Seller Take Back Financing

When a seller wants to close a sale of real estate but the buyer is not yet in a position to fully fund the purchase, the parties can close the sale with the seller taking from the buyer a purchase money note and mortgage in lieu of an all-cash payment.

Two Ways for a Seller to Finance a Purchase

If a buyer needs time to raise money to purchase a property, and the seller (1) doesn't want to wait to close the sale and (2) is willing to defer payment in full for the needed time, there are two ways forward:

- **Seller Take Back Financing.** At closing, the seller deeds the property to the buyer. At the same time, the buyer delivers a promissory note to the seller for the unpaid purchase price and records a mortgage on the property to secure that debt.
- **Installment Payment Financing.** At closing, the seller and buyer sign and record an agreement that sets out the terms for payment of the unpaid purchase price. The seller retains title to the property until the purchase price is paid. (Installment payment financing is the focus of the guide *Installment Agreement*.)

Either financing alternative provides the buyer the right to use the property while paying off the purchase price. In either case, the seller can defer recognition of capital gain on the sale for federal tax purpose over a period of two or more years.

Weighing the Options

Of the two alternatives, seller take back financing provides a more secure position for the buyer. By taking title at the beginning of the payment period, the buyer may be afforded clearer and more robust legal rights in the event of an alleged default.

However, an installment agreement may provide solutions to a variety of practical problems. For example, it is notoriously more challenging to fundraise for a project after a property has changed hands as compared to before. It is best to use seller take back financing in the context of having pledges or relative certainty in advance rather than thinking that fundraising will somehow get easier after the transaction. In the absence of such certainty, a buyer may decide that a well-drafted installment agreement (with its payment period culminating in acquisition of title) may better complement fundraising efforts. The ability of a seller to retain title until final closing may also be a valuable inducement.

Not Suitable for Conservation Easements

Seller take back financing is highly inadvisable for a conservation easement transaction as it necessarily involves the right of a landowner to retake the property in the event of default. This would forfeit potential federal tax benefits in the case of a bargain sale due to conservation easement perpetuity requirements and, more generally, introduce potentially confounding complexities regarding application of the law.

A Well-Used, Useful Tool for the Right Circumstance

Sellers frequently help buyers obtain favorable financing by taking back a purchase money note secured by a mortgage on the property. Seller take back financing is a conventional tool and is substantially the same in a conservation transaction context as in any other loan transaction involving real estate.

Seller take back financing is sometimes referred to by other names, such as seller financing, owner financing, or carryback financing. Note that these terms are colloquial and may also be used to refer to an installment arrangement, so it's important to inquire about the actual intent of any party using them in a financing proposal or discussion.

Benefits to the Seller

The primary benefit to the seller for selling to the buyer on credit, aside from selling the property sooner rather than later, is the opportunity to implement tax, estate, and financial planning strategies during the term of the financing, as discussed in more detail below.

Benefits to the Buyer

The primary benefit to a buyer is the ability to obtain financing at a cost that is typically less expensive than third-party financing sources:

- The seller may charge a lower interest rate;
- There is no need to pay for a separate appraisal or environmental audit to satisfy the lender; and
- There are no loan fees or commitment fees to be paid and no bank attorneys' fee to be reimbursed.

Guarantors and Angels

If a seller is not satisfied that a conservation organization has or will have the funds necessary to repay the purchase money note, guarantees or other assurances from financially responsible people may be requested. If there are project supporters willing to underwrite the transaction, an effective role for them can be that of an angel—a donor who pledges to contribute up to a certain amount if funds sufficient to repay the purchase money mortgage have not been contributed by others. If necessary, the conservation organization can assign these pledges to the seller as additional security for the purchase money financing.

Installment Reporting

The seller of real property not used in a trade or business, when providing seller take back or installment payment financing, can elect an installment method for reporting capital gain from the sale of property. IRS Tax Topic 705 provides an overview of the tax treatment of installment sales. IRS Publication 537 provides more detailed guidance including how to calculate gross profit from the transaction, the gross profit percentage to be applied to each installment, and sales income. Payments received by the installment seller during each tax year are, for tax purposes, comprised of three components: interest income (either stated or imputed at the applicable federal rate), which is subject to tax at ordinary income rates; tax-free return of adjusted basis in the property; and gain on the sale, which is subject to tax at capital gain rates. IRS Publication 225 provides a detailed explanation of the tax implications of installment sale as applied to a farm property.

