

Making Everything Easier!™

Financing Real Estate Investments

FOR
DUMMIES®

Learn to:

- Evaluate potential lenders
- Maximize your cash flow
- Finance through private lenders
- Tap into government programs

Ralph R. Roberts

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Foreclosure Investing For Dummies*

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Financing Real Estate Investments FOR **DUMMIES®**

**by Ralph R. Roberts and
Chip Cummings with Joe Kraynak**



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Dedication

From Ralph: To real estate investors and professionals who are dedicated to supporting and promoting the American dream of homeownership.

From Chip: To my assistant Debbie Forth who has managed to keep me organized for the last 14 years, and to my wife Lisa who puts up with all the crazy hours and remains my #1 fan.

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Introduction



Real estate investing is an expensive habit. You need money to finance the purchase, renovate your fixer-upper, and cover the holding costs while you prepare to sell or rent the property. The good news is that it doesn't all have to be *your* money. In fact, the less of your own money you can use and the more you can borrow, the bigger the return on your investment. Add the potential credit and market woes like the first decade of the 2000s, and investing in real estate also becomes a bit more of an adventure.

Lining up financial resources well in advance of scouring the neighborhood for investment opportunities enables you to pounce on a bargain and gives you leverage in negotiating the price you ultimately pay for a property. When you place an offer on a house and other bids come in, the seller may accept your offer of thousands of dollars less simply because you have the financing in place to quickly close the deal. Ready cash also frees you to plan and begin rehabbing the property immediately instead of waiting around for sluggish loan approvals and credit checks.

If you're thinking that you can't possibly get your mitts on enough cash to finance your venture, *Financing Real Estate Investments For Dummies* is the book for you. Here you discover the best sources for investment capital and how to go about tapping into these sources to fuel your next venture.

About This Book

This book isn't a get-rich-quick guide to investing in real estate or a guide or a tutorial on how to buy property with no money down (although we do cover that topic). *Financing Real Estate Investments For Dummies* delivers what the title promises — a treasure map that shows you where to find sources of real estate investment capital and guidance on how to dig it up.

Ralph and Chip are both seasoned investors. We've each built wealth through investing in real estate — buying and selling fixer-uppers and buying and renting out both residential and commercial property. Although we have used our own money on occasion to finance our purchases and renovations, we've primarily succeeded with the use of other people's money (OPM). Our grandmothers were our first financial backers, but we've expanded our options since then.

We have more than 50 years' worth of combined experience in buying and selling real estate and securing the financing to do it. In this book, we share what we know with you, showing you how to tap into loans from banks; mortgage companies; private lenders; federal, state, and local government programs; and more. In the process we cover financing for both residential and commercial properties.

Conventions Used in This Book

Compared to other books on financing real estate investments, *Financing Real Estate Investments For Dummies* is anything but conventional, but we do use some conventions to call your attention to certain items. For example:

- ✓ *Italics* highlight new, somewhat technical terms, such as *hard money*, and emphasize words when we're driving home a point.
- ✓ **Boldface** text indicates key words in bulleted and numbered lists.
- ✓ Monofont highlights Web addresses.

Financing the purchase and renovation of residential properties, such as homes, is quite different from financing the purchase and renovation of commercial properties. You deal with different lenders who use different methods for evaluating your loan application and the property you're planning to buy.

In this book, we cover both types of financing, but you should know up front the differences between residential and commercial property:

- ✓ **Residential:** One- to four-family dwellings classify as residential properties, which qualify for residential financing.
- ✓ **Commercial:** Properties used to conduct business and any rental properties designed to house more than four families qualify as commercial real estate. Loan approval for these properties hinges more on the property's potential for generating sufficient income to make the payments than on the borrower's financial strength.

In addition, even though you see three author names on the cover of this book — Chip, Ralph, and Joe — the “we” is usually Chip and Ralph talking. Joe is the wordsmith — the guy responsible for

keeping you engaged and entertained and making sure *we* explain everything as clearly and thoroughly as possible.

What You're Not to Read

Although we encourage you to read this book from cover to cover to maximize the return on your investment, we realize that in today's busy world you may have time to read only the information pertinent to your situation. If so, you can safely skip anything you see in a gray shaded box. We stuck this material in a box for the same reason that most people stick stuff in boxes — to get it out of the way, so you wouldn't trip over it. However, you may find the stories and brief asides uproariously funny and perhaps even mildly informative (or vice versa).

Foolish Assumptions

We assume you already mastered the basics of investing in real estate. If you haven't, we encourage you to pick up a copy of either (or both) *Real Estate Investing For Dummies*, 2nd Edition, by Eric Tyson and Robert S. Griswold, or *Commercial Real Estate Investing For Dummies* by Peter Conti and Peter Harris (Wiley).

