the option is binding.

An option to purchase the land at the appraised agricultural value is a mechanism used by land trusts to be able to buy back land on which they hold an agricultural easement. See Chapters 3 and 4 for more information.

An option to purchase at the appraised value before leasehold improvements locks in the value of the land before the farmer makes any leasehold improvements, including improving the soil or obtaining organic certification. This option allows the leasing farmer to benefit from improving the quality of the soil or making investments in trees or infrastructure during the lease term. A qualified agricultural appraiser will be able to separate the increase in market value due to farmer-improvements from increases due to the market generally.

### Crop Share Lease

A crop share arrangement is a type of *joint venture* between a landlord who provides most of the assets, and a farm operator who provides most of the labor. Typically the landlord provides the land and improvements to the land, and pays land maintenance costs, including taxes, insurance, and utilities. Rent is either *in-kind* as a portion of the harvested crop, or paid as a portion of the crop proceeds. The farm operator normally provides all annual inputs, including labor and equipment. Crop share leasing is a commonly used model for permanent crops such as trees and other low-input crops. The model is less common in more complex operations such as diversified fruit, vegetable, and flower farms.

A crop share can be a great way for a beginning farmer to get started without having to invest in land, especially if there is the potential for mentorship from the landowner. Crop share leasing is also attractive to retiring farmers because it provides the satisfaction of participating in land management and realizing annual income without demanding significant cash outlays, physical labor, or constant oversight.

FarmLink recommends a minimum of a three-year term to provide ample time for the operation to be productive. For example, many orchard crops will not begin to bear fruit for four years. A crop share is best suited for these situations because during those first years while the landlord will not be getting “rent” for their property, the tenant will be investing in significant improvements and adding value to the land (in the form of trees, irrigation infrastructure, etc.). As the trees become more productive with maturity, so too will the value of the lease for the landlord. For beginning farmers, a crop share can allow a farmer to start slowly and only have to pay a percentage of their small earnings. In this scenario a landlord is

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betting on the success of the beginning farm with the hope that the farm will establish itself and they can bring in a larger rent over time. This is also a reason that many landlords will invest in certain infrastructure to increase the farmer's chances of success— in these situations the landlord will often require a higher crop share percentage.

Crop shares require the tenant farmer to keep excellent records and engage in active and open communication with their landlord. There must be a relationship based on trust as the tenant will be sharing its books and all the risk associated with farming with their landlord.

For the landlord, the income from a crop share has different tax treatment depending on the degree to which the landlord is an active participant in the farming operation using the definition(s) of active participation in the Internal Revenue Code.<sup>20</sup> While crafting a crop share agreement it is important to keep a distinction between the roles and relationship of the parties so as not to cross over into a partnership arrangement.

For purposes of participating in other federal programs through the USDA, the landlord in a crop share agreement needs to look to the individual program rules.

### Other Issues

#### Financing with a lease

Lenders will often require borrowers to supply a copy of their lease agreement. The lender may require that lease agreement be at least as long as the term of the loan, e.g., five years for an equipment loan, one year for an operating loan, so that the lender can be assured that the loan will be used for its intended purpose on the land indicated in the lease.

#### Determining market rate

It is difficult to find market data for parcels of 1-10 acres in diverse production. For larger scale production the California Chapter of the American Society of Farm Managers and Rural Appraisers publishes lease rates for most agricultural counties of California on an annual basis. Data over one year old is available on the group's website. More current data is available by purchasing the group's annual publication: *Trends in Agricultural Land and Lease Values*.

### Additional Resources and Technical Assistance

Agricultural leases can be quite different from regular residential or commercial leases, and not every attorney is aware of this fact. Before you sign, you should have your lease reviewed by an attorney knowledgeable in agricultural law, or bring this Guide with you so your attorney can use the footnote citations to do research into your particular situation.

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<sup>20</sup> 26 USCS § 1402

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Before you bring your lease to an attorney, you can do a lot of valuable background research on your own. Doing your own research is a good way to keep the attorney bill affordable and ensure that the attorney is used as an expert rather than as someone who provides basic information. FarmLink staff members often help with lease negotiation and development in California. We strive to work in ways that balance the interests of both landlord and tenant, and help to establish a lease that can be reviewed, rather than drafted, by an attorney. Other specialists and experts in your local area may provide valuable insight and advice:

- Accountants, bankers and real estate brokers
- Professional farm appraisers
- Insurance brokers
- Irrigation district personnel
- Title company personnel
- Extension Agents

Additional resources for research:

