Installment Agreement

An installment agreement requires the buyer of real estate to pay the seller the purchase price in installments over time; the buyer takes immediate possession of the property but the seller retains legal title as security until the buyer pays in full. An installment agreement can be a low-cost, flexible alternative to a traditional mortgage loan.

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Introduction

Both the buyer and the seller may benefit when payment of the purchase price of a property is spread over time. Payment amounts and timing can be structured in an infinite variety of ways and tailored to best meet the needs of both the seller and buyer.

Reasons to Consider Seller Financing

A conservation organization may want to suggest to a seller the deferral of all or a portion of the purchase price for a number of reasons, among which are the following:

- Payments can be timed to coincide with the buyer’s projections for funding availability from grants and donations.
- Private arrangements between the seller and buyer avoid the fees and interest rates charged by banks and other mortgage lenders.
- The seller holds the land as security to insure payment in full of the purchase price.
- The seller can defer recognition of capital gain on the sale until installment payments are received, creating federal tax benefits for the seller that could induce the seller to provide better terms to the buyer.

Two approaches

If a buyer needs time to obtain funding for the purchase of real estate and if the seller is willing to wait for full payment, two choices are available to protect the conservation organization’s interest in owning the land while safeguarding the sellers’ interest in receiving full payment of the purchase price:

- **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 in favor of the seller to secure that debt. This strategy is the subject of the guide [Seller Take Back Financing](#).
- **Installment Payment Financing** (i.e., Installment Agreement). At closing, the seller and buyer sign and record an agreement that sets out the terms for payment of the unpaid purchase price in installments over time. The buyer can exercise all of the rights of ownership, use and enjoyment of the property following the execution of the installment contract, but the seller retains title to the
property until the purchase price is paid. This strategy is the subject of this guide.

**Installment agreements versus seller take back financing**

In some cases, a conservation organization may prefer an installment agreement to seller take back financing because individuals and institutions may be more willing and motivated to contribute towards the purchase of a property than the repayment of a mortgage on the same property. The intended conservation outcome may be the same but donor perceptions may not be.

Another possible advantage of an installment agreement over seller take back financing is that, in the unfortunate event that the anticipated third party funding does not materialize, the parties can quietly unwind the transaction by recording a termination of installment agreement—no foreclosure or deed in lieu of foreclosure is needed.

**Buyer Becomes Equitable Owner; Seller Remains in Title**

When an installment agreement is signed by the buyer and seller, the buyer becomes the equitable owner of the property (which could be land, an access easement or a conservation easement). This means that the buyer can exercise all of the rights of ownership, use and enjoyment of the property during the term of the installment agreement. However, the seller retains legal title (sometimes referred to as holding bare legal title) to the property. This provides the seller security—if the buyer fails to make payments in accordance with the terms of the installment agreement, the seller may be able to recover possession of the property quicker and at less expense than if foreclosing on a mortgage.

Some sellers feel more secure retaining title to their property until the purchase price is paid in full, making an installment payment financing arrangement more satisfactory than the seller take back financing alternative. (Conversely, some sellers may not want to remain in title if they are not in control of the property.)

**In Use for Many Years**

Installment agreements (sometimes called contracts for deed) have been used for many years in both residential and commercial transactions as an alternative to purchase money mortgage financing.

Governmental entities frequently couple installment agreements with tax-free municipal bonds to finance economic development projects. Less frequently, governmental entities couple installment agreements with tax-free municipal bonds for land conservation projects. For example, the Pennsylvania Department of Agriculture uses installment sales and municipal bond issues in its Agricultural Conservation Easement Purchase Program.

**Appropriateness of the Tool**

Use of an installment agreement is more likely to be a good strategy if one or more of the following circumstances apply:

- The buyer, who views the property as a critical acquisition, is concerned that the seller, who is presently willing to sell, might be less amenable by the time the buyer raises funding for the purchase; at the same time, the buyer is relatively confident that the purchase price can be raised over a period of time.

- The seller is motivated to sell to the buyer, perhaps wanting to see the land conserved, and is concerned that the sale may not occur if the seller doesn’t provide financing.

- For federal tax purposes, the seller desires to spread the recognition of capital gains over a number of years.

- The buyer wants use of the land but the seller does not want to part with title unless and until the purchase price is paid in full.

- The buyer views fundraising for a pending land acquisition as preferable to fundraising to retire indebtedness for a completed acquisition.