If you're interested in flipping houses or focusing on foreclosure properties, check out *Flipping Houses For Dummies* or *Foreclosure Investing For Dummies* by Ralph R. Roberts with Joe Kraynak. If you're thinking of becoming a landlord, we strongly encourage you to first read *Property Management For Dummies* by Robert S. Griswold. Not everyone has the right stuff to be a landlord, but if you know what you're getting into before you take on the role, you can significantly improve your survival odds.

How This Book Is Organized

Financing Real Estate Investments For Dummies facilitates a skip-and-dip approach. It presents the information in easily digestible chunks, so you can skip to the chapter or section that grabs your attention or meets your current needs, master it, and then skip to another section or simply set the book aside for later reference.

To help you navigate, we took the 17 chapters that make up the book and divvied them up into five parts. Here, we provide a quick overview of what we cover in each part.

Part I: Gearing Up for Financing Your Real Estate Investments

When you become a real estate investor, you're essentially building a business; you should build it on a strong foundation. In this part, we cover the basics, providing you with definitions of standard terminology and concepts you're likely to encounter, introducing you to the various sources of investment capital, showing you how to protect yourself against potential risks, and leading you through the process of gathering all the documents and other information you need to apply for financing.

In the process, we reveal the power of using OPM to gain leverage and expose your own money and other assets to less risk.

Part II: Financing the Purchase of Residential Properties

In this part, we explore the many residential loan programs currently available, show you how to compare different loan packages to find the one that costs the least overall, and lead you through the loan application process from filling out the forms to closing.

By the end of this part, you should have the financing you need to start hunting for residential real estate investment opportunities.

Part III: Financing the Purchase of Commercial Properties

In this part, we introduce you to the most common commercial property types, so you can choose the type best suited to your investment goals and evaluate the properties based on their potential for generating a positive cash flow. We take you on a tour of some of the unique sources of financing available for commercial ventures. Finally, we step you through the process of applying for commercial real estate loans from application to closing.

Part IV: Sampling More Creative Financing Strategies

In this part, you discover the pros and cons of *hard money* — cash that's generally easier but more expensive to borrow for purchasing

investment properties. We also show you how to finance the purchase through the seller by purchasing properties on contract, how to partner with an investor who's cash heavy, and how to track down no-money-down deals.

These options aren't for everybody, but when you're in the market for investment properties and can't get your hands on conventional financing, these unconventional sources can be a deal saver.

Part V: The Part of Tens

The Part of Tens is the highlight of every *For Dummies* title, offering quick strategies, tips, and insights on whatever subject the book covers. The chapters in this Part of Tens reveal how to avoid the ten most common mistakes when financing real estate investments, which questions you should ask prospective lenders, ten steps to take to prepare for your next closing, and ten strategies for surviving a credit crunch.

Icons Used in This Book

Throughout this book, we sprinkle icons in the margins to cue you in on different types of information that call out for your attention. Here are the icons you'll see and a brief description of each.



We want you to remember everything you read in this book, but if you can't quite do that, be sure to remember the important points flagged with this icon.



Tips provide insider insight from behind the scenes. When you're looking for a better, faster, cheaper way to do something, check out these tips.



"Whoa!" This icon appears when you need to be extra vigilant or seek professional help before moving forward.

Where to Go From Here

Financing Real Estate Investments For Dummies is sort of like an information kiosk. You can start with the chapters in Part I to master the basics and then skip to Part II if you're planning on financing the purchase of residential property or Part III if your focus is more on commercial properties.

For a quick primer on financing the purchase of real estate investments, check out Chapter 1. Chapter 4 is a great place to start if you're not sure where to start looking for lenders — this chapter touches on everything from banks and mortgage companies to private lenders and partnering with others who have cash.

We do consider Chapter 6 required reading. All too often investors get burned because they focus too much on interest rates and not on other factors contributing to the overall cost of borrowing money. This chapter offers a quick way to compare two loans side-by-side to determine which one costs less over the life of the loan.

If you're planning to invest in commercial properties, Chapter 8 is also required reading. In this chapter, we show you how to evaluate different types of properties the way lenders do it when you apply for a loan.

If you're looking for information on a very specific topic, flip to the back of the book, where you can find a comprehensive index of key topics.

Part I

Gearing Up for Financing Your Real Estate Investments

The 5th Wave

By Rich Tennant



"Robert wants to use a traditional method of financing our real estate investments known as OPM — Other People-in-laws' Money."

In this part . . .

