SELLER FINANCING

Mark Perelman

CONSERVATION
FINANCE TOOLKIT

Seller financing allows current owners to enable their dreams to continue beyond their ownership. Seller (or owner) financing – unlike traditional bank mortgages – can be advantageous for both landowners and buyers. There are numerous permutations by which sellers can assist buyers in buying their property, including:

- Lease-to-own options with right of first refusal
- Wrap or All-Inclusive Trust Deed (AITD)
- Formation of joint-venture LLCs to split ownership and profits

Understanding individual needs and areas of flexibility allows for creative negotiation of factors that extend beyond down payments and interest rates.

How It Works

Sellers can specify that owner financing is available – but buyers can also inquire about it and make the case for it.

For negotiations to be synergistic, there needs to be trust. By developing strong reputations through respect for landowners and the environment, buyers may achieve more favorable terms with seller financing relative to properties sold on the open market through bank financing.

Negotiation guides – like the ones referenced in the resources section – hold that great negotiators are not born that way but learn these skills through preparation and practice.

PREPARATION

The first step is preparation. It involves understanding one's own and counterparties' needs and flexibilities.

Real-estate transactions are often very personal. Important factors such as history, arability and location vary greatly among individuals.

Therefore, it is necessary to conduct a thorough analysis of all factors that relate to the transaction. This includes being aware of the legal and regulatory guidelines as well as knowing about competitive pricing.

Look for insight into the interests and driving goals of your counterparty. Organizing thoughts in list form can help identify which counterparties have the best fit. The list can also be shared with lawyers and accountants.

As there are state and federal guidelines involved, it is prudent for both parties to consult with real estate agents, accountants and attorneys. It would be helpful to familiarize yourself with these guidelines as well.

NEGOTIATIONS

Preparation will not only build trust but will also be helpful in tailoring arguments. Negotiators need to always be grounded in reality and explain why their offers are fair.

The sheer range of seller financing approaches may seem like a maze but individual circumstances will lead to only a few viable options. Presenting the pros and cons of several seller-financing approaches for the specific transaction can invite the owner to engage in joint problem solving.

The final part after the negotiation is complete is to itemize the agreed-upon interest rate, repayment schedule, default consequences, and all other terms into a legally binding promissory note - a written promise - between the parties. This document does not need to be recorded with the county.

The remaining requirements for owner financing are the deed and a land or sales contract.

How to Get Started

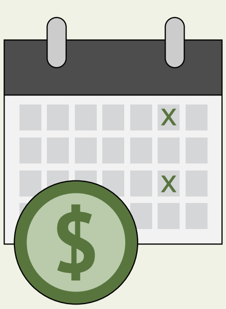
There are two ways in which seller financing can proceed, but there are many names for each of them. The distinction between the two is *when* the deed of trust (legal ownership of the property) is transferred to the buyer.

SELLER TAKE-BACK MORTGAGE

This approach is similar to traditional mortgages with the notable exception of owner financing instead of bank financing.

During closing, the seller signs over the title (or deed for the property) to the buyer. The buyer signs a promissory note on the unpaid purchase price while recording a mortgage on the property to secure that debt.

Because the buyer holds the title, she is entitled to sell the house or refinance it. However, she must keep making the agreed-upon payments to the seller or else the seller can foreclose using the signed note.



SELLER TITLE OWNERSHIP

In situations when the buyer has questionable finances or cannot pay a large down payment, the seller may prefer to keep the property's title. In some states, all seller-financing arrangements are handled in this way.

During closing, the parties sign and record an agreement that sets out the payment terms as well as what happens if the buyer fails to pay the full purchase price. The deed of ownership is not transferred to the buyer until all agreed-upon contract terms are met.

The final signed contract between the seller and buyer is known by various names, including "contract for deed," "contract of sale," "land sale contract," or "installment sales contract."

When This Tool Is Appropriate

Buyers may be able to make down payments and pay interest while raising the money for the purchase. For example, nonprofits raising funds through five-year campaigns can pay interest over the five years and make a balloon payment at the end of the campaign.

The primary benefit to buyers is the ability to obtain financing at a cost that is typically less expensive than that of third-party financing sources. With seller financing, the loan-closing process is more flexible than with bank financing.

Expenses such as closing costs can be included in the overall loan. Unlike with bank financing, there is no need for separate appraisals, environmental audits, loan fees, or reimbursed bank-attorney fees.

Landowners needing cash quickly may prefer getting money upfront from a bank and not choose to finance the transaction. Still, for many other owners, providing financing to buyers makes sense.

With 5-year bond yields near historic lows[1], installment payments allow sellers to earn competitive interest rates. As rates are paid on the pre-tax mortgage rather than on after-tax lump payments, installment payments may generate higher returns for sellers. Sellers may be more familiar with the value of their land than other

1 https://fred.stlouisfed.org/series/HQMCB5YR

investments – such as the stock market – while retaining the property as collateral in case the sale falls through or the buyer defaults.

Moreover, there are potentially lower taxes from installment plans as opposed to lump-sum payments. As gains are spread among a number of years, annual income is lower and so taxes are paid at potentially lower brackets.