Financial Planning Opportunities

Spreading out the tax burden over a period of years can provide tax, estate, and financial- planning opportunities for the seller who is willing to accept payment of the purchase price over two or more tax years, whether by seller take back financing or by installment payment financing.

Time Value of Money

Whenever a taxpayer can defer a tax liability at no cost to the taxpayer, that is financially advantageous. During the time of deferment, the taxpayer can invest what would otherwise have been paid to the U.S. Treasury. If the seller has a tax liability of $150,000 on a $1,000,000 gain, then spreading that gain over 10 years and investing it in the interim at 5% would result in a net benefit (even without compounding interest) of $33,750 ($15,000 deferred for one year @ 5%= $750; $15,000 deferred for two years=$1,500; for three years = $2,250 and so on).

Tax Planning

Whenever a taxpayer can use losses to offset taxable gain or use deductions to offset taxable income, it is an economic benefit to the taxpayer. An installment agreement can defer recognition of gain into future tax years when the taxpayer may anticipate substantial tax losses or deductions, perhaps for contribution of a conservation easement; or the taxpayer may anticipate a diminution in income, perhaps by retirement; or an elderly taxpayer may want to defer a balloon payment for a sufficiently long period so that it is taxable, if at all, as part of their estate.

Estate Planning

Deferring payment of the purchase price can allow time for the taxpayer to make a series of gifts of their interest in the property to family members so that, by the time a balloon payment under the note is made, it is payable to family members other than the seller and, to that extent, is no longer part of the seller's assets either for income tax or estate tax purposes. The seller can give up to $18,000 in value (for 2024) to any number of persons in any year without incurring adverse gift tax or estate tax consequences. If the balloon payment is deferred for a number of years, a series of gifts of proportionate shares of the note to family members could result in the balloon payment being paid to them rather than the seller. This may result in a substantial tax saving if, as a result of the gifts, payments are made to family members in lower tax brackets than the seller. If the seller's estate is likely to be subject to federal estate tax (as of 2024, the estate tax rates range from 18% to a maximum of 40%), then removing the value of the note from the estate will not only reduce the estate tax liability but may also reduce the overall value of the estate under the limit ($13.61 million for 2024) at which no estate tax is paid.

Financial Planning

Payments under the note can be timed so as to meet the seller's cash flow and tax- planning requirements. Rather than a fixed term of five years, the note may provide for a term of 30 years with an option on the part of the seller to call the loan (i.e., require payment in full) at five-year intervals. If the seller does not exercise the call option, then regular payments continue until the next option to require the balloon payment. A buyer is much more likely to obtain long-term financing of an acquisition if the seller has an option to call should their financial circumstances change. Of course, the buyer should negotiate for a substantial notice period so as to be in a position to find substitute financing if needed.

Bargain Sale

A bargain sale occurs when a buyer acquires an interest in real property for less than its fair market value. For a sale to a qualifying nonprofit (or government), the difference between the sale price and the fair market value can be treated as a tax-deductible donation. If the bargain purchase price is to be paid over time, the taxpayer may want to use the charitable deduction to offset ordinary income (otherwise taxable at rates of up to 37%) and defer the recognition of gain on the same transaction (usually taxed at 15% or, with respect to recapture of depreciation, up to 25%) to later years.

Planned Giving

A conservation organization may want to propose to the seller a planned giving strategy of forgiving the interest income component of installment payments. As discussed above, a portion of each payment will be allocated to interest income taxable at ordinary income rates of up to 35% for federal tax purposes. The other two components of installment payments are either not taxable or are taxable at capital gains rates (usually 15% or, with respect to recapture of depreciation, up to 25%). If payments of $9,000 during a tax year are allocated as $3,000 to interest income, $3,000 to return of investment, and $3,000 to gain, then the taxpayer's annual tax liability is $1,500 calculated as follows: $3,000 of interest income taxed at 35% = $1,050 plus $3,000 of gain taxed at 15% = $450. To the extent the taxpayer forgives all or a portion of the interest component, they not only reduce the more highly taxed portion of their payment but also have a charitable deduction to offset their tax liability on the remainder of the taxable portion of the payment. If the seller reduces the interest component of the payments from $3,000 to $2,000, a $1,000 donation results. The seller saves $350 that would have been paid on the forgiven $1,000 interest income and can use the $1,000 donation to offset $1,000 of other income received, resulting in another $350 of tax savings. Effectively, the $1,000 donation to the land trust cost the owner only $300. This could be an incentive to entice a seller into a program of planning giving at an affordable cost.