The key to scoring affordable financing and keeping a bigger chunk of your after-tax profits from real estate investments is preparation. By understanding the leverage you can gain using other people's money (OPM) to finance your investments and having all your financial records in place, you increase your odds of securing financing with attractive terms and interest rates.

By understanding tax laws and loopholes before you get started, you can lay the groundwork necessary to maximize your tax deductions and exclusions and keep more profit for yourself. And by understanding the differences between different types of lenders, you gain access to additional sources of investment capital you may never have considered.

In this part, we help you build your real estate investment venture on a firm foundation so you have ready access to cash while minimizing your exposure to risk.

Chapter 1

Taking a Crash Course in Real Estate Investment Financing

In This Chapter

- ▶ Gaining leverage with other people's money
- ▶ Deciphering key terms
- ▶ Grasping the difference between a home and investment property
- ▶ Discovering vital sources of real estate investment capital
- ▶ Getting ready to meet your lender

Are you eager to set out on the road to building wealth through real estate? Although we hate to hold you back, we do discourage you from moving forward without the proper preparation. Our advice doesn't necessarily mean, however, that you need to read the entire book from cover to cover before you purchase your first investment property.

Here, we provide a quick primer on real estate financing along with what you need to do to secure financing for your real estate investments. We also provide a generous supply of references to other chapters in the book where you can find more detailed information on specific topics. So without further ado, let the real estate financing primer begin.



Don't let negative economic and credit information dampen your desire to invest in real estate. The best time to purchase real estate is when prices are low. You can still find and secure financing; you just may need to look and work a little harder and smarter to get it.

Pumping Up Your Purchasing Power with Borrowed Money

If you have any reservations about borrowing money to buy real estate, you need to overcome those reservations by developing a better understanding of leverage — using borrowed money to buy more and better properties, thus improving your chances of earning bigger profits.

In the following sections, we show you why the goal of owning a property free and clear isn't such a smart move, reveal the secret of leveraging the power of borrowed money, and explain how you can offer “cash” for properties even when financing the purchase.



Although we encourage investors to borrow money to increase their leverage, keep in mind that borrowing money can carry significant risks. As an investor, you can take action to minimize the risks — by carefully evaluating your real estate market and properties under consideration, overestimating costs, underestimating profits, developing realistic backup plans, and so on; however you can never completely eliminate the risk. You have to decide for yourself what an acceptable level of risk is.

Minimizing your potential by owning property free and clear

For many Americans, paying off their mortgage early and owning their home free and clear is the real American dream. Life would be so much better if they didn't have to deal with a house payment.



For real estate investors, however, owning property free and clear means that valuable equity is locked up in those properties — equity they can use to finance the purchase of other revenue-generating real estate. Don't get caught in the trap of thinking that paying off a mortgage loan is a smart move — it may be a noble goal, but it's rarely a savvy strategy.

Maximizing your potential with other people's money

Other people's money (or *OPM* for short) is money that you borrow from other people to finance your investments. OPM isn't much of a secret. Assuming you own a home, you probably used OPM to buy it. You may have put down 5 to 10 percent of your own money as a down payment and then borrowed the rest.



Dealing with a major credit crunch

The mortgage meltdown, foreclosure epidemic, and global financial crisis that all came to a head in 2008 led many real estate investors to believe that credit had all but dried up. Banks were failing left and right, and the United States was forced to step in with more than \$1 trillion in economic rescue funds to keep cash flowing to individuals and businesses that needed credit. Surely, real estate investors would be the last on the list for cheap and easy credit.

Actually, the credit crunch didn't put real estate investors out of business. In fact, in many cases, it made conditions better for investors:

- ✓ When the bubble burst, properties became much more affordable. Investors could buy better properties for less money.
- ✓ As millions of people worked through foreclosure, demand for rental properties soared.
- ✓ Financial institutions, eager to rid their books of empty, expensive, cash-sucking foreclosures, became more willing to offer great deals. I (Chip) just had a client pay \$82,000 for a brand new property with a market value of about \$275,000. The bank had taken it back from a builder, was more than glad to just get it off the books, and was willing to finance it with a 15-year loan.

A credit crunch doesn't mean that financing disappears — it just means that you probably need to look for it in some unusual places. Even FHA has investor financing with 25 percent down — and a lot of foreclosures they're willing to deal on. Throughout this book, we show you how to tap into these markets — credit crunch and all.

In most cases, OPM helps you earn a profit. When you calculate in the appreciation of the home, the tax savings it represents, inflation, and other factors, you're likely to earn more money off the home than you pay out in interest over the life of the loan — barring a major housing meltdown.

