Appendix H: Installment Purchase Agreement Fact Sheet

Installment Purchase Agreements to Save Farmland

Introduction

The use of installment purchase agreements to save farmland is an innovative funding mechanism that has generated a great deal of interest as PACE programs gear up around the country. Its two-fold purpose is to help programs successfully compete with developers by providing unique financial and tax advantages to landowners and to enable jurisdictions to leverage present and future revenues to protect land while it is still available. First applied to the purchase of development rights in Howard County, Maryland in 1989, installment purchase agreements are now being used in a number of other jurisdictions as well to protect farmland.

What is an installment purchase agreement?

An installment purchase agreement (IPA) to save farmland is an alternative to a lump sum payment for the purchase of an agricultural conservation easement (PACE). Jurisdictions with PACE programs may use this landowner payment method if it suits their goals and conditions are right. An IPA is used by a governmental entity to buy agricultural conservation easements and pay for them over time with dedicated revenues and maturing zero coupon bonds that were purchased at closing.

What are the components?

An *agricultural conservation easement* is a binding legal instrument, recorded in the land records, that restricts land to its agricultural and natural resource uses. The landowner continues to own the land and may sell it for its restricted value. The easement is permanent and binds all future owners as well.

An *installment purchase agreements (IPA)* is the vehicle of payment by the jurisdiction to the landowner. Instead of cash at settlement, the landowner is given an installment purchase agreement, which is a legal, valid and binding promise to pay in 20 or 30 years (typical time periods). While the principal will not be paid until the end of that time period, tax-free interest on the face value of the IPA will be paid to the landowner (or whomever holds the IPA) twice a year for the term of the agreement. While IPAs are used to buy permanent easements that bind all future owners of the land, the IPA itself is separate from the land and the easement and can be transferred to someone other than the original grantor of the easement.

A *dedicated revenue source* is a steady income stream to the jurisdiction during the term of its IPA commitments that is used to make the interest payments to the holders of the IPA's.

A *zero-coupon bond* is the means of financing the principal "balloon" payment at the end of the term of the IPA. A jurisdiction buys these U.S. Treasury bonds at a deep discount from their face value because they pay no periodic interest payments. Instead, the interest from the zero-coupon bond builds up over time (accretes) and is paid in a lump sum at maturity when the bond is

redeemed at its face value. After buying the “zero”, the government entity simply holds it until maturity into order to make the final principal payment to the holder of the IPA.

How does it work?

A landowner voluntarily applies to sell an agricultural conservation easement to a government farmland preservation program. After going through a process of eligibility determination, public notice, priority ranking, price determination, and official approval action, a date is set for settlement of purchase of the easement. The day before settlement, the jurisdiction purchases a zero-coupon bond with a face value equal to the purchase price of the easement. Because these bonds are deeply discounted, the jurisdiction only spends a small percentage (approximately 27% to 18% for a 20 to 30 year obligation) of the purchase price of the easement at the time of sale. On that same day, the interest of the IPA is locked in at a at least equal to the yield on the zeros purchased. A jurisdiction may choose to guarantee a minimum interest rate on the IPAs for predictability during the easement acquisition process. If this is the case, then, on the day of settlement, the interest rate to the landowner from the IPA is the higher of the jurisdiction’s minimum or the zero’s yield. This interest remains the same throughout the term of the IPA.

At settlement, the landowner grants a permanent agricultural conservation easement to the jurisdiction that is recorded in the land records. An installment purchase agreement (IPA), which has the full faith and obligation of the jurisdiction behind it, is given to the landowner to hold until the end of its term (typically 20 or 30 years). The jurisdiction makes twice yearly interest payments to the holder of the IPA over this term. These interest payments come from whatever identified revenue source the jurisdiction has established.

Why use it?

The use of installment purchase agreements has advantages for both the landowners and the jurisdiction that is purchasing conservation easements.

The **landowner,** who has sold the easement and accepted an installment purchase agreement as compensation, receives semi-annual interest payments on the face value of the IPA. This stream of **interest income** over the term of the agreement (typically 20 or 30 years) is **tax exempt** from federal, state and local income taxes. By entering into an IPA for the sale of a conservation easement, a landowner may **defer capital gains** until they actually receive the principal amount at the end of the term.

If the landowner needs to realize the purchase price of the easement during the term of the agreement, the IPA can be securitized, that is, sold on the bond market. This particular course of action does trigger capital gains, however. The ability to sell the IPA offers **flexibility for better estate planning**. If they choose, the heirs can sell the IPA rather than having to sell the land to pay estate taxes.

As with lump sum payments for easements, if a landowner agrees to a price for the easement that is less than its appraised value, they may be able to realize a **charitable tax deduction** on their federal income taxes for the difference.

All of these financial and tax advantages are in addition to the traditional advantages to selling an easement rather than selling out to development – namely, the ability to keep one’s home, land

and livelihood. As one Howard County farmer said when weighing his choices, “It’s not what you get, it’s what you get to keep!”

