



Seller- Carry Loans: Should You or Shouldn't You?

By James Kilpatrick

With interest rates heading back up and banks increasingly hesitant to give big loans on investment properties "Seller- Carry" Loans are making a comeback.

I say comeback because there were times when interest rates were in the high teens. Since new loans were so pricey, assumptions of existing loans were often the only way a Buyer could get outside financing on reasonable terms, with Seller-Carry loans filling in the gap between the assumed loan and the net purchase price, after deduction of the down payment.

In today's lending environment, financial institutions are willing to fund about 65% of the typical investment real estate transaction (5+ units). This means Buyers must come up with 35% of the price in cash or exchange equity. This limits the number of potential Buyers a property may have.

The solution for some Sellers is to carry a first or 2nd loan back. There are various advantages and risks to this arrangement. I will cover a few of them here.

Logically a property offered with a very low-interest-rate, Seller-Carry loan will sell at a higher price than if the property were offered without that loan. It is common for Seller-Carry loans to be "interest only" meaning no principal is paid back and the outstanding loan amount stays the same for a fixed period of time. The advantage for the Buyer: any cash that would have gone to pay down the loan can be used to fix up the property. The "interest only" feature also improves the current cash flow. Advantage for the Seller: if the Seller has not elected to "exchange" for another income producing property, the tax hit comes all at once. With an interest-only Seller carry, the income from the loan should be taxed as ordinary income, but the built-up capital gain is included in the loan, and (depending on the way the loan is structured) does not become due until the principal loan balance is paid back from the Buyer to the Seller.

There may be a downside to this arrangement for the Buyer such as a big pre-payment penalty (a fee that must be paid if the loan is paid off early) or some increase of interest over time, but these negatives are generally nothing more than what should be watched for in a commercial loan. For the Seller it's more complicated. Generally carrying a loan means giving up the right to exchange those proceeds on a tax deferred basis. More

ominously, no matter what Purchase Agreements, other legal agreements and the “Seller Carry Note” might say, there is always a risk that a Buyer will come back with a dispute or allegation after close of escrow. Should that happen, a Seller must realize that where possession is half the battle, the Buyer possesses all that money that was borrowed via the Seller Carry Loan. Foreclosing is a hassle, if the Buyer withholds some small amount of money from a loan payment due to a disagreement, the Seller may have little other recourse than to foreclose. If the documentation is all in order, foreclosures are fairly straightforward for an attorney to perform, but are still never fun. Indeed, if the Buyer is *really* unhappy, she may try to enjoin the foreclosure on the ground that there was fraud in the inception of the deal. Foreclosures also have their own set of added risks such as the Borrower who resigns herself to losing the property and therefore trashes it, or stops all maintenance.

Other issues come up if the Seller-Carry is in second position behind a senior loan by a bank. If the Buyer/Borrower stops paying everyone, generally the first lender will get paid before the second lender. This means the second is in an inferior position—but can also usually get a slightly higher interest rate. Add all the loans together and the higher the “loan to value” (ratio of the loan amounts to the purchase price) the greater this risk is statistically, and the more difficult it will be for the Lenders to recover their money, fees, etc. It goes without saying that in such a situation, the holder of the second (here, the Seller) bears the brunt of the added risk. Another of the many important considerations when considering a second position loan is to read the loan documents for the first loan to make sure it allows a second. The first Lender may have the right to “Call” (declare immediately due) its loan when a second is put behind the first. There may be other limitations on the second as well.

One other type of Seller Carry that is less common but bears mentioning is a “Wrap”. Typically, this is where a Seller (in order to avoid a prohibition in the loan documents) doesn’t tell the first lender that a sale has occurred and continues making payments. The Buyer makes payments to the Seller, who continues to be responsible to pay off the first note. The property has changed hands and the first Lender still doesn’t know. This is particularly risky because the Seller is breaking its agreement with the lender by doing this, and thus immediately technically defaulting on the initial loan. This means the first loan could be called at any time if the Lender finds out what’s going on. It also means that the Seller is on the hook for a loan secured by a property that is no longer under the Seller’s control. Wraps in general are done at the risk of the Buyer and Seller. Any investor should think twice about knowingly violating any agreement.

The moral of the story is that Seller- Carry loans do work out well for some situations but should be researched thoroughly and implemented with the help of the appropriate professionals who will know what pitfalls and opportunities to look for.

Please keep in mind that my area of expertise is Real Estate Brokerage. The tax consequences, exchange validity, accounting rules and legality of various strategies are best discussed with the appropriate professional. I have several that I will be happy to recommend. If you missed last month’s installment, you may contact me for a copy of the last issue.

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