The National AgLaw Center: <http://nationalaglawcenter.org/overview/agleases/>

Drake University Ag Law Center Sustainable Agricultural Land Tenure Initiative  
<http://sustainableaglandtenure.com/2010/08/farm-lease-agreements-and-the-law/>

University of California Small Farm Program – Family Farm Series / leases  
[http://sfp.ucdavis.edu/pubs/Family\\_Farm\\_Series/Farmmanage/leases/](http://sfp.ucdavis.edu/pubs/Family_Farm_Series/Farmmanage/leases/)

Ag Lease 101 (North Central Farm Management Extension Committee)  
<http://aglease101.org/>

California Bureau of Real Estate: Chapter 9 Landlord and Tennant  
<http://www.dre.ca.gov/files/pdf/refbook/ref09.pdf>

A Landowner's Guide to Leasing Land for Farming–Land for Good  
[http://www.thegreenhorns.net/wp-content/files\\_mf/1344531092landownersguide.pdf](http://www.thegreenhorns.net/wp-content/files_mf/1344531092landownersguide.pdf)

Farmers Legal Action Group has a number of useful introductions to leasing:

Leasing Farm Land in Minnesota <http://www.flaginc.org/wp-content/uploads/2014/09/20140917-Leasing-Farm-Land-in-Minnesota-FLAG.pdf>

Using Leases to Meet Financial and Stewardship Goals  
<http://www.flaginc.org/wp-content/uploads/2014/09/2014-FLAG-Land-Leasing-Workshops-PPT-for-LSP1.pdf>

## Chapter 3: Owning Land

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### What it Means to Own Land

As you think about purchasing real estate you are thinking about things like soil, water, location and price, but the legal attributes of the property are also significant. The way you own the property, particularly if you own it with other people, will affect everything from how you pay taxes, to if or how you can pass the property to your heirs, to the actual economic value of the property.

In Chapter 1 we looked at land ownership in terms of a *bundle of rights*. The bundle of rights is often called the *title* to the property, meaning the rights and restrictions of ownership, the owner or owners of the rights, and the *estate* or length of time during which the rights are owned. *Title* is a concept. A *deed* is a document that memorializes the title of a piece of land and is used to transfer title. Note that title can only be transferred with a written document.<sup>21</sup> All deeds are not created equal. Most come with guarantees that the deed passes good title of ownership, but a *quitclaim deed* has no guarantees and may leave the buyer with uncertainty about other possible landowners who may have claims to the title.

As a part of considering a land purchase, you should consider who will hold what kind of title and exactly what sort of deed you will receive. This is a decision best made in consultation with an experienced attorney, particularly when you plan to have more than one landowner, or if you are receiving something other than a general warranty deed.

Generally, when land is owned jointly each owner has a shared interest in the whole property, rather than an exclusive interest in a physically defined portion of the property. The types and consequences of joint ownership vary with state law, federal tax law, and circumstance. Below

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<sup>21</sup> Generally, the statute of frauds in all states. In California see Cal Probate Code § 15206 for transfers of decedent's estate and Cal Civil Code § 1091 for other transfers.

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are some simple concepts and definitions. The purpose of presenting this information is to motivate you to seek professional advice to understand which options are best for you given your unique circumstances, including income and estate tax considerations.

### Types of title

#### Sole Ownership

Like a sole proprietorship, this is the simplest form of ownership: one person owns the property. In California, if the sole owner is married, the title must specify that the property is owned as the “sole and separate” property of one spouse or else it will be *community property*.<sup>22</sup>

#### Community Property

In California, property purchased jointly by a married couple is community property<sup>23</sup> unless the title specifies otherwise.<sup>24</sup> Both parties must sign all binding documents associated with the property. Each owner has the right to dispose of his or her one-half of the community property by will, which is how children often come to be co-owners of family land with one parent after a parent dies. Typically, the surviving spouse will own a 50 percent interest in the land, and the children together will own the other 50 percent interest. In contrast, a community property interest where the deed specifies a “right of survivorship” means the deceased spouse’s interest will automatically transfer to the surviving spouse regardless of any will.

