Chapter 1

Carryback financing in lieu of cash

Learning Objectives

After reading this chapter, you will be able to:

- comprehend the financial benefits afforded sellers and buyers who enter into seller carryback finance arrangements;
- identify the seller's financial risks involved in carryback financing;
- advise on the various forms of documentation used to structure seller financing; and
- explain the tax advantages available to a seller for carrying back a portion of the sales price.

Key Terms

all-inclusive trust deed (AITD) note

nonrecourse mortgage

portfolio category income

private mortgage insurance (PMI)

seller financing

Seller financing supports the price

When mortgage money is plentiful and readily accessible, lenders are eager to make loans to nearly every buyer. This is the case no matter the type of property sought, its location or the buyer's creditworthiness.

However, when the availability of mortgages tightens, loan approvals become more elusive. Further, the definition of a "qualified buyer" becomes more restrictive. A seller hoping to locate a buyer amenable to the seller's asking price during a tight mortgage market needs to consider **seller financing**.

seller financing
A note and trust deed executed by a buyer of real estate in favor of the seller for the unpaid portion of the sales price on closing. Also known as an installment sale, credit sale or carryback financing.

Seller financing is also known as:

- an installment sale;
- a credit sale;
- carryback financing; or
- an owner-will-carry (OWC) sale.

Seller financing occurs when a seller carries back a note and trust deed executed by the buyer to evidence a debt owed for purchase of the seller's property. The amount of the debt is the remainder of the price due to the seller after deducting:

- the down payment; and
- the amount of any existing or new mortgage used by the buyer to pay part of the price.

Rights and obligations

On closing, the rights and obligations of real estate ownership held by the seller are shifted to the buyer. Concurrently, the seller carries back a mortgage, taking on the rights and obligations akin to that of a mortgage holder.

Editor's note — Before making, offering or negotiating consumer mortgages for compensation, California brokers and agents need to first obtain a mortgage loan originator (MLO) license endorsement on their California Bureau of Real Estate (CalBRE) license. A consumer mortgage is a consumer-purpose loan secured by a one-to-four unit residential property.

A broker offering or negotiating a carryback consumer mortgage as part of a home sale transaction triggers the MLO license endorsement only if the broker or agent receives separate additional compensation for arranging the carryback, a fee beyond the fee collected for their role as seller's agent or buyer's agent in the real estate transaction.[1]

Marketing property: the seller will carry

The seller who offers a convenient and flexible financing package to prospective buyers makes their property **more marketable** and **defers the tax bite** on their profits.

Qualified buyers are willing to pay a higher price for real estate when attractive financing is available. This holds true regardless of whether financing is provided by the seller or a lender. For most buyers, the primary factors when considering their purchase of a property is:

- the amount of the down payment; and
- the monthly mortgage payments.

Seller's agents use these circumstances to inform their sellers about pricing arrangements in hyper-competitive buyer's markets.

1 Calif. Business and Professions Code §10166.01(b)(1)

Buyer willingness is especially apparent when the interest rate on the carryback mortgage is equal to or below the rates competitive lenders are charging on their purchase-assist loans. The lower the interest rate, the higher the price may be.

Flexible sales terms for the buyer

Seller financing also provides tangible benefits for buyers. For buyers, seller carryback financing generally offers:

- a moderate down payment;
- competitive interest rates;
- less stringent terms for qualification and documentation than imposed by traditional lenders; and
- no origination costs or lender processing hassle.

Lenders automatically require a minimum down payment of 20% if the buyer is to avoid **private mortgage insurance (PMI),** which adds over one percent to annual mortgage costs and reduces the maximum amount a homebuyer can borrow. Further, **Federal Housing Administration (FHA)**-insured mortgages include a **mortgage insurance premium (MIP)** regardless of the **loan-to-value (LTV)**.

private mortgage insurance (PMI)
Default mortgage insurance coverage provided by private insurers for conventional loans with loan-to-value ratios higher than 80%.

In a carryback sale, the amount of the down payment is negotiable between the buyer and seller without the outside influences a traditional mortgage broker and buyer have to contend with.

Additionally, a *price-to-interest rate tradeoff* often takes place in the carryback environment. The buyer is usually able to negotiate a lower-than-market interest rate in exchange for agreeing to the seller's higher-than-market asking price.

Tax benefits and earnings for the seller

Taxwise, it is preferable for a seller to carry back a portion of the sales price, rather than be cashed out when taking a significant taxable profit. [See Chapter 26]

The seller, with a reportable profit on a sale, is able to defer payment of a substantial portion of their profit taxes until the years in which principal is received from the buyer. When the seller avoids the entire profit tax bite in the year of the sale, the seller earns interest on the portion of the note principal that represents the tax not yet due and payable.

If the seller does not carry a note payable in future years, they will be cashed out and pay significant profit taxes in the year of the sale (unless the profit is exempt or excluded from taxation, such as occurs in a §1031 transaction).

What funds the seller has left after taxes are reinvested in some manner. These *after-tax sales proceeds* will be smaller in amount than the principal on the carryback note. Thus, the seller earns interest on the net proceeds of the carryback sale before they pay taxes on the profit allocated to that principal.