The parties may elect out of using the installment method and recognize the entire gain in the year of sale – even if the sale proceeds are not all received in that year. See IRS "Tax Topic 705: Installment Sales"[2] for basic information. IRS Publication 537[3] provides details about accounting for installment sales. The IRS requires that a minimum annual interest be paid on top of the principal that goes towards paying off the loan amount.

Owners are able to sell off the promissory notes to other investors for lump sums if needed later on. Investors would demand a discount to the present value of the income stream and the higher capital-gains taxes upon sale.

Owners who are not financially or personally ready to retire can retain aspects of the property and possibly pay less for property taxes, insurance and maintenance. For example, owners may want to live or farm on the property for several more years or for the rest of their lives.

Partial ownership options for transitioning land may involve forming different legal ownership structures such as a limited liability corporation (LLC). Ownership of the property is then wrapped into a business and the new buyer acquires larger ownership over time.

Last but not least, sellers may not always be able to sell to their preferred buyers. First-time farmers, land trusts, and conservation professionals promising to protect land from development may not be able to pay as quickly as private equity firms.

2 https://www.irs.gov/taxtopics/tc705

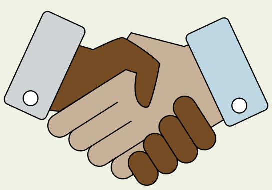
3 https://www.irs.gov/publications/p537

What the Pros and Cons Are

While the pros for both parties revolve around negotiated mutual benefits, the major cons are several event risks that include:

- If the buyer will be unable to pay installed interest and/or balloon payments
- If the buyer fails to pay and then loses all equity (especially in land contract sales)
- If the seller has not paid off their own mortgage, the buyer may have a subordinated interest in the farm if seller bankruptcy occurs

If these and other risks are clearly understood by both buyers and sellers, seller financing can make sense for the farm as well.



DIFFICULTY LEVEL

Seller financing is not complicated and has been used in conventional real-estate transactions for decades. It can be faster and easier than bank financing but requires an understanding of accounting and legal issues. Both buyers and sellers should work with property lawyers and tax accountants.

COMMON ISSUES

Bank financing remains an option that can be used to finance the down, principal and interest payments. This can further enable buyers that are only eligible to borrow a portion of the purchase price from traditional mortgage sources.

If buyers are not able to keep up with payments, they break the terms of the owner-financed sale's promissory notes. The owner then has the right to foreclose and repossess the property without repaying the interest payments.

It is important for all parties – including any other financiers to the buyer and the original owner – to understand whether the land is encumbered by existing commitments.

Typically, the oldest loan claims the property as collateral in case of foreclosure. This information can be accessed through local public records. If the buyer makes payments faithfully, but the seller herself has a mortgage from a bank that she does not pay, the property could be foreclosed upon by the bank.

Buyers should also take precaution in situations where the owner has any outstanding loans with property liens. For example, supposed contractors performed work on the property but have not been paid by the owner. Some states allow for mechanic's liens to be placed on the property and these get repayment priority in the case that the property foreclosed upon. Conservation easements have priority over all other liens. They cannot be subordinated to seller financing - or else tax authorities can deny the easement deduction[4].

In addition to reviewing the resources mentioned after this section, please consider online real-estate forums relating to owner financing and the particular features that appeal most to you and your counterparty. For example, see these two discussions (example 1[5.1] and example 2[5.2]).

Where to Find Additional Resources

Primers for negotiation include Negotiation Genius[6] and this online course by Barry Nalebuff[7].

A Field Guide to Conservation Finance[8] explores seller financing as well as many related concepts. Other guides on seller financing can be obtained from extension services (such as this one from the University of Vermont[9]) and land trusts (such as the Pennsylvania Land Trust[10]). Guides issued by organizations in the same jurisdictions as the property may offer additional insights particular for that area.

For assistance in coming up with creative solutions, this guide from Food:Land:Opportunity[11] presents a broad range of options that may be used in negotiating.

4 https://www.lexology.com/library/detail.aspx?g=d8104a61-fabf-4fb0-a977-945aef707f0e

5.1 https://www.biggerpockets.com/forums/311/topics/296515-looking-for-a-win-win-solution-here

5.2 https://www.biggerpockets.com/forums/88/topics/154893-lease-option-or-seller-finance-vacant-land

6 https://books.google.com/books/about/Negotiation_Genius.html?id=ChWCIeUW3CEC&printsec=frontcover&source=kp_read_button#v=onepage&q&f=false

7 https://www.coursera.org/learn/negotiation

8 https://www.amazon.com/Field-Guide-Conservation-Finance/dp/1597260592

9 http://www.uvm.edu/newfarmer/business/finance-guide/Chapter3.pdf

10 https://conservationtools.org/guides/25-seller-take-back-financing

11 https://www.foodlandopportunity.org/downloads/BreakingGround_081616.pdf

MARK PERELMAN is a Master of Business Administration degree candidate at the Yale School of Management. He has over a decade of experience sustainability economics, investment and strategy. He has a degree in Mathematical Economics from Colgate University.

Seller Financing is one tool in the Conservation Finance Toolkit.
Get more tools at:

conservationfinancenetwork.org/toolkit