The same applies to your real estate investments. The more OPM you can put to work for you, the more you stand to earn — as long as your earnings from it exceed the cost of borrowing it. For more info about OPM, check out Chapter 5.

Paying cash with borrowed money

In the world of real estate, cash is king. The buyer who shows up with cash is in a significantly stronger position to purchase a property and negotiate an attractive price and terms than a buyer who shows up needing financing.

When we say cash is king, however, we're not advising you to show up with a suitcase full of money. We're telling you to show up with preapproved financing — a financial backer who can deliver the cash on closing day. In other words, although you're financing the purchase as explained throughout this book, you're still placing yourself in a position to offer cash.

Brushing Up on Basic Real Estate Financing Lingo

Throughout this book, we toss around some jargon common in the real estate and mortgage lending industries. To the average consumer, these terms may sound Greek, but we assure you that they're part of the English language. In the following sections, we define the most common and often misunderstood of these terms.

Identifying types of lenders

The money men and -women you deal with when securing financing for purchasing investment property play various roles in the process. You need to know whom you're working with:

- ✔ **Commercial lenders:** They're financial institutions rather than individuals. They include banks, credit unions, mutual savings banks, savings and loan associations, and stock savings banks. (Chapter 9 discusses commercial lenders in greater detail.)
- ✔ **Private lenders:** A private lender is any individual who loans money outside the channels of institutional lending. This person can be a friend or relative, such as your Aunt Mabel, or an investor. Real estate investors often rely on private lenders for access to investment capital when banks and other financial institutions turn them down. (For more about private lenders, check out Chapter 11.)
- ✔ **Mortgage banker:** Mortgage bankers are financial institutions that directly fund home loans and either service those loans themselves (arranging and collecting monthly payments and managing any escrow accounts) or sell the mortgages to investors and contract out the servicing of the loans.
- ✔ **Servicer:** The servicer is the institution contracted or appointed to collect the monthly payments from the borrower. They have to account for all payments and disbursements and provide yearly statements showing all transactions within a mortgage account to the borrower.

- ✓ **Mortgage broker:** Mortgage brokers are licensed by the state to assist borrowers in finding mortgage lenders, comparing loan programs, applying for mortgage loans, and securing financing for purchasing real estate. They act as the eyes and ears for many different mortgage lenders.
- ✓ **Loan officer:** Loan officers work for mortgage bankers or brokers to assist clients in securing financing for purchasing real estate. They essentially do the same thing brokers do, but they have to work for a licensed broker or lender.
- ✓ **Loan originator:** Another name for a mortgage broker or loan officer.

See Chapter 4 for more on these types of lenders.

Grasping different loan types

Throughout this book, we introduce you to various types of loans for financing the purchase of real estate, including conforming and nonconforming loans, jumbo loans, and hard money loans. In the following list, we define the most common loan types and toss in some additional information that you may find useful.

- ✓ **Conforming loan:** A *conforming loan* is one that meets the criteria set forth by Fannie Mae or Freddie Mac — the organizations that purchase the loans and then package them up to sell on Wall Street. In general, to qualify for a conforming loan, the borrower must
 - Show sufficient income to cover monthly payments.
 - Have enough cash for a down payment and reserves.
 - Have a good credit history.

For additional details about conforming loans and current criteria, visit the Fannie Mae Web site at www.efanniemae.com.

- ✓ **Nonconforming loans:** These include everything else outside the Fannie/Freddie box. Sometimes referred to in the market as *subprime* or even *exotic* loans, they're bought by other financial companies or investment banks and packaged to be sold to Wall Street investors. When the subprime market suffers, as it did starting in 2008, far fewer of these types of securities make it to market.
- ✓ **Conventional loans:** These loans are outside the sphere of the government. In other words, they're not FHA- or VA-secured loans and aren't underwritten by any government agency.



- ✓ **Jumbo loans:** As its name suggests, a *jumbo loan* represents a lot of money — specifically, more money than you can borrow under the limits of a conforming loan.
- ✓ **Hard money loans:** Also referred to as *bridge loans*, they're typically short-term, high-interest loans that enable investors to get their mitts on some cash in a hurry. You can expect to pay several points upfront (a *point* is equivalent to one percent of the total loan amount) plus up to double the going interest rate. (For more about hard money and strategies for using it to your advantage, check out Chapter 11.)
- ✓ **Government loan programs:** The government isn't really in the business of loaning money to homeowners and investors, but it facilitates the process for lenders by insuring the loans — if the borrower defaults on the loan, the government steps in to cover any losses for the lender.