#### Tenancy in Common (TIC)

A tenancy in common is the default type of joint land ownership in California and most states.<sup>25</sup> A TIC agreement may specify the rights and obligations of co-tenants to contribute for things like property taxes, maintenance, and insurance, and how rents or profits from the land are to be allocated. Without such an agreement state law will be the default. Each co-tenant may transfer the interest through sale or lease or in their will.<sup>26</sup> Also, a co-tenant may mortgage their share, and the mortgage may foreclose, causing the share to be sold at auction. In some situations, other creditors may have rights to liquidate a co-tenant’s interest. Any owner may sue to have the TIC liquidated through the forced sale of the property.<sup>27</sup>

#### Joint Tenancy

A joint tenancy is another common type of joint land ownership, but it is not the default form, so there is only a joint tenancy if the deed specifically creates it. The key distinction between

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<sup>22</sup> Cal Family Code § 2581

<sup>23</sup> Cal Civil Code § 687

<sup>24</sup> Cal Fam Code § 2581

<sup>25</sup> Cal Civ Code § 683

<sup>26</sup> Cal Civ Code § 683

<sup>27</sup> Cal Code Civ Proc § 872.210

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joint tenancy and tenancy in common is that in a joint tenancy the interest of a deceased co-owner passes automatically to the other co-owners upon death regardless of any will.

As with a TIC, any co-owner in a joint tenancy may, without the permission or knowledge of the other owners, make a sale of their ownership interest,<sup>28</sup> or cause a lien to be placed on his or her partial interest in the property.<sup>29</sup> Typically state law governs the rights and obligations between joint tenants for things like payment of property taxes, maintenance, improvements, and rents. Joint tenancy can only be created simultaneously in all joint tenants through a document that declares the multiple owners to be joint tenants.<sup>30</sup> Any owner of a joint tenancy interest can sue to convert the joint tenancy to a tenancy in common.<sup>31</sup>

### Owning land through a business entity

A corporation or partnership may own property, or an interest in property, in the name of the corporation or partnership.<sup>32</sup> In that case the terms of the corporation or partnership documents will govern the corporation or partnership owner's rights in the property. This allows the owners to develop a reasoned plan to address things like maintenance, improvements, taxes, rents, and circumstances under which the property may be mortgaged, and to protect the property against liens related to personal debts of any of the co-owners.

Note that not all business entity types are equally advantageous for land ownership. In California some otherwise advantageous entity types come with fairly high minimum taxes, and often the tax treatment of an asset sale is disadvantaged. This is one reason we go to great lengths to help you think about separating your farming business from your land ownership. Even if the same parties own both in the same percentages, for tax purposes it still might be more advantageous to own them under two separate (and different) business entities. This is a decision that can only be made in consultation with an advisor who is knowledgeable about taxation and the personal tax situation of each of the owners: a Certified Public Accountant (CPA) or an attorney who has expertise in business taxation.

### Buying Land

You already know that before you buy land you need to research different areas and considerations like soil quality, access to water and markets, and zoning restrictions. You have probably also started to think about ways you might finance a land purchase. Beyond that, if you have never purchased real estate the process may seem mysterious. There are real estate

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<sup>28</sup> Wilk v. Vencill, 30 Cal. 2d 104 (Cal. 1947).

<sup>29</sup> Rupp v. Kahn, 246 Cal. App. 2d 188 (Cal. App. 2d Dist. 1966).

<sup>30</sup> Cal Civ Code § 683

<sup>31</sup> Cal Civ Code § 683.2

<sup>32</sup> Though note that since a corporation has an unlimited life it may not take title to property in joint tenancy with right of survivorship.

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agents and escrow companies and lots of paper. Below is a brief overview of what happens between the time you make an offer and the time the sale is closed. Again, this information is presented to encourage you to seek the guidance of a licensed professional to advise you in your particular situation.

Also keep in mind that in California and many other states the sale of residential real estate is regulated differently from the sale of commercial real estate. If a property is offered for sale with a residence it will be *residential real property* or *residential real estate*, but a separate lot without a residence would be commercial property.<sup>33</sup> See also the section on mixed use property below.

### *Offer and acceptance*

A seller makes an offer to sell by placing the property on the market, or by making an offer directly to you. You can either accept the offer, or make a counteroffer which the seller may accept or decline. Usually an acceptance or a counteroffer is contingent upon a number of things, including the prospective purchaser's inspection of the property; a determination that the owner holds good title to the land (see the discussion of title above – you want to know if you are buying into a joint tenancy, for example); and the buyer's ability to secure financing within a specified period of time.

The acceptance or counteroffer will also specify things like what the seller must do to bring the property to a certain condition, how much time the seller has to make necessary repairs or improvements, and which party is responsible for paying which closing costs.

Usually the seller's offer is open for a period of time while the buyer obtains inspections, title assurances, and financing, and then if all goes well the purchase agreement is signed forming a binding contract to complete the transaction.

