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SELLER FINANCING OF LAND SALES: FINANCIAL, TAX AND LEGAL FACTORS

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This publication explores some financial, tax and legal factors involved in low-equity, seller-financed land sales from both the seller's and the buyer's point of view. Transfers of farmland are often characterized by somewhat unique financing. Individuals who sell their own land on contract or through personal mortgage have provided the largest amount of farm real estate debt—about 35 to 40 percent of total debt in the United States, and about 30 to 35 percent in Texas. The result of this type of financing is a direct negotiation between buyer and seller, bypassing the specialized lending institutions.

WHY SELLER FINANCING

Financing by sellers occurs for a number of reasons. Many farming and ranching operations are (or were) owned by farmers who have retired or are approaching retirement. Oftentimes, large tracts of land in these operations have increased substantially in value. Capital requirements for purchasing such land tracts usually would exceed the financial resources of most buyers, thus requiring external financing.

However, traditional lending institutions have achieved only limited success in providing *favorable* financing terms for farm real estate transactions. When they have loanable funds, life insurance companies prefer to finance large, low-risk operations. Commercial banks also are typically reluctant to make large, long-term real estate loans. Farmers' Home Administration offers favorable real estate financing terms, but only to borrowers who cannot obtain financing from commercial sources. Federal Land Banks (FLB's) specialize in farm real estate loans. While their loan lengths and interest rates are favorable, FLB's have historically required high equity or down payments by borrowers, and have used real estate valuation practices that have tended to underestimate current land values. Legislation passed in 1971, however, has eased the situation by enabling FLB's to modify these equity and valuation practices. They can, consequently, now offer more favorable financing terms to their borrowers. As a result, recent data indicate a substantial increase in FLB financing to buyers.

CHARACTERISTICS OF SELLER FINANCING

These shortcomings in lending institutions, as well as factors related to income tax and other aspects to be discussed below, have encouraged a relatively large amount of seller financing in farmland transactions. Some of these sales are financed with a "land-purchase contract," also known as a "contract of sale," a "conditional sales contract," a "land contract," or an "installment contract." It is an agreement to transfer permanently the control of the land to the buyer while title remains with the seller until the repayment conditions of the contract are met.

Mortgages and deeds of trust are often used in the seller-financed arrangements. Here, the title is transferred to the buyer at the time the real estate transaction is closed, with the buyer's personal payment note secured by either a mortgage or deed of trust. If the buyer defaults in repayment, under a note secured by a mortgage, the seller must go through a judicial foreclosure procedure in order to collect the outstanding debt, which may be both time-consuming and expensive.

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Much of this time and expense is avoided under the deed of trust (used almost exclusively in Texas), as it permits a relatively rapid, nonjudicial foreclosure in case of default by the buyer.

Seller-financed arrangements, whether using a contract, mortgage or deed of trust, usually require relatively low down payments—only 30 percent or less. Most of them also require the buyer to maintain the property to a specified standard until the debt is repaid. The terms and rates of interest specified vary substantially, especially for transfers between close relatives. The term is often rather short—usually no more than 10 to 19 years. Oftentimes, a large final or balloon payment (that is 30 to 40 percent of the sale price) is required at the end of the repayment period.

ADVANTAGES AND DISADVANTAGES

Both the seller and the buyer of land can find advantages and disadvantages associated with this type of low-equity seller-financing. The optimum approach to the financing of farmland real estate transfers will vary with each individual land transaction; however, the several financial, tax and legal factors common to all such transactions are briefly reviewed below.

The Seller and Seller Financing

Sellers of farmland can benefit from these low-equity financing arrangements in several ways. First, they can provide the seller with a steady and easily manageable flow of returns from an agricultural investment when payments of principal and interest are made. This feature may be important to retiring farmers or other landowners who want to withdraw from active management.

Second, by reducing the down payment requirement, the seller might broaden the demand for his land, thereby increasing its sale price.

On the negative side, however, the informal, personal nature of the contract market may reduce the liquidity of the financing paper. Moreover, the buyer's low-equity position increases the risk of the financing arrangement. Consequently, the seller may find his investment "frozen" into the contract for many years unless he is willing to accept a discount when selling the financing paper to a commercial lender.

In addition, land prices at the end of longer-term low-equity financing arrangements are often considerably above the original transaction price. The seller thus foregoes further capital gains from the land or from other investments to which he might allocate the proceeds of a cash sale of land. And, because of the general inflation, the seller will find that the fixed annual payments have reduced purchasing power.

Income Tax Features

The Internal Revenue Service (IRS) code and tax regulations permit capital gains from certain seller-financed sales of an asset (land, in this case) to be spread over the years of repayment if the seller receives 30 percent or less of the sale proceeds in the year of sale. In addition, at least one payment must occur in each of 2 years, and the seller must not be legally classified as a real estate dealer or a subdivider. Because the sales of most farmland usually involve substantial capital gains, this "installment sale contract" treatment is usually attractive to sellers. (It should be noted that the term "installment sale contract" has a special meaning for income tax purposes, and may involve a contract, deed of trust or mortgage sale, so long as down payment requirements are met.) The advantage depends on the current and expected income tax position of both the seller *and* the buyer.