- A government program to fund acquisitions of land or easements wants to spread funding commitments over a term of years.
Key Implementation Components
The first key to successful implementation of an installment agreement is that the buyer and seller must have a meeting of minds as to the length of time available for the buyer to pay the purchase price in full; the amount and frequency of installment payments; and the rights and responsibilities of the respective parties during the installment period.

Second, the parties will need the professional advice of their respective counsels to structure and document an installment transaction that protects the investment of the conservation organization in the property as well as the seller’s interests, including tax-planning objectives.

If creating a vehicle for public financing through issuance of tax-free municipal bonds, a much greater investment of time and energy will be needed, including the expertise of experienced bond counsel and investment advisor.

Examples of Payment Terms
The parties are free to set the amount and frequency of installments any way they choose in the installment agreement. The following examples are intended to show the flexibility of these arrangements:

Example 1: Similar to Purchase Option
The parties agree to installment payments in an amount and frequency sufficient to induce the seller to keep the property off the market and to cover the seller’s carrying costs (property taxes, etc.) for continuing to own the property. At a particular time, a balloon payment is to be made to complete the purchase. In the event that the buyer fails to make payment, the seller’s remedies would be limited to terminating the installment agreement. The conservation organization’s risk would be limited to forfeiture of amounts already paid as of termination.

This arrangement is similar to that of a purchase option where in exchange for buyer’s payment for an option or option payments, the seller agrees to refrain from selling the property to others while the buyer seeks funding for the purchase of the property.

A chief difference between the installment agreement and purchase option arrangements is that the former, unlike the latter, places equitable ownership in the hands of the buyer. Also, for some sellers, the installment agreement may be perceived as providing greater assurance that the buyer will complete the purchase. (Depending on the specific terms of the agreement, this could in fact be the case.)

Example 2: Similar to Lease with Purchase Option
Some installment agreements are structured so that payments are similar to a lease with a purchase option. Monthly payments are due in amounts similar to the rent that would have been payable under a lease for exclusive occupancy of the property. A balloon payment is due at the end equal to the purchase price to acquire ownership of the property. If the balloon payment isn’t made, the agreement typically terminates with no refund of payments made and no further liability on the part of the buyer.

Example 3: Similar to Seller Take Back Financing
Some installment agreements are structured so that the amount payable monthly to the installment seller is similar to the amount that would have been paid under a note in the amount of the purchase price bearing interest at an agreed upon rate and payable in level monthly installments over an agreed upon amortization period. There may be a balloon payment required after some number of years. If not provided otherwise in the agreement, in the event that the buyer fails to make payment(s), the seller can either terminate the installment agreement (in which case the buyer may forfeit all payments previously made) or the seller can enforce the agreement by suing the buyer to obtain judgment for the balance due and collect the judgment from buyer’s assets other than those, if any, that have been protected from seller’s recourse under the agreement. See “Liability” section of Seller Take Back Financing.
Issues to Address in an Installment Agreement

Taxes
The installment seller remains the legal owner of the property on the public records including records of taxing authorities.

If real estate taxes are not paid, both the interest of the installment seller and the interest of the installment buyer are at risk of divestment at a tax sale. Accordingly, both the seller and buyer have an interest in seeing that tax bills are forwarded to the proper party for timely payment with evidence of payment furnished to the other.

In any transaction that involves both a taxpayer and a non-taxpayer, it makes sense to allocate responsibilities so as to maximize tax benefits and take those tax benefits into account when negotiating the overall consideration for the transaction. When a conservation organization is the buyer, it makes sense to allocate the burden of tax payment to the seller, who, unlike the nonprofit organization, likely will be able to take the benefit of a tax deduction. Likewise, if there is the possibility of obtaining an exemption for real estate taxes due to the equitable ownership or use of the property by the conservation organization, the economic benefit of the exemption ought to be taken into account as part of the overall consideration.

Standards of Care; Insurance
Since the buyer typically has full care, custody and control of the property once the installment agreement is signed, the buyer typically assumes responsibility under the installment agreement to keep the property in good order and repair and in compliance with laws.

The installment agreement typically requires the buyer to provide policies of insurance or otherwise provide funds to repair or rebuild improvements within the property after a fire or other casualty.

Condemnation
If the property is condemned in whole or in part during the term of the installment agreement, both the installment seller and buyer will have claims for the taking of their respective interests in the property. The installment agreement can require the parties to cooperate with each other to obtain the full fair market value of the property taken and allocate the proceeds in accordance with a mutually agreeable formula.

The Transaction

Inspect
Before entering into an installment agreement, the buyer should be satisfied that the property is in compliance with applicable laws and there are no discoverable conditions that may result in unanticipated cost and expense.