### *Purchase agreement*

A purchase agreement contains all of the terms of sale, including price, deposit, closing date, disclosure requirements, additional inspections, and the fees each party has agreed to pay. Once the purchase agreement is signed the sale goes into *escrow* (see below) until all of the terms of the purchase agreement have been fulfilled, at which time the escrow, or sale, is *closed*.

### *Escrow*

Escrow is a process whereby a third party ensures that each of the terms of the purchase agreement are fulfilled before a deed is written to transfer title of the property; the third party receives and disburses money and/or documents for the buyer and seller. The types of

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<sup>33</sup> Cal Fin Code § 50003

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businesses that can provide escrow services, and the circumstances under which they must be licensed, are regulated by California law.<sup>34</sup>

### *Risk of loss after signing but before closing*

In California (and many but not all other states), if a buyer is in possession of the property after a sales contract is created, then the buyer bears the risk of loss even before escrow is closed. This means it is imperative for a buyer in possession of the property to have insurance on the property. If the buyer does not have possession of the property, then the risk of loss remains with the seller until the sale is closed.<sup>35</sup>

Similarly, for a buyer in possession, the seller may enforce the sales contract even after there has been significant damage to the property, but a buyer not in possession may be excused from completing the sale if the property is damaged before closing.<sup>36</sup>

### Financing a Land Purchase

Land purchases are typically financed through a financial institution using a *mortgage*, or directly by the seller using a *land sale contract*.

In a mortgage-financed transaction, the seller receives the sale price and the buyer owes money to the financial institution. The buyer gives the financial institution a mortgage, which is an instrument granting a property right to the land. In the event the debt is not paid, the mortgage allows the financial institution to force the sale of the land and take the proceeds up to the amount owed if the borrower does not pay back the loan. State law protects borrowers in a number of ways, including limiting the financial institution's ability to force a sale, and ensuring that if the property is sold the borrower receives their equity in the property after the mortgage is paid.

In a seller-financed sale, also known as an *installment sale* or a *land contract sale*, the landowner retains title to the property until the buyer has made all the payments agreed to. State laws vary greatly regarding buyer protections under this type of agreement, but in California a buyer is similarly protected using either a mortgage or a land contract sale for financing.

### *Mortgage financing*

Mortgage financing is done through a regulated lending institution, so the purchaser has clear obligations and protections.<sup>37</sup> A mortgage is a contract to secure a debt by giving the lender an

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<sup>34</sup> See generally California Financial Code Division 6

<sup>35</sup> Cal Civ Code § 1662

<sup>36</sup> *Id.*

<sup>37</sup> Cal Fin Code § 50002.5 regulates residential mortgages and for banking generally see Cal Fin Code.



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interest in property which can be exercised if the borrower fails to comply with the terms of the loan.<sup>38</sup> Typically the person buying the land borrows money from a lender and gives the lender a mortgage, which is a document allowing the bank to take possession of the land, or force the sale of the land, if the borrower fails to comply with the repayment terms. As long as the borrower remains in compliance with the terms of the loan the borrower has all the rights of ownership to use and enjoy the property and to exclude others from the property.<sup>39</sup> If the borrower defaults on the loan then there are many protections for the borrower under California law, but eventually the lender has the right to possess or sell the land.<sup>40</sup>

### *Contract financing*

Contract financing is still governed by state law, but it is not regulated through institutions, and is often done informally and without legal counsel. Disputes have to go to arbitration, mediation, or a court, and can be expensive and time-consuming to resolve.

A sales contract may be appealing to a buyer, especially one with poor credit, however it is important to understand that the contract may be more restrictive than a regular mortgage. Foremost, since the escrow process is bypassed, the buyer has no guarantee that the seller has good title to the land. Next, if the seller dies, or becomes bankrupt or incompetent during the duration of the contract, the purchaser could have to endure a long and confusing legal process before title is finally settled. Also, the contract may include restrictions against assigning or transferring rights in the contract, so there are potential complications to the buyer or the buyer's heirs if the buyer dies or becomes bankrupt or incompetent during the term of the contract.

Many of these risks can be mitigated by securing the contract with a deed of trust, which essentially makes it like a mortgage,<sup>41</sup> or by using a third party trustee, and by buying title insurance. All good reasons to work with a knowledgeable attorney or real estate finance professional.

### *Purchase at Auction*

California's counties have the right to assess property tax on private real estate within the county. If taxes are not paid for a number of years, the county may sell the property to satisfy the debt. The sale is usually done at public auction, but may also be done through a sealed bid process, or sometimes a negotiated sale to a public agency or qualified nonprofit organization.