When a jurisdiction enters into an IPA with a landowner, it purchases zero-coupon bonds for the face value of the easement. The “zeros” cost the jurisdiction approximately 10% of their face value. The jurisdiction holds this bond while it accrues in value and then uses it to pay the “balloon” principal payment at the end of the term of the IPA. The use of these two components offers several **advantages to jurisdictions**. Payment with an IPA requires **minimal depletion of program funds** while protecting large numbers of acres at a critical point in time. By financing the principal payments with zeros, the jurisdiction **leverages dollars over time** but does not leave future governments with balloon payments.

The landowner’s “bundle of benefits” - financial, tax, flexibility, and intangibles – can make the jurisdiction’s offer competitive with developers and may make some landowners willing to sell easements at less than full easement value. This allows for further leveraging of current dollars by the jurisdiction.

History

The use of installment purchase agreements for farmland protection was pioneered in Howard County, Maryland in 1989. Equidistant between Baltimore, Maryland and Washington, D.C., Howard County experienced intense development pressure in the 1970s and 1980s. The county participated in the state purchase of development rights (PDR) program for a number of years, beginning in 1980. In 1982, after a public referendum, the county began its own program, funded by a dedicated portion of a 1% real estate tax. By 1987, the state and county programs had protected 7,500 acres. The late eighties brought intense development pressure and the purchase of development rights program stalled because land prices had risen dramatically and the lump sum payments were not nearly enough to be a viable option for farmers. The farmland available for protection was rapidly diminishing and the county was challenged to find a way to make the program work or give up on ten years of farmland protection.

The solution came in the form of a reinvigorated program conceived by financial advisor Daniel P. O’Connell that combined installment purchase agreements and zero-coupon bond financing with traditional elements of a farmland protection program. Directed by the County Executive, county agencies, financial advisor and bond counsel worked together to develop the innovative approach. Once up and running in 1989, the county began buying easements at a rate that allowed it to double, in the first three years, the acreage accomplishments of the previous ten years. It became a viable alternative to development for almost 80 landowners, preserving another 9,000 acres to date. In the process it has allowed the county to leverage $9 million upfront and $3 million annually to enter into $55 million worth of IPAs . Ten of the IPAs have been sold by landowners through competitive bids to local brokerage firms in order to liquidate them. In 1990, the new program won The Government Finance Officers Association Award for Excellence in Financial Management.

Since then, Harford County, Maryland, Burlington County, New Jersey, Peninsula Township, Michigan, and Virginia Beach, Virginia have developed PACE programs using installment purchase agreements and zero-coupon bonds.

Transferability

The basic concept of paying for preservation easements through a long-term installment purchase agreement offering tax-exempt interest income and principal at the end of the term should be applicable in other public jurisdictions. The financing plan is adaptable for use by jurisdiction that 1) seeks to preserve for public purposes valuable assets owned by individuals, 2) is enabled under state and any applicable local laws to enter into bonding multi-year obligations. and 3) has a predictable cash flow for the term of the obligation.

Issues to Consider

Dedicated revenue stream - Since IPAs have the "full faith and obligation" of the jurisdiction behind it, the interest payments must be made throughout the term of the agreement. The ability to make the interest payments should be secured with a dedicated revenue source to ensure the smooth operation of the financing mechanism. The act of dedicating a revenue source to farmland protection, rather than leaving it to the uncertainties of annual budget allocations, reinforces the notion that farmland protection is a long-term investment, both in the land base for agriculture and in growth management.

Administrative costs – Once the program is set up, most of the operating expenses are those that accompany the running of the easement program itself, rather than the IPA. Somewhat more support from the county's legal and finance departments may be needed and the county's bond counsel assists in each settlement. A bank, serving as paying agent, mails semi-annual checks to IPA holders.

Authority - Since IPAs constitutes long-term debt, each agreement will require approval of the purchaser's governing body in the same manner that bonds require approval. Different state and local laws may mandate voter or state regulatory/legislative approval, and may dictate the time and terms of each IPA. Finally, any state or local limitations on negotiating the sale of IPAs with balloon payments at the end will need to be addressed, potentially by using another government agency or authority as a conduit for payments. In general, however, a local government can enter into IPAs if it can negotiate the sale of general obligation bonds.

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PAYMENT COMPARISON

Farmer Jones – 102 acres

Lump Sum Method		***Installment Purchase Agreement***	
102 acres Easement valued at $3,500/acre	**$357,000**	102 acres Easement valued at $3,500/acre	**$357,000**
Direct cash payment	**$357,000**	Installment purchase agreement 6.5% tax free interest for 30 years $357,000 x 6.5% = $23,205annually (in semi annual payments)	**$23,205**
		CUMULATIVE EFFECT	
		Total Tax free interest paid over 30 years	**$696,150**
		Principal payment after 30 years (subject to capital gains)	**$357,000**
Total benefit to farmer minus 25% in taxes	**$357,000**	Total benefit to farmer	**$1,053,150**
Depletion of Farmland Protection Fund	**$357,000**	Initial county cost to secure easement	**$35,700**