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The commercial classroom: Buying investment real estate creatively

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Buying real estate investments today must conform with the new underwriting guidelines established since what is now being referred to as the "Great Recession."

Generally speaking you need 30 - 40% as a down payment to finance and have a debt service ratio of at least 1.25. Basically, 25% more cash flow (NOI) than is necessary to repay the annual mortgage debt.

Owners with little or no debt, who wish to sell could "hold paper;" offering to provide a mortgage loan themselves. This gives them several advantages. They may require a smaller down payment that the banks do, perhaps 20% down, in so doing they increase their pool of potential buyers. If the buyer defaults on the loan, they get the property back to sell again. Their capital gains taxes on the sale are spread out over the term of the loan; only paying the tax on the principal collected each year.

Clients who will use the building for their own use (at least 51% owner occupied) may qualify for a Small Business Administration (SBA) loan with as little as 10% down.

Fractional Ownership

Consider Fractional ownership. Multiple investors pool their funds to make one large purchase. For example your client gathers four associates and they each contribute $100,000 to buy a building; each then owns a 20% interest in a cash flow property.

There are also investment companies that buy large parcels of real estate and sell fractional shares. Imagine owning 5% of a $10 million shopping center or office building. These shares are usually in the form of Tenants-in-Common (TIC) or Delaware Statuary Trust (DST), which also makes them eligible for 1031 Exchanges.

Fractional ownership may be relatively simple or quite complicated, depending upon how and who is managing the property. Often these "ownership shares" are considered to be securities sales requiring a securities license to sell them. Make sure your clients check with their attorney and tax advisor if they are considering this.

Self-Directed IRA's

Many people have money in IRA accounts which may be used to buy real estate. There are different types of IRA accounts some restrict one's investments to stocks, bonds and mutual funds. But a Self-Directed IRA is designed to hold alternative assets; primarily real estate. The first step is for your client to speak to the company that services their IRA and find out if they permit a Self-Directed IRA.

When opening a Self-Directed IRA you do not have to close your current IRA. You can transfer as much or as little as you choose to your new account. If you do roll over the entire IRA to start a Self-Directed IRA you can still invest in all the traditional assets you wish. A self-directed IRA has all of the features of a traditional IRA with the added ability to hold alternative assets. Just like a traditional IRA, all appreciation and cash flow are tax deferred. Owning cash flow producing real estate in an IRA, offers a great stream of revenue which generally exceeds what you could achieve investing in annuities or stocks. Today many income properties are generating 7 - 8% or more in annual cash return, plus the long term appreciation in value. What a great way to build up your retirement account.

Another advantage of this type of IRA is that the IRA can borrow money. In other words you provide the down payment from your IRA to buy real estate and get a mortgage for the balance of the purchase price.

Self-directed does not mean you do everything yourself you need to work with a firm that does this, they will provide services as the custodian of your account.

There is quite a bit of technical information in this article, we hope it gets you thinking about creative ideas to share with your clients. Be sure to direct them to the appropriate professional for complete information.

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