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<sup>38</sup> Cal Civ. Code § 2920

<sup>39</sup> Cal Civ. Code § 2920

<sup>40</sup> Cal Civ. Code § 2923-2944

<sup>41</sup> 48-555 California Forms of Pleading and Practice--Annotated § 555.12 (2015); 5-122 California Real Estate Law & Practice § 122.62

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Counties are required to publicize the sale and notify the State Controller's Office at least 45 days before the sale.

By law, the minimum bid amount is what is needed to pay the tax deficiency, which can include interest, penalties, and other costs, and the costs of the sale. There may also be Internal Revenue Service (IRS) and other types of tax and special liens on the property. While property can be purchased well below market value, the buyer takes the property as is, including an absolute responsibility for any and all safety and environmental issues, such as improperly disposed of dangerous chemicals. In California a property owner has five years to "redeem" the property by paying the back taxes. After the five-year period has expired the County may auction the property, and the original owner's right to redeem expires at the close of business on the last business day prior to the sale date.<sup>42</sup> Also, the prior owner has one year to sue to overturn the sale.

### Special Considerations for Mixed Personal and Business Use

If you purchase a property for use as both a private residence and working farm or ranch you will need to take additional steps to ensure that your tax reporting and financing agreements reflect the way the property is used.

If you or a business entity in which you are an owner own the mixed use property then you need to be able to separate the portion of mortgage interest and property taxes associated with the residence from the portion associated with the business. This is true if you live in the residence or rent it out since rental income is reported (and taxed) differently than farm or ranch income, and the deduction for mortgage interest is reported and allowed differently if for a residence or a business.

A qualified farm and ranch appraiser will have the experience to prepare an appraisal showing the different values of different parts of the property and the various improvements on the property. This is a critical document. Your tax accountant will use it to:

1. Determine the value of assets you may depreciate on your tax return; these include barns, fences, pumps, orchards and vines.
2. Determine the ratio to use to allocate mortgage interest, insurance, property taxes, and common maintenance costs between the residence and the business.

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<sup>42</sup> Cal. Rev. & Tax. Code § 3706

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### Final Thoughts on Financing Your Farm, and Additional Resources

We started this Guide by making a clear distinction between owning land and farming. Now that you have reviewed the building blocks of land tenure as separate from the activities of farming, it is important to remember that there are many resources targeted to your active farming operation which may help you finance your farmland acquisition. Also, remember that after you meet with a qualified Certified Public Accountant to review how your farmland purchase will change your income tax liability, you may find that the tax savings generated by cash losses on your farming activities in early years will also help to finance your land acquisition.

For multiple resources on financing your farm, see [www.beginningfarmers.org/funding-resources/](http://www.beginningfarmers.org/funding-resources/)

For an introduction to financing your farming operation (not your farmland acquisition) see *The Farmer's Guide to Agricultural Credit*, Rural Advancement Fund International (RAFI USA).  
<http://rafiusa.org/blog/the-farmers-guide-to-agricultural-credit/>

For more information about how local land use policy affects farmland see *Farmland Protection Action Guide—24 Strategies for California*, Institute for Local Self Government 2002.  
[http://www.ca-ilg.org/sites/main/files/file-attachments/resources\\_Farmland\\_Action\\_Guide.pdf](http://www.ca-ilg.org/sites/main/files/file-attachments/resources_Farmland_Action_Guide.pdf)

*Finding Land to Farm: Six Ways of Securing Farmland*, Kendra Johnson, California FarmLink; Rex Dufour and Marisa Alcorta, National Center for Appropriate Technology, 2009.  
[www.attra.ncat.org/attra-pub/PDF/finding.pdf](http://www.attra.ncat.org/attra-pub/PDF/finding.pdf)

*How to Finance a Small Farm*, Karen Klonsky, Extension Specialist, University of California, Davis University of California Cooperative Extension Small Farm Program.  
[http://sfp.ucdavis.edu/pubs/Family\\_Farm\\_Series/Farmmanage/finance/](http://sfp.ucdavis.edu/pubs/Family_Farm_Series/Farmmanage/finance/)

The California Department of Consumer Affairs, Bureau of Real Estate has numerous excellent resources to guide you through every aspect of buying and financing real property in California:  
<http://www.dre.ca.gov/Publications/CompleteListPublications.html>

For more information on purchasing land at auction see The California State Controller's website: [http://www.sco.ca.gov/ardtax\\_public\\_auction.html](http://www.sco.ca.gov/ardtax_public_auction.html)

