Equity Sharing: Purchasing Property with an Investor

By Attorney Robert Muir

Equity sharing is a financing option for homebuyers who need assistance with their purchase. With tighter lending standards, some buyers may benefit from having an investor to help with the down payment or to qualify for a loan. Investors can benefit two ways by being able to purchase a property they would not be able to qualify for by themselves, and having an owner, rather than a tenant, live in the property and pay the debt service.

In a typical equity sharing arrangement, the buyer and investor become co-owners. The investor, sometimes called the owner-investor, usually provides all or most of the down payment and their good credit. The buyer, or owner-occupant, pays the mortgage, taxes, insurance and maintenance expense. Later, at an established time or when the property is sold, any appreciation (or loss) is shared by the co-owners.

Although equity sharing has been around for many years, it is more popular when loans are harder to obtain, whether this is due to high interest rates or, as it is now, due to tightened loan qualifying standards. Equity sharing is always popular with buyers who do not have the necessary down payment. C.A.R. currently has no equity sharing agreement, although it does have a Q & A (March 11, 2008), so the agreement should be prepared by an attorney. Agents dealing with clients interested in equity sharing should be familiar with the issues common to equity sharing agreements.

ESSENTIAL TERMS

Equity sharing is basically a partnership arrangement. Like all partnerships, the duration of the agreement should be spelled out as well as how the partnership can be terminated, whether this be voluntarily and involuntarily (such as upon foreclosure). The agreement should include what would occur if the owner-occupant fails to make the payments, how tax benefits are apportioned, who pays for the maintenance and any improvements, how this is approved, and how a party can purchase the other's interest, and what happens if the parties cannot agree on a sales price. In our current market, the agreement should also address the possibility of negative equity.

One variation in equity sharing agreements involves whether the owner occupant and owner-investor initially purchase the house together or the agreement comes into play after one party has already purchased the home. This is important because when the owner-investor sells an interest in the property to an owner-occupant, or gives a lease with an option to purchase, this may trigger the lender's due-on-sale provision in the note and deed of trust. Parties should be aware of this risk and the agreement should address what the parties will do if the lender calls the note due.

Equity sharing agreements vary in length from two pages, when the parties show little concern for possible contingencies, to over 50 pages detailing numerous possible events. The key, however, is to have an agreement written in plain language covering the essential terms.

Clients interested in equity sharing usually have the co-owner picked out, often a relative or close friend. The parties should understand their investment objectives, their financial abilities, and the tax risks and benefits.

DISCLOSURES

As with other transactions, agents may represent one or both parties as long as the required agency disclosures are made. In equity sharing agreements, the parties may be in unequal bargaining positions such as with an experienced investor with capital and a new homebuyer with little or no capital. To ensure the fairness of such a transaction, the parties should each have the opportunity to review the agreement with their own attorney. In all cases, the parties should know whether the attorney represents one or both parties.

A real estate agent's duty to their client may extend beyond the initial date of the equity sharing agreement since the agreements are often executed over a period of time. Agents can be helpful by reminding their clients to calendar important dates in the agreement, and to be sure the agreement is followed or to contact their tax or legal professional if ques¬tions arise.

TAX BENEFITS

The parties to the agreement share the tax benefits. Although an equity sharing arrangement is like a partnership, for tax purposes it is not treated as such. The owner-investor can receive certain interest and expense deductions, such as the depre¬ciation allowance. The owner occupant, on the other hand, can take similar deductions to a homeowner, depending on the percentage of ownership and structure of the agreement. Due to IRS re¬quirements in this area, an experienced CPA should review the tax issues before the parties sign the equity sharing agreement.

RISKS

As with other business relationships, much of the success of equity sharing arrangements depends on how well the parties work together. Each party should know the other's business experience and financial status and this information should be verified, if necessary. Optimism at the outset is good but parties need to be realistic.

Problems can occur if a party defaults. Should the owner occupant stop making monthly payments, the owner-investor may not be able to bring an unlawful detainer action to evict the owner-occupant, as with an ordinary tenant. Some agreements anticipate this problem by allowing the owner-investor to hold a quitclaim deed from the owner-occupant, however, a court may not allow this procedure.

There are ways to lessen the burden of a default and the procedure to address this possibility should be set out. Events such as bankruptcy, death, divorce and default should be anticipated. Arbitration and mediation provisions for disputes can also allow a quicker and more cost effective resolution of any problem.

CONCLUSION

Equity sharing arrangements can benefit both parties and can result in a sale of property that might not otherwise occur. Equity sharing agreements should be written plainly and be fair to both parties. The terms of the agreement should be realistic and possible contingencies should be anticipated. With a good equity sharing agreement, owner investor and owner occupant, as well as agent can benefit.

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