Only the *capital gains* from real estate sales represent taxable income. The capital gains constitute the difference between the sale price and the seller's *basis* in the property. In its simplest form, *basis* is the *price* he *paid* for the farm, *increased* by the value of subsequent capital improvements to the real estate, but *decreased* by depreciation claimed or allowable on all depreciable items legally considered to be a part of the land (omitting consideration of recapture of depreciation under Section 1250 of the IRS code).

Capital gains on land held less than 6 months are considered short-term gains and are taxed at ordinary income rates. Gains on land held longer than 6 months can generally be considered as long-term. In determining his tax obligation, the non-corporate seller can choose (1) to pay tax on one-half of the long-term capital gain at ordinary rates, or (2) to pay a 25 percent tax on the first $50,000 of long-term gain ($25,000 for a married taxpayer filing a separate return), and 35 percent on any additional long-term gain. It is cheaper to choose the first option unless the taxpayer is in a tax bracket above 50 percent. Thereafter, the second option is cheaper up to $50,000 of long-term capital gains.*

The installment-sale-contract treatment offers the advantage of reducing current tax obligations and of deferring tax obligations to future years. As an example, consider a tract of land that has increased in value from its purchase price of

*IRS manuals or personnel should be consulted for detailed explanations of deriving capital gains or losses and their tax consequences, or for any changes occurring in the regulations themselves from year to year.

$30,000 in 1960 to a current market value of $100,000 in 1974. It will be assumed that it has no depreciable features and that no capital improvements have been made, so that its basis would also be $30,000. The long-term capital gain is $70,000. The owner would sell the land for $100,000, and accept a down payment of $28,000 during 1974. The sales agreement would call for the balance of $72,000 to be paid in 9 annual installments of $8,000 principal, plus interest at 6 percent on the outstanding loan balance. This arrangement would qualify the transaction for installment-sale-contract treatment, because the payments to be received in the year of the sale would not exceed 30 percent of the purchase price.

Under the IRS installment sale provisions, the capital gains income of $70,000 may be prorated over the life of the financing arrangement. Since capital gains constitute 70 percent of the total sale value, the down payment and each annual installment may be assumed to be comprised of 70 percent capital gains income. Of the original $28,000 down payment, 70 percent of $19,600 is considered as taxable, long-term capital gain. Similarly, $5,600 (70% of $8,000) of each annual installment is considered as taxable, long-term capital gain, and it is taxed according to the taxpayer's choices (as discussed above). The result will be a lower total tax obligation.

If the note or other evidence of indebtedness covering the real estate transaction is sold or discounted before termination, then the seller is considered to have collected the note when it is sold and thus incurs the remaining tax obligation at that time.

Interest paid on the low-equity sale will be treated as ordinary income at the time it is received by the seller. This distinction in tax treatment between interest and long-term capital gains can affect an individual seller's or buyer's preferences toward the level of the interest rate and the sales price in the transaction.

Depending on the level of gain, his present and his expected tax brackets or his other tax strategies, a seller would likely prefer a relatively high sale price and a relatively low interest rate because he has a lower tax obligation for capital gains than for ordinary interest income. The buyer also might prefer certain price and interest trade-offs, since the sale price establishes his basis for future capital gains and his interest payments are thus tax deductible. Hence, in seller-financed sales, both the price and the terms of finance are subject to negotiation from both parties involved in a sale transaction.

The IRS "unstated interest rule" sets a minimum interest rate which can affect the seller's ability to qualify for installment tax treatment. The "unstated interest rule" essentially says that if the installment sale arrangement calls for less than 4 percent interest, the IRS will consider it as containing 5 percent interest (compounded semi-annually) when determining whether the 30 percent down payment rule has been violated. Thus, if the interest rate in the above example were less than 4 percent, IRS would adjust the $100,000 sale price downward to reflect the amount of interest the seller would have received in an "arm's length" transaction with an interest rate of 5 percent. The procedure is to calculate the present value of the right to receive $8,000 per year for the next 9 years at an annual interest rate of 5 percent, compounded semi-annually. This present value is $56,705.

To determine whether the seller qualifies for installment tax treatment, the IRS would add $56,705 to the $28,000 received in the year of sale to obtain an adjusted sales price of $84,705. Thirty percent of the adjusted sale price is $25,411. Since the down payment of $28,000 exceeds this 30 percent value (in fact, the down payment is 33 percent of the adjusted sales price), the seller would not qualify for installment sale treatment. He must then treat the entire long-term capital gain as taxable income during the year of sale. If this places him in a higher tax bracket, more of the sale price will be lost to taxes. This may also create severe cash flow problems, especially when the payments received in the year of sale are less than the seller's income tax liability.