The two most common government loan programs are Federal Housing Authority (FHA) and Veterans Administration (VA) loans. But federal, state, and local governments also provide loan programs to encourage investment in disaster areas and neighborhoods that they're seeking to develop. Within the FHA and VA programs are some great hidden opportunities for investors. (See Chapter 4 for more about specific government loan programs.)

Brushing up on important legal lingo

Even though real estate deals are generally classified as financial, they involve plenty of legalities, especially in relation to who owns the property or has a stake in it. Although real estate-related legal terms can fill an entire dictionary, you should have a working knowledge of the following three:

- ✓ **Deed:** A *deed* is a legal document that grants rights to a property. Whenever you purchase a property, whoever is handling the closing must file the deed with the county's register of deeds to make the transfer of ownership official. As the official owner, you have the right to borrow against the property and transfer your rights of ownership.

Be careful signing any deed, especially a *quitclaim deed* (the deed that allows a property's owner to relinquish all rights to the property). Real estate con artists often use the quitclaim deed to hijack property from unwary owners. They may hide a single page quitclaim deed in a stack of papers, fooling the owner into signing the document without knowing what they're signing. Then, they run down to the register of deeds and file the deed, making themselves the new owners, so they can take out bogus loans against the property.



Who gets first dibs?

In the event of a foreclosure, certain liens take *precedence* over others, meaning that when the property is sold at auction, certain lien holders are paid off first:

- ✔ **Tax lien:** The proceeds from the foreclosure sale pay off any unpaid property taxes first.
- ✔ **First mortgage:** If any money from the proceeds of the sale remain, it pays off the first mortgage or as much of the first mortgage as possible. This is also referred to as a *senior lien*.
- ✔ **Second mortgage:** If the homeowner took out a second mortgage, any remaining proceeds from the sale go toward paying it off. Any second (or third or fourth) mortgages are also referred to as *junior liens*.
- ✔ **Construction liens:** If money still remains, it goes to the next lien holders in order of precedence.
- ✔ **Homeowners:** After all the lien holders receive their cuts, the foreclosed-upon homeowners get the remaining crumbs, which can actually be quite a chunk of change if they had a lot of equity in the property.



- ✔ **Lien:** A *lien* is a legal claim that a creditor holds against a property in lieu of payment. Several parties can place a lien on a property, including the lender who holds any first or second mortgage, the county tax assessor (for unpaid taxes), and contractors (if they financed the repairs or renovations).

As an investor, knowing who (if anyone) has a lien against a property you're purchasing and the monetary value of that lien is important. All lien holders need to be paid in full upon sale of the property. If the property has a lien against it that the seller fails to disclose, you may become liable for paying it when you take ownership of the property.



- ✔ **Promissory note:** Whenever you borrow money, you have to sign a promissory note pledging to pay back the loan in full according to terms of the loan, which always specifies a deadline for full payment. Think of a promissory note as an IOU (as in "I owe you" this amount of money).

The promissory note is your pledge to pay back the loan. The mortgage or deed of trust names the property as collateral in the event that you default on the loan.

Pointing out mortgage concepts

When you take out a loan, the lender requires something of value (*collateral*) to make sure it has something valuable to sell and recoup its investment if you default on the loan. This collateral is officially presented in the form of a mortgage or deed of trust depending on the jurisdiction:

- ✓ **Mortgage:** A *mortgage* is a contract between the lender and borrower that gives the lender the right to foreclose on the property in the event that the borrower defaults on the loan.
- ✓ **Deed of trust:** A *deed of trust* is a mortgage contract that places control of the deed in the hands of a third party — a trustee. The trustee has the power to foreclose on the property in the event that the borrower defaults on the loan.

The mortgage market is large and complex, but it consists of two main divisions: a *primary* and a *secondary* mortgage market.

- ✓ **Primary:** This is the market in which you do business. It consists of financial institutions that lend you money.
- ✓ **Secondary:** This is the market where institutional lenders and Wall Street investors converge. The primary lenders who actually loan money to homeowners and investors turn around and sell the mortgages or deeds of trust to investors. This gives the lenders more money to make available to borrowers.

Examining equity

Equity is the amount of money you'd have if you sold the property today and paid off the balance due on the loan. More importantly, as an investor, you can pull equity out of a property by borrowing against it. This power enables you to put that equity to work for you in other investments.



Thanks to the credit crisis in 2008 and 2009, the equity requirements to obtain financing are growing. Lenders are taking a closer look at market values, especially in what they call *declining areas* — areas showing a pattern of recently declining housing values. As an investor, you should be doing the same thing. Be cautious when calculating equity positions and profit margins.



