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.

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Two Ways for a Seller to Finance a Purchase

If a conservation organization 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 conservation organization. At the same time, the conservation organization 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 conservation organization 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 conservation organization 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.

If a conservation easement, rather than land, is being purchased, then only the installment agreement approach works. (A conservation easement is not a kind of property interest that can be the subject of a mortgage to secure payment of the purchase price.)

A Well-Used, Useful Tool for the Right Circumstance

Sellers frequently assist buyers to obtain favorable financing by taking back a purchase money note secured by a mortgage on the property. Neither the concerns of the seller and buyer nor the documentation of the conservation-related transaction materially differ from any other loan transaction involving real estate.

Benefits

Benefits to the Seller

The primary benefit to the seller for selling to the conservation organization on credit, aside from selling the property sooner rather than later, is the ability to spread the taxable capital gain on the sale over two or more tax years (using the installment reporting method and the opportunity to implement tax, estate, and financial planning strategies during the term of the financing. See "Federal Taxes and Installment Sales" in the guide *Installment Agreement* for a full review of installment reporting and financial planning opportunities.

Benefits to the Buyer

The primary benefit to a conservation organization 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 the 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 the 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 his 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 $15,000 in value (for 2018) 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 estate tax (40% in 2018), 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 ($11,180,000 in 2018) 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 conservation organization is much more likely to obtain long-term financing of an acquisition if the seller has an option to call 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.

Bargain Sale

A bargain sale of a conservation easement results, as to the charitable contribution portion, in a tax deduction offsetting up to 50% of adjusted gross income and, if not used in the year of the gift, can be rolled forward for up to 15 years. 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 35%) and defer the recognition of gain on the same transaction (taxed at 15% or, with respect to recapture of depreciation, 25%) to later years.

Planned Giving

The 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 (15% or, with respect to recapture of depreciation, 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. This could be an incentive to entice a seller into a program of planning giving at an affordable cost: the after-tax cost to the seller of a $1,000 donation to the conservation organization in the example given above (by reducing the interest component of the annual payments from $3,000 to $2,000) is only $300. Taxpayer saves $350 in tax otherwise payable on the $1,000 of income they have forgiven, and uses the $1,000 charitable deduction to offset $1,000 of income received, which results in another $350 tax savings. That is a $700 economic benefit from a $1,000 contribution.

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.

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

It is unwise for anyone, and particularly a nonprofit charitable organization, to enter into a loan transaction without realistic expectations that sources of funding will be available to it as and when needed to make required loan payments. The typical objectives of the conservation organization in its loan negotiation are to minimize required monthly payments and to stretch out the payment schedule to ensure sufficient time to accumulate the cash needed to pay the loan in full by the end of the term. If these are the objectives, the conservation organization will want to:

- 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 conservation organization that needs to ensure that its landholdings and other conservation assets will not be threatened by one conservation transaction going bad.

No Recourse

The first negotiating position for the conservation organization should be that the loan ought to be non-recourse to the conservation organization. That means the seller is to look solely to the property for recovery of its indebtedness. If the conservation organization 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 the conservation organization's assets—its preserves, its investments, its stewardship funds—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 conservation organization'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 conservation organization's liability to the property and its other assets excepting certain excluded assets. 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.

The most recent version of this guide and related resources can be found online at https://conservationtools.org/guides/25

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