Protecting Interest

Title commitment
Before entering into an installment agreement, the buyer should obtain a title commitment to insure its equitable ownership of the property under the installment sale agreement.

Exceptions
No mortgages or other liens should be permitted as exceptions to the title commitment unless there is an agreement between the buyer and the seller as to who is obligated to continue payments and remedies for failure to do so. The seller should be prohibited from further encumbering the property by mortgages or liens.

Recording
The installment agreement or a memorandum of the agreement should be recorded promptly after signing. Typically a memorandum, rather than the entire agreement, is recorded so as not to publicize the precise terms of payment or other private agreements of the parties.

Realty Transfer Tax
Realty transfer tax is due upon recordation of a contract for deed or agreement for the sale of realty based upon the entire consideration paid under the agreement. If the transfer is to a conservancy recognized as a charitable organization under 501(c)(3) of the Internal Revenue Code, then the transfer will be an
excluded transaction under Pennsylvania Code §91.191(18).

Federal Taxes and Installment Sales

Installment Reporting
The installment seller of real property not used in a trade or business 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 [http://www.irs.gov/app/picklist/list/federalRates.html], 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.)

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 taxpayer, that is an economic benefit—the taxpayer has money to invest in the interim that would otherwise have been paid to the U.S. Treasury. For example, 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 = $1500; for three years = $2250 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. Both seller take back financing and installment payment financing 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 his estate.

Estate planning
Deferring payment of the purchase price can allow time for the taxpayer to make a series of gifts of proportionate shares of his interest in the property to family members so that, by the time the balloon payment 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 $14,000 in value (for 2015) 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 to family members could result in the balloon payment being paid to them rather than 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 seller. If the seller’s estate is likely to be subject to estate tax (top rate of 40% in 2015), then removing the value of the property from the estate will not only reduce the estate tax liability but may also reduce the overall value of the estate under the limit ($5.43 million per person in 2015) at which no estate tax is paid.

Financial planning
Installment payments can be timed so as to meet seller’s cash flow and/or tax planning requirements. For example, rather than designating a five-year fixed term, the installment agreement may provide for a term of 30 years but with an option on the part of the seller to extend the term for an additional 15 years.
seller to require payment in full after five years and, if the seller does not exercise the option at that time, each five-year interval thereafter. If the seller does not exercise the option, then regular payments continue until the next option to require the balloon payment.

A seller is probably more likely to provide a conservation organization with long-term financing if the seller has an option to require full payment as described above should his financial circumstances change. Of course, the conservation organization should negotiate for a substantial notice period so as to be in a position to find substitute financing if needed.

Combining Installment Agreements with Tax-Free Municipal Bonds

Tax-free Municipal Bond Structure Generally
Installment agreements are frequently used as a vehicle to support economic development through issuance of tax-free municipal bonds. Ownership of the project is vested in a governmental entity, typically an industrial development authority, which enters into an installment agreement with the private company who will have all of the rights of beneficial ownership of the project. Bonds are issued by the industrial development authority and sold on the public market to raise funds to acquire the project. These bonds bear interest at a lower rate because the income is tax-free to the bondholder. Installment payments from the private company to the governmental entity under the installment agreement are used by the governmental entity to pay the principal and interest due to the bondholders under the terms of the bonds.

Conservation Projects
Government funders of conservation projects can use the installment structure to spread out payments over time. Funds derived from the sale of tax-free municipal bonds can be used to fund conservation acquisitions over a period of years. The bonds can also be issued to the owner in lieu of cash payment of the purchase price. See the Pennsylvania Department of Agriculture’s A Guide to Farmland Preservation for a description of the installment purchase of agricultural conservation easements using bonds issued by the New Garden General Authority.

Installment Buyers Should be on Guard
Lease-purchase and contract for deed transactions have been used for many years by unscrupulous operators to cheat vulnerable segments of the population. Pennsylvania’s Installment Land Contract Law (68 P.S. 902 et seq.) was enacted in 1965 to require disclosures and periodic accounting of payments for installment sales of residential real estate in all counties of the first and second class (i.e., Philadelphia and Allegheny County). While this act may not be applicable to a particular transaction, an installment buyer is well-advised to include in the installment agreement protections similar to those provided in the act, in particular: the disclosures that the installment seller is required to make; provisions for periodic accounting by sellers of the application of payments; and limitations on remedies to avoid forfeiture of payments previously made.

Resources at ConservationTools.org
To find experts on the topics covered by this guide, see the right hand column of the on-line edition at http://conservationtools.org/guides/show/26. The on-line edition also contains the most up-to-date listing of related library items and guides.

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