Although we encourage investors to tap the power of equity, keeping some equity in a property (especially the home you own) is a good idea. Having equity to borrow against in the event of a financial setback may save you from foreclosure and bankruptcy.

Looking at loan-to-value (LTV)

The *loan-to-value* (LTV) is the ratio of the total loan amount to the value of the property. If you're buying a \$200,000 home with \$40,000 down and applying for a \$160,000 loan, the LTV would be

$$\$160,000 \div \$200,000 = 80 \text{ percent}$$



Generally speaking, lenders want to see lower LTVs for investment properties than for homes because a lower LTV provides more of a buffer to cover the increased risks inherent in investment properties. Check out Chapter 3 for more about calculating the LTV and how lenders use this number to evaluate risk.

Distinguishing Investment and Home Financing

Your first real estate investment should be your own home. In fact, if you don't own your home, we advise you to put down this book and pick up a copy of *Home Buying For Dummies* by Eric Tyson and Ray Brown (Wiley) first. Owning your own home carries the least risk and the most potential tax benefits while bringing you up to speed on the basics of real estate investing and ownership.

After you've purchased a home, you should have a fairly good understanding of the mortgage loan application and approval process. (We provide a refresher course in Chapter 7.) However, real estate financing differs quite a bit when you take on the role of investor rather than homeowner. You and the lender take on more risk. As a result, you can expect to pay more for the privilege of borrowing money. In addition, your borrowing strategy is likely to change. In the following sections, we cover these differences in greater detail, so you know what to expect before diving in.

Paying a premium for riskier investment loans

When you invest in your own home, you literally have a vested interest in making payments — if you don't, you lose the roof over your head. On the flip side, if you lose an investment property, it may be painful, but it's never *that* serious, and lenders are well aware of the difference. For them, investment loans are riskier propositions. To mitigate the risk, they generally

- ✓ Require a larger down payment.
- ✓ Demand a larger loan-to-value ratio. (See “Looking at loan to value (LTV)” earlier in this chapter.)
- ✓ Charge more interest upfront in the form of points.
- ✓ Charge a higher interest rate.
- ✓ Require proof that you have *reserves* or liquid assets available in case things don’t go as planned.

The actions that lenders take to mitigate the risks and the interest rates and fees they charge vary greatly depending on the borrower and the deal that’s on the table. Just make sure you have all the documentation and figures ready when you meet with your lender for the first time, as explained in Chapter 3.

Using quick cash to snag bargain prices

When you’re shopping for a mortgage to buy a home for your family, you’re usually looking for a low-interest package, no or very few points, and attractive terms. With investment properties, *cash flow* trumps interest rate. In other words, access to cash is often more important than the cost of the loan. To find out more about the relative importance of cash flow and how to shop for loans with the lowest interest rates and fees, see Chapter 6.



If the numbers work, what you pay in interest doesn’t matter. Interest is just another expense. If you subtract all your expenses and can still earn the profit you want, paying thousands of dollars in interest over a relatively short period is acceptable.

Accounting for taxes on your capital gains (or losses)

When buying and selling a primary residence, you don’t have to think too much about the tax ramifications of the transactions. In the United States, a huge chunk of any profit you earn from the sale is usually tax exempt — up to \$250,000 if you own the home yourself or double that if you and your spouse sell the home.

However, when you’re selling investment real estate, any profits are subject to capital gains taxes. During the writing of this book, profits from real estate investments were taxed as follows:

- ✓ **Long-term capital gains:** 15 percent if you hold the property for at least a year and a day.
- ✓ **Short-term capital gains:** 35 percent if you sell the property in fewer than 12 months from the date you purchased it.
- ✓ **Income tax:** If profits from investing in real estate are your sole income, the IRS may consider it your job and tax your profits as income, complete with an additional 15 percent in self-employment tax.



We're not tax experts. Consult a CPA who has experience dealing with real estate investors for details on how the government is going to tax your profits and for suggestions on how to reduce your tax burden. Your measure of success isn't how much you gross but how much you net. By reducing your tax bill, you can significantly increase your net gain.

Protecting your personal assets

Just like most things worth doing, real estate investing exposes you to risk. Perhaps the biggest risk is that you're working with borrowed money from lenders who expect you to pay it back. If you make a lousy investment decision or an investment goes belly-up despite your best efforts, lenders are going to do everything legally possible to collect their money.

You also face the ever-present risk of litigation — having a disagreement with a buyer, seller, tenant, contractor, or someone else that eventually leads to a costly lawsuit.

Eliminating risk isn't possible, but you can take several measures to lessen the risk, including operating through an LLC, transferring personal assets to someone else, or having a qualified attorney cover your back. Check out Chapter 2 for more details.

