

NEW CONSTRUCTION: CUSTOM VS. PRESALE?

Although many people do not appreciate the differences between a custom and a presale in residential construction, legally and practically speaking the two are as different as apples and oranges. In a "custom," the *purchaser* owns or acquires the land, obtains the construction financing, and hires the builder to build the house. In a "presale," the *builder* owns or acquires the land, obtains the construction financing, builds the house, and then conveys the completed house to the purchaser.

From the purchaser's perspective, the primary advantages of a custom are that: (1) the purchaser may deduct for federal income tax purposes the interest paid on the construction loan for a principal residence; and (2) the purchaser actually owns the land during construction, and as a result, has a greater security if the builder defaults or becomes insolvent after the purchaser has made payments to the builder, and has more control over the project, including the ability to fire the builder if the builder materially breaches the construction contract. On the other hand, the most significant disadvantages of a custom are that: (1) unpaid subcontractors and suppliers may file construction liens against the property if the builder has underbid the job or has diverted funds from one project to another, leaving the purchaser with little choice but to pay such subcontractors and suppliers even though the purchaser already has paid the full contract price to the builder; (2) the risk (and the cost) of delays by the builder may fall on the purchaser, since the purchaser is personally liable for the construction loan; and (3) the purchaser must pay sales tax on the entire construction contract price.

From the builder's perspective, the primary advantages of a custom are that: (1) the purchaser must obtain the construction financing and acquire the land and therefore, bears the acquisition and carrying costs; (2) the builder is not "stuck" with the house if the purchaser wants to backout of the deal, which is particularly important if the house contains unmarketable features; and (3) the builder is paid as work progresses, typically on a percentage-of-completion basis, rather than upon final completion. The disadvantages of a custom are that: (1) the builder must work with the purchaser's lender, rather than its own lender; (2) if the purchaser defaults, the builder must commence a lien foreclosure action, rather than simply sell the house to another buyer, since the purchaser owns the house; and (3) the builder cannot use the house to as great an extent to generate other jobs.

In most instances, the transaction can be structured either as a custom or as a presale. Which of the two is more appropriate depends upon a number of factors and circumstances.

The following factors would weigh in favor of a custom: (1) Does the purchaser already own the land? (2) Is the purchaser in a better position than the builder to obtain the construction financing? (3) Is the construction loan interest deduction important to the purchaser? (4) Does the purchaser want significant upgrades, changes, or unmarketable features in the house? (5) Does the builder require a substantial nonrefundable deposit? (6) Does the builder have a good reputation?

The following factors would weigh in favor of a presale: (1) Does the builder already own the land? (2) Does the purchaser want one of the builder's "canned" plans with only minor changes? (3) Does the builder intend to build the house on speculation regardless of whether it is presold? (4) Is the house saleable and compatible with the builder's inventory? (5) Does the purchaser have to sell his or her present house before buying the new house? (6) Is the builder in a position to carry the house in inventory if the purchaser defaults?

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The documentation is also different between a custom and a presale. A custom involves an earnest money agreement (if the purchaser does not already own the land), *and* a construction contract. The earnest money agreement, if applicable, is between the purchaser and the seller of the land, and covers *only* the land. The construction contract is between the purchaser and the builder, and covers *only* the house -- not the land and the house. There is no earnest money agreement between the purchaser and the builder (unless the builder is also the seller of the land), because the construction of a house on the purchaser's land does not involve a sale of real estate. A presale, on the other hand, *does* involve a sale of real estate and is written on an earnest money agreement covering *both* the land and the completed house to be built on the land.

There are substantial differences between a custom and a presale. The role of the real estate broker or salesperson in structuring the new construction transaction is to counsel the parties as to which type of transaction best suits the circumstances and the intentions of the parties.

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