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## Chapter 4: Case Studies and Examples of Structuring Land Access

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### Farm and Ranch Land Tenure in Action

You may already be deep in discussions about acquiring land, or starting a farm, or you may be just beginning your exploration. We hope by now you are thinking about land access and business structure as two very different decisions. You may end up with one set of relationships related to the right to access the land (through purchase or lease) and another set of relationships related to the daily operations of your farm or ranch (i.e. a partnership or a corporation). But we also know that outside of this guide, and the offices of your professional advisors, you will seldom hear people express their ideas with clear distinctions between land ownership, business ownership, and the relationship between the two. This chapter will help you learn how to ask the right questions to analyze any situation involving land tenure for a farming or ranching operation.

Each of the case studies below highlights either a particular tool, or the way the tools work together. The case studies are written in a narrative form following the way the people involved tell their own story. After each case study we present a summary of the same story using a framework you can apply to any situation to identify the building blocks of agricultural land tenure. After reading this chapter you should be able to talk about examples of farmland tenure and listen for answers to three questions: 1) What rights to the land does the farmer(s) have? 2) how are those rights acquired? and 3) Who else has rights to the land, and how were those rights acquired?

### What about innovative new models for land tenure?

Innovations in land and farm ownership are primarily new ways of using the same building blocks. The case studies that follow could all be considered innovative, but each uses the same building blocks. The more clearly you understand each of the components of land tenure and farm business ownership, the more options you have for engaging other people. The components can be assembled to create models that meet multiple goals such as income and wealth-building opportunities for the farmer, and open spaces, working landscapes, and fresh healthy food for the community.

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### What about using “sweat equity” to buy into land or a business?

The prior chapters briefly discussed types of entities that can own a business or land. Chapter 3 discussed different ways to finance land ownership. Financing and ownership interest in a business is similar in that there are a variety of ways someone can buy into a business if they do not have all of the cash they need at the time they want to buy in. One way to buy into a business is to use part of the earnings as an employee of the business to buy an ownership share.

Sometimes in a seller-financed land purchase the landowner will want to receive part of the payment in the form of labor. The important thing to understand about the concept of sweat equity is that it is labor, and as such must comply with all of the law applicable to labor, including in particular the payroll tax and income tax requirements. Although the labor is not paid in cash, it has a cash value, and taxes must be paid on the cash value. So if a certain amount of labor earns you an ownership stake worth \$10,000 then you have \$10,000 of taxable income and taxes are likely owed. For more information about labor see California FarmLink's "[California Guide to Labor Law for Small Farms](#)."

Also note that there are estate tax consequences associated with gifts, and for tax purposes gifts between people who have no personal relationship may be considered non-gift payments subject to income tax. If you contemplate a sweat equity purchase of land or of a business share it is critical to consult with a knowledgeable Certified Public Accountant and/or attorney.

### Putting it all together - Farm, Farmland, and Farm Owners

The first case study below is actually taken directly, without edits, from the Terra Firma Farm website. Read it through and try to identify each of the elements discussed in this Guide. After the case study we have provided our analysis.

#### Terra Firma Farm

The seeds for Terra Firma Farm were planted in the late 1980s when Paul Holmes began farming a few acres in the hills west of Winters with a few friends under the name Sky High Farm. Paul developed a following for his garlic, tomatoes, and other vegetables as one of the founding members of both the Davis Farmers Market and Berkeley Farmers Market. Sky High Farm was also one of the original members of California Certified Organic Farmers, prior to official state and federal recognition of organics.

In the early 1990s, Paul hired Hector Melendez-Lopez and Paul Underhill (Pablito) as employees. Pablito became a partner in 1993, when the name of the farm was changed to Terra Firma, and Hector joined on in 2005.

## Growing on Solid Ground: A Farmer's Guide to Land Tenure

Terra Firma started its CSA in 1994 with a few dozen acquaintances at a single drop site in San Francisco's Mission District (Capp Street). As word spread and the CSA slowly grew to include other sites in the City, the East Bay, and Sacramento, the farm grew as well. We rented additional fields for growing vegetables and leased small neglected or abandoned fruit orchards to augment the vegetables. We currently provide food for 1300 subscriber households farming around 150 acres of vegetables and 50 acres combined of fruit and nut orchards.

Before he became a partner in Terra Firma, Hector became one of its landlords when he and his family purchased 25 acres of land we were already farming, in 1999. In 2003, with the critical help of CSA subscribers, Paul and Pablito were able to finally purchase 80 acres of land. With the addition of Hector to the ownership team in 2005, Terra Firma has secure tenure on fully half the total land we farm.