Exploring Common Sources of Investment Capital

You probably picked up this book because you want to start investing in real estate, but you don't know where to dig up the cash to do your first deal. In the following sections, we show you where to start digging.

Tapping your own cash reserves

If you're single, or you and your significant other are on the same page about this real estate investing thing, cracking into your nest egg to finance your investments may be the quickest way to get your fingers on some investment capital.

It's also the riskiest option, because if anything goes wrong — you get laid off or fired, become too ill to work, or encounter unexpected expenses — you have fewer reserves to keep you afloat. In addition, limiting yourself to your own resources also limits your purchase power — you have to buy houses in a lower price range and may not have sufficient cash to properly renovate the property.



A great way to ruin a relationship is to bet the farm on big profits without the knowledge and complete agreement of your spouse or significant other. If your investment doesn't pan out (and even if it does), the other person may take offense at not being consulted.

Even with these caveats, many beginning investors have gotten their start by financing their own ventures — partially or in full. And you want to know about these resources if you need some quick cash in a pinch.

Clearing out your bank accounts

Having a few thousand dollars socked away in a savings account is always a good idea, just in case you run into a cash flow problem. If that house you bought and fixed up is taking a few months longer than expected to sell, your little nest egg can help cover the payments until you find a buyer.



Use your savings as a reserve, not as your main mode of financing. Having some cash to fall back on can save you in a pinch.

Borrowing against the equity in your home

As your home's value rises and you pay down the principal, you build equity. You can often borrow against this equity by taking out a home equity loan or line of credit and then use the money for whatever you want, including purchasing other real estate. The recent credit crisis has made it harder to find these loans, but they're still out there for well-qualified borrowers.

We don't recommend that you cash out all the equity in your home, but if you have a substantial amount of equity, cashing out a portion of it can help you come up with a down payment or cover the cost of repairs and renovations. (For more about home equity loans and lines of credit, skip to Chapter 11.)

Financing investments through a self-directed IRA

More and more investors are choosing to set up *self-directed IRAs* and other types of retirement accounts that enable them to invest in real estate rather than in stocks and bonds. The reasoning: Real estate often provides a better and sometimes even more secure return on your investment.

With a self-directed IRA, you can buy and sell properties out of your retirement account. Setting up a self-directed IRA, however, is no simple matter. Typically, a trust company manages the money and properties in the account, and all profits and losses from your investments must stay in that account. Withdrawing money from the account results in the same IRS penalties you have to pay if you withdraw money from any type of retirement account.



Consult your financial advisor and accountant for details about using a self-directed IRA to finance your real estate investments. If a self-directed IRA isn't an option, you may be able to borrow money against your retirement account. Keep in mind, however, that borrowing against your retirement savings places those savings at risk, as does any other investment.

Charging expenses on your credit cards

Maxing out your credit cards to purchase a car, clothes, electronics, groceries, and other items that provide no return on your investment is never a good idea. Using your credit cards to purchase investment properties that offer a solid, relatively quick return on your investment, however, can be a savvy (though risky) financial move.



Consider credit cards a last resort to cover the costs of repairs and renovations if financing is tight near the end of a project. With this strategy, your investment activities can directly affect your personal finances, which increases your exposure to risk. For more about this option, check out Chapter 11.

Borrowing from commercial lenders

One of the best ways to finance the purchase of investment properties is to meet with a qualified mortgage broker who can help you find and evaluate various loan programs. These plans are often your best deals — costing the least in upfront fees and interest.

For more about finding commercial lenders, check out Chapter 4. If you're investing in residential property, Chapter 5 reveals the various residential loan programs to choose from. If you're buying commercial property, turn to Chapter 9 for guidance on choosing the right loan program.



Don't confuse "commercial property" with "commercial lender." A *commercial property* is any property that isn't a one- to four-family residential dwelling. A *commercial lender* is an institution (as opposed to an individual) that loans money. In other words, you can use a commercial lender to finance the purchase of residential investment property.

Obtaining a hard money loan

When banks and other financial institutions turn down your requests for investment capital (or you don't have the time to convince them that a deal is pure gold), consider borrowing money from a hard money lender, as explained in Chapter 11.



One of the main advantages of a hard money lender is that the person is likely to accept the property you're buying as all the collateral needed to secure the loan, so you don't have to place your home at risk.

Financing your purchase through the seller

Property owners who are eager to sell and don't need all the cash at once are often willing to finance the purchase themselves. This tactic enables them to profit in two ways — by selling you the property for more than they paid for it and collecting interest from you. Seller financing takes either of the following forms:

- ✓ **Land contract:** A *land contract* is like a mortgage, except the seller acts as the bank.
- ✓ **Lease option agreement:** A *lease option agreement* is like a rent-to-own deal — you lease the property for a specified period, at the end of which time you have the option to buy it.