Considerations in Negotiating Loan Terms

Set out Terms in Sales Agreement

If the seller agrees to accept a purchase money note as part of the acquisition transaction, it is important to set out in the sales agreement all of the material terms of the financing. In addition, it is good practice to identify the form of note and mortgage that will be used to document the transaction and, if not a standard FNMA/FHLMC form, incorporate it into the sales agreement by attachment as an exhibit.

While it is generally advisable to consult with an attorney regarding the terms of an agreement of sale and financing documents when acquiring real estate, it is critical to do so if the form of note and mortgage are in an original negotiated form (other than FNMA/FHLMC). The note and mortgage include many important details that will materially affect the rights and responsibilities of the buyer and seller for the duration of the loan. For example, is the seller permitted to sell the note to a third-party? Is there a cure period for any events of default? Are there penalties associated with pre-payment?

Principal; Interest

Interest income is taxed at ordinary federal income tax rates, which are higher than capital gain tax rates. This differential sometimes results in the parties to the sale agreeing to the seller take back financing at a below-market rate (but not less than the applicable federal rate) in exchange for a higher purchase price. Since the allocation of payments as to principal and interest does not adversely affect the tax position of the conservation organization or increase its overall expenditure, this is an area in which the buyer can accommodate the seller at no cost to itself.

Amortization; Balloon Payment

A buyer must be realistically confident that funding will be available to make required loan payments. To reduce monthly payments and make debt service more affordable, a buyer may:

- Try to negotiate payment of interest only for a period of time.
- Request equal monthly payments of both principal and interest (commonly called "mortgage amortization") rather than equal payments of

principal plus interested accrued thereon (commonly called “commercial amortization”).

- Request payments calculated on the basis of as long an amortization period as possible (usually 30 years) and defer the balloon payment at the end of the term for as long as possible (usually 5 to 7 years, sometimes as long as 10).
- Try to negotiate the possibility of a short extension at the end of the term if needed to accommodate a refinance with a commercial lender.

Recourse

What assets of a borrower, other than the property that is the subject of a loan, can a lender go after if the borrower fails to pay back the loan in accordance with the terms of the loan? What recourse does the lender have? This is a crucial question for a buyer that needs to ensure that its landholdings and other assets will not be threatened by one transaction going bad.

No Recourse

The first negotiating position for the buyer should be that the loan ought to be non-recourse to the buyer. That means the seller is to look solely to the property for recovery of its indebtedness. If the buyer finds it is unable to pay the purchase price in full, the worst that happens is the seller gets the property back by foreclosure or deed in lieu of foreclosure.

The rationale for the non-recourse loan is this: Since the purchase price reflects the value of the property and since the amount owed the seller is less than the purchase price, if the seller gets the property back, the seller will be made whole.

Full Recourse

If not clearly provided otherwise in the loan documents, the loan is *full recourse* to the borrower. This means that, in the event of default, all of a buyer’s assets are exposed to the seller’s efforts to recover the indebtedness due on the note. The seller does not have to go after the property first. The seller can obtain a judgment lien and attach the buyer’s bank or other investment accounts. Loan documents that include a *confession of judgment* can be particularly problematic for the borrower.

Limited Liability

An intermediate position between full recourse and no recourse is to limit the buyer’s liability to the property and its other assets excepting certain excluded assets. For a conservation organization, the excluded assets should include, among any others that can be negotiated with the seller: all donor-restricted assets; all board-restricted or other assets necessary to maintain its qualification as a qualified conservation organization under §170(h) of the IRC; and other assets held for the benefit of others, including employees of the conservation organization.

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Patricia L. Pregmon, Esq., and Andrew M. Loza authored the 2009 and 2019 editions of this guide. Justin Hollinger, Esq., and Loza updated the guide for 2024.

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