Like the households of many of our subscribers, Terra Firma is a non-traditional version of a "family farm". Nonetheless, Hector's mother Genoveva, father Alfredo, brother Victor, and sister-in-law Juanice have all worked in critical positions at the farm.

### Key to understanding Terra Firma Farm's land tenure

#### Who are the farmers?

Terra Firma Farm, a Limited Liability Company with three owners: Paul Holmes, Paul Underhill, and Hector Melendez-Lopez. Note that two owners were formerly employees.

#### What rights to the land does the farmer have?

Terra Firma Farm LLC has the rights of an agricultural tenant to farm leased lands.

#### How did the farmer acquire the rights?

Through leases only (see below). Terra Firma Farm LLC does not own land.

#### Who else has rights to the land, what are they and how were they acquired?

The member-owners own parcels of land that they lease back to Terra Firma Farm LLC. They have the right to receive lease payments and they retain the right to sell their ownership interest in the land. Note that Terra Firma Farm LLC leases separately from Hector and from Paul Holmes and Paul Underhill. It also has separate leases with neighboring landowners.

Most of the following case studies come from California FarmLink's publication "[Conservation and Affordability of Working Lands](#)," to help illustrate various ways to access land. Below we selected certain cases to outline: 1) What rights to the land does the farmer(s) have? 2) How are those rights acquired? and 3) Who else has rights to the land, and how were those rights acquired?

## Growing on Solid Ground: A Farmer's Guide to Land Tenure

The purpose is to provide information to help you analyze land tenure opportunities in terms of landowners, farm business owners, and the relationships, rights and responsibilities between them.

### Private Landowner Leases Land to Farmer with Long-Term Lease and Option to Purchase

Who is the farmer?

Chris Hay, dba Say Hay Farms. After five years of farming various parcels on short-term leases in Yolo County, Chris found his landlords through California FarmLink and entered into a short-term agreement on their small citrus orchard. This enabled him to explore the relationship and the property while preparing the remaining fallow acreage for organic production.

What rights to the land does the farmer have?

Chris was able to negotiate a 34-year lease on 36 acres with an option to purchase. Also as per the lease, he has the right to renovate the existing barn and building infrastructure. These improvements are protected with a clause that provides security for his capital improvements in the event that his lease is terminated without his purchase option being exercised.

How did the farmer acquire the rights?

Also, he operates the farm on other leased lands with a right of first refusal.

Who else has rights to the land, what are they and how were they acquired?

Lease with Purchase Option and Lease with Right of First Refusal

The entire acreage is 50 acres with two houses and a small pasture. Private landowners live on the farm and are highly supportive. The landowners reserve the right to access any portion of their property and there is a shared road used by the residents and the farm operation.

## Growing on Solid Ground: A Farmer's Guide to Land Tenure

### Farmland Purchased, Encumbered by Easement, and Sold to Beginning Farmer

Who are the farmers?

Stephen Pedersen and Jeanne Byrne dba High Ground Organics. They purchased the farm property from a land trust, the Open Space Alliance, which had purchased the farm with grant funds, part of which required repayment to the state. They placed conservation and agricultural easements on the property and put it up for sale at a reduced purchase price that allowed the land trust to repay the state.

What rights to the land does the farmer have?

The owner's use is subject to the agricultural conservation easement which requires certified organic farming and limits future development of homes and farm buildings, but allows for the use and improvement of a home and farm structures. The farmers also negotiated the right to graze animal on a portion of the property that, due to slopes and wetlands, was not allowed as cropland.

How did the farmer acquire the rights?

Purchase subject to mortgage made possible with family assistance.

Who else has rights to the land, what are they and how were they acquired?

The County of Santa Cruz and the California Department of Fish and Wildlife own agricultural and conservation easements on the property.



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### USDA Farm Service Agency Financing and Sale of Easement Allow Farmer to Hold Family Land

Who is the farmer?

Initially there was no farming entity, only family-owned ranch land being leased out to unrelated parties. The Gutierrez brothers' mother was one of five landowners in a Tenancy in Common, and owned a majority share. The brothers formed a new ranching operation (an LLC) to start buying other shares in the land, which allowed them to secure financing through a USDA Farm Service Agency (FSA) guaranteed loan. First they bought two family members' shares totaling 20% of the property. A conservation easement payment, totaling approximately half of the property's development value, would eventually allow the brothers to buy out the remaining owners.

What rights to the land does the farmer have?

Heirs owned the land as a Tenancy in Common so there was a risk that one family member could force a sale on all.