The seller who is considering installment tax treatment thus should always be sure that the interest rate specified is at least 4 percent, or that the payments received in the year of sale are adjusted downward in order to stay within the 30 percent rule.

Other "hidden" traps also must be avoided if the seller is to receive the installment tax treatment described above. To avoid these traps, competent tax advice should be obtained before the sale agreement is negotiated. In this discussion, comments are only generalized as to when certain payments, transfers and assumptions are treated as part of the sale price, and the reader's tax adviser for individual transactions can point out the exceptions to the present discussion. Earnest-money deposited 1 year, and applied to the down payment in a subsequent year, generally will be treated as being received during the year of sale. Hence, such a payment must be included when determining the amount for the 30 percent rule. A corporate buyer's debt or equity paper transferred to the seller may be similarly treated if there is a ready market for it. If the buyer pays any obligation for which the seller is legally liable (e.g., taxes, interest, mortgage), either at closing or subsequently in the same year, it will probably be treated as payment received by the seller during the year of sale. Finally,

whether the assumption of the seller's mortgage is treated as a collection in the year of sale depends on whether the seller's basis was greater or less than the mortgage. All of the above factors must be considered to avoid violating the 30 percent rule.

The Buyer and Seller Financing

For the buyer, the primary advantage of seller financing is the acquisition of all the benefits and responsibilities of land ownership with a relatively small down payment. This feature enables low-equity operators to purchase additional land and achieve a rather strong financial leverage position. In addition, the low-equity arrangement also provides a means of overcoming the tenure uncertainties of leasing. The operator can put more of his capital into machinery, livestock and annual operating inputs, where the payoff is usually much greater.

If the property being purchased is the family homestead, a further incentive exists to obtain a strong financial leverage position. In Texas, the homestead can only be mortgaged for purchase money, for ad valorem taxes or for permanent and valuable improvements. Thus, homestead property *cannot* be refinanced at will, with the loan so obtained used to finance other business activities—in this case, the purchase of additional land.

In buying on contract, parties involved also may encounter several disadvantages. The risk of losing the land by default in payment is typically greater with a purchase contract than with a note secured by a deed of trust. The loss could also extend to the buyer's other assets, if the financing arrangement assigns personal liability to him in case of default. This risk of loss may have a negative effect on short-term financing available from commercial lenders. Most lenders will not include the buyer's equity in the contract as an asset on a balance sheet until the contract terminates or title is transferred. Yet they probably will include at least the current year's annual contract payment among his liabilities.

Whether the financing arrangement involves a contract, mortgage or deed of trust, the annual payment poses an even more serious liquidity problem. Large annual payments place severe demands on the cash flow of the buyer, leaving less cash available to service short-term loans. Because of this reduced liquidity, non-real estate lenders may be more conservative in financing farmers with heavy annual installments on real estate debt.

Prospective buyers may often discover outstanding mortgages or deeds of trust existing on property they plan to buy. If so, they must decide whether to (1) "assume the mortgage," or (2) buy "subject to" the mortgage. When assuming a mortgage, a buyer becomes personally liable for the "old" mortgage. "Personally liable" means that all the buyer's other assets could be reached to satisfy the old mortgage if the buyer should default and if the forced sale of the land does not generate sufficient funds to pay off the mortgage.

Purchasing land "subject to" a mortgage does not legally oblige the buyer to repay this mortgage. However, he can never acquire clear title to the land until the prior mortgage has been repaid.*

CONCLUDING COMMENT

The relatively large amount of seller financing of farmland indicates shortcomings in the programs of some real estate lenders as well as tax and financial incentives on the part of both sellers and buyers. Potential sellers and buyers should each analyze both the advantages and disadvantages. Traditionally, seller financing has been viewed as a useful tool for beginning farmers with low equity and high payoff expected from non-real estate capital. However, in view of its negative effect on access to short-term financing, this purchase arrangement may be better suited to farmers who are in a highly liquid, working-capital position. These buyers can bargain more effectively for part of the tax savings which the seller stands to gain from an installment sale.

Both parties should also be informed about changes in tax laws. For additional information about tax treatment of installment sales, consult local IRS personnel and obtain IRS Publication No. 537, *Installment and Deferred-Payment Sales.* In addition, other tax strategies, including income averaging and income shifting associated with cash accounting, may also influence the tax advantages of low-equity, seller-financed sales. All these factors need to be considered in reaching satisfactory real estate financing arrangements.

*Moreover, he would ordinarily account for the mortgage by offering the seller a price no greater than fair market value *less* the amount of the mortgage. Then, by repaying the old mortgage, for which he had no personal legal obligation, he would still pay no more than the fair market value of the property.

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