For more about seller financing, check out Chapter 12.

Taking on a partner

Whenever you don't have something (like money, skills, time, or talent) to accomplish a particular goal, you can acquire those skills, buy or hire them, or create a partnership with someone who already has what you need. If you have something someone else needs and they have what you need, you have what it takes to form a mutually beneficial relationship. For details on how to partner with someone who has the cash you need, check out Chapter 13.



Choose a partner as carefully as you choose a spouse. Partnerships often end when one person scams the other or disagreements arise over who's putting more into the projects and who's getting more out of them. Have your attorney write up a contract, complete with a prenuptial type agreement stating how all the assets will be divvied up in the event that you part company.

Prepping to Meet with a Lender

Walk into a bank empty-handed and explain to the loan officer that you need a loan to start investing in real estate, and we can almost guarantee that you'll be laughed out the door. Before you even think about meeting with a prospective lender, get all your ducks in a row. Copy all the financial documents lenders are going to ask for and construct a fairly detailed plan on how you're going to profit by investing in real estate. This section gives you an overview of what you need to do before visiting your lender. Chapter 4 provides complete in-depth info.

Gathering paperwork and other info

Before approving your request for a loan, lenders want to know whether you're good for the money — how likely you are to make the monthly payments and pay back the loan in full. For investors, this means two things:

- ✓ You're in pretty good financial shape right now and have a fairly clean credit history.
- ✓ The property you're planning to buy is more than worth the money you're borrowing to pay for it, and (if you're going to be renting out the property) it will generate sufficient income to more than cover all your expenses along with the monthly payments.

To verify your creditworthiness for yourself and be sure you have all the documents and other information your lender requires, stuff a folder full of a copy of each of the following items:

- ✓ Credit reports from all three credit reporting agencies
- ✓ A net worth statement (assets – liabilities = net worth)
- ✓ A debt ratio statement (ratio of what you owe to what you own)
- ✓ Last two months' bank statements
- ✓ Last 30 days' pay stubs

- ✓ Last two years' federal tax returns and schedules
- ✓ Statements of any business income
- ✓ Appraisal or comparative market analysis for the property
- ✓ Cash flow analysis of the property
- ✓ Loan-to-value ratio of the property
- ✓ Zoning information for the property's location
- ✓ City and county records for the property

Crafting a business plan

Real estate investors often scoff at the idea of creating a *business plan* — a detailed presentation that shows how an investor plans to purchase a specific property and earn a profit from it. Investors often just want to buy and sell and rent out property and make a lot of money — that's the plan. They don't like to think of themselves as pencil-necked pencil pushers. If they feel in their gut that a property is a solid investment, that's good enough for them.

At least that's the false image that many people have of investors. The most successful investors, however, do the math. They crunch the numbers. And if the numbers don't work, they don't do the deal.



Do your homework. Do a comparative market analysis of the property to make sure it's worth what you think it's worth. If you're buying rental property, check the rental history of the property — the owner's tax records showing income and expenses. Craft a business plan showing exactly how this property is going to be a revenue generator.

Chapter 2

Shielding Your Personal Assets from Investment Risks

In This Chapter

- ▶ Grasping the need to cover your assets
- ▶ Investing as a corporation to reduce your exposure to risk
- ▶ Assigning ownership of certain assets to others
- ▶ Avoiding collateral and cross-collateral damage
- ▶ Dodging real estate and mortgage fraud

Funny thing about lenders — when you borrow money from them, they expect you to pay it back. To ensure repayment of a loan, the lender usually requires that you sign a promissory note and a mortgage or deed of trust. The *promissory note* is your personal promise to repay the loan in full. The *mortgage or deed of trust* names certain property as collateral for the loan.

If you happen to *default* on the loan (fail to make payments as stipulated), the lender has the right to *foreclose* (sell your property to the highest bidder). If the lender can't sell the property for at least as much as you owe on it, it may be able to sue you for the difference (*deficiency*) in jurisdictions that allow deficiency judgments.

As an investor, you want to limit the assets that the lender has the right to seize in lieu of payment. If you fail to make payments on a loan you took out to purchase an investment property, for example, you want to make sure that the bank can't take possession of the home you live in, other businesses you own, or other assets, such as your car. To prevent the lender from going after personal assets and other business assets as payment, you need to *shield* those assets — keep them legally and financially separate from your investment properties. In this chapter, you discover various strategies for doing just that.

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