After the easement sale, the land is now owned by the brothers and their mother and is subject to a conservation easement.

How did the farmer acquire the rights?

The transition required a process to buy out shares of a Tenancy in Common. USDA FSA financed the first purchases. The sale of a conservation easement provided resources to buy two other family members' shares and start the brothers on a path to pay down the FSA-guaranteed loan.

Who else has rights to the land, what are they and how were they acquired?

The American River Conservancy now owns a conservation easement which restricts development on the property.

## Growing on Solid Ground: A Farmer's Guide to Land Tenure

### Appendix A. Understanding the legal terms in a lease agreement

A written lease can be intimidating and difficult to read. Below is a general discussion of the standard parts of most leases. This should make it easier to read a lease and understand the function of each of the sections.

**Designated parties:** This is the correct legal name and address of tenant and landowner for correspondence and rent payment, and if necessary for legal purposes to determine which court has jurisdiction. If one of the parties to the lease is a married couple, both must sign. For corporations and trusts the signer must be duly authorized, and it is wise for the other party to require evidence that the signor is properly authorized.

**Property Description:** Property is often described using an Assessor's Parcel Map with a hashed area for the leased land. It can be useful to itemize machinery, equipment, buildings, and wells in the lease. If the owner wants the land left in a certain condition, it is important to specify this up front in the lease agreement, e.g., disposal of prunings, disking weeds, or cultivation.

**Term of Lease:** The start and end date of a lease can run from one specific date to another, such as October 1 to September 30, or "from the beginning of the crop season in year X until conclusion of harvest." The lease term should match the crop for the tenant to get the full benefit of the crop. For example, alfalfa is a 3- to 8-year crop in California. Vineyards, orchards, and nut crop leases usually go for 25 years with one or two options to extend. California law says that an agricultural lease rolls over to a month-to-month tenancy if the lease expires and the tenant stays in possession for more than 60 days beyond the lease expiration.

**Property Taxes:** In a 5-year lease or less, the landowner usually pays the property taxes. If the lease extends for a longer period, the tenant's share of property taxes can step up over time. If payment of taxes is not specified in the lease, usually the landowner will be responsible. (This is the same for assessments and special assessments.)

**Insurance:** Landowners will often require proof of insurance from the tenant and copies of insurance renewals. Usually the lease states that the tenant indemnifies the landlord. Tenants must carry their own insurance to enable them to indemnify. The tenant can request that the owner carry insurance and indemnify the tenant as well – this dual indemnification is part of FarmLink's suggested lease terms.

**Utilities and Potable Water:** The lease agreement should describe what the utilities are and who will pay for them. Generally, the tenant pays for water, electricity, and gas. In the case of shared meters it is important to specify the allocation process in the lease.

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**Agricultural Water:** If the land is serviced by agricultural water the lease should specify the amount and source of the water (well, irrigation district, riparian) and what happens if the well fails or the surface water allocation is cut. From the tenant's perspective if the land is not usable for the intended purpose without access to irrigation water then either the landlord should be responsible for establishing a new well, or the lease should be voidable. From the landlord's perspective being required to replace a well might be a financial disaster, and it may be important to try to share the risk of loss of irrigation water with the tenant by writing a lease that requires the tenant to continue lease payments even if the water supply fails. This is a critical issue to be negotiated between the parties in consultation with an attorney who is familiar with the issue of agricultural water in leases.

**Maintenance and repairs:** This clause should spell out what is maintenance and what is repair and who pays how much of each. Usually the tenant pays for routine maintenance, and is required to maintain the property in the condition in which it was received. If a major piece of infrastructure such as a road or irrigation pump needs a major overhaul or total replacement typically the landlord is responsible. For longer term leases tenant and landlord may agree to share long term repairs and replacements. A well is long term infrastructure, and as described above, the tenant needs to be sure to understand the implications of a well failure.

**Termination of lease:** This section of the lease describes the circumstances and consequences of a breach or cancellation of the lease by either party. It is critical to understand the extent of economic obligation you as a tenant may incur from walking away from a lease, and also important to understand the extent of the obligation of the landlord to you in the event they breach the agreement. This section relates to the issue of agricultural water discussed above and is the section that specifies the real results of a worst-case scenario. It is critical to negotiate these terms in consultation with an attorney who is familiar with agricultural leases.

**Notification:** This section describes the formal methods for communicating about the terms of the lease and any disputes related to the lease.

**Sublease and assignment:** This section will specify the terms under which the lease may be assumed by others.

