CHAPTER 1

Make Money in Short-Sale Foreclosures

To make money in short-sale foreclosures you must first understand foreclosures. Two strategies to make money in foreclosures are *quick cash* and *long-term wealth building.* Some real estate investors employ the real estate investment strategy of long-term wealth building. In long-term wealth building you buy and hold property for income and appreciation. This can be a very effective strategy in areas of the country that experience very high rates of price appreciation, such as California and the Northeast.

Once you invest your money in real estate, however, it can be difficult to liquidate or sell your assets quickly. Because real estate is the biggest-ticket item for most people, there are the fewest number of buyers in the marketplace compared to most other commodities. The quick cash strategy addresses the problem historically associated with real estate investing: the lack of liquidity.

Quick Cash Strategy

To keep yourself more liquid in your investments, we recommend you use a quick cash strategy to make money in foreclosures. Another name for the quick cash strategy is *flipping.* Flipping is the fastest way to make money in real estate. When you flip a property you get in and out of a property in a short period of time.

Investing in foreclosures can be very cash intensive. When you buy a foreclosure on the courthouse steps, you have to pay cash. Usually there are fix-up expenses with foreclosures that require cash outlays. Also, there may be holding costs like mortgage payments, property taxes, and homeowner's association fees. You may have to flip your foreclosure property so you can get your cash out in order to be able to buy another foreclosure deal.

Top 10 Advantages of the Quick Cash Strategy

The quick cash strategy is especially useful for foreclosure investing. We like quick cash because we do not like landlording (we have tried it), we love the art of the deal (flipping allows you to make lots of deals), and we like making money right away. Here are the top 10 advantages for using the quick cash strategy.

10. No Income Tax Problems

One of the major advantages of the quick cash strategy is you avoid income tax problems. When you hold rental real estate it is very easy to recapture depreciation when you sell the property. Current tax law has you paying a 25 percent tax when you recapture depreciation. How easy is it to recapture depreciation? Just own rental real estate and take depreciation. When you sell the property you will recapture the depreciation.

9. No Extensive Record Keeping

When you own rental real estate you must keep extensive records. You will either have a full-time job as a bookkeeper or you will be paying a bookkeeper. You will have rent receipts, security deposit receipts, and check books (notice we used the plural here). You will have checking accounts to reconcile. How about the legal requirement in some areas of having a trust account for tenant security deposits?

You will keep maintenance records. You may have employees, with all the paperwork and tax nightmares that entails. Items such as worker's compensation insurance, unemployment insurance, health insurance, Occupational Safety and Hazards Association (OSHA), Social Security taxes, and withholding federal income taxes. The list goes on and on.

8. *No Lawsuits*

If you own real property, there is a very high probability that you will be sued. You will be sued by one of your tenants, their guests, or by a cutthroat attorney. This is the type of attorney who looks up your real estate holdings in the public record to determine whether they will take a case based on the real estate assets you own that they can go after.

When you own property you become a target for frivolous lawsuits. Some of you reading this know exactly what we are talking about because you have been sued for no apparent reason. We also know that some of you have paid legal settlements just to make the frivolous lawsuits go away.

What is our solution? Do not own real property. Not even foreclosure property. The secret is to control real property and not own real property. That is what the quick cash strategy is all about!

7. *No Homeowner's Association*

If you are, or have ever been, part of a homeowner's association, you know the frustration of dealing with mini tyrants, not to mention the $100, $200, or $300 monthly dues.

Or what about the special assessments for painting, landscaping, or roofing that can run into the thousands of dollars? And, if you do not pay your monthly dues or special assessments, your friendly homeowner's association can foreclose on you and/or sue you.

Homeowner's associations are no longer just attached to condominiums or townhouses. We are seeing an increasing number of maintenance associations attached to planned unit developments (PUDs) and single-family residences (houses).

6. No Repairs and Maintenance Costs

We are sure you have heard the expression *deferred maintenance.* Deferred maintenance is the polite way of saying a property is a fixer-upper. Usually this is because the property owner did not spend any money on regular maintenance through the years. When a property is in foreclosure, you can bet the last thing the property owner will spend money on is repairs and maintenance.

New roof: $7,500. New dishwasher: $400. Gardner: $100 per month. Pool maintenance: $75 per month. Real estate ownership entails significant repairs and maintenance costs. Using a quick cash strategy with property helps you avoid these costs.

5. No Hazard Insurance

No fire insurance, liability insurance, or earthquake insurance. No insurance, period. The last time we checked, any kind of hazard insurance is expensive. And, real estate lenders calculate a monthly insurance payment when qualifying you for a real estate loan, even when you prepay the insurance premium in an escrow account for the next year.

4. No Property Taxes

Depending on your local regulations, you may pay property taxes once a year or perhaps twice a year. In places such as Texas, where there is no state income tax, property taxes can be quite substantial on even modest properties.

For example, on a property valued at $137,000 by the county tax assessor for a particular area in Texas, the annual property tax bill can amount to $4,000! If you calculate that on a monthly basis you are paying $333 a month for every month you own the property.

Monthly Property Taxes

Annual Property Taxes:	$4,000
Monthly Property Taxes:	$333

3. No Monthly Mortgage Payments

Month in and month out, 12 months a year for 30 years. That is 360 payments. Let's look at an example. A $200,000 loan for 30 years at 8 percent interest is payable at $1,467.53 per month, including principal and interest. Multiply the monthly payment by 360 payments and you will pay a total of $528,310.80

Monthly Payments

Monthly Payment	$1,467.53
30 Years	× 360
Total of Payments	$528,310.80

The really nauseating number is when you realize that you originally borrowed $200,000! You wind up paying $328,310.80 in interest. That is 164 percent of the amount you borrowed.

Amount of Interest

Total of Payments	$528,310.80
Amount Borrowed	−$200,000.00
Amount of Interest	$328,310.80

2. No Landlording

There are quite a number of landlording horror stories out there. Do you really think you can be a successful landlord?

Being a landlord is a heartless, thankless job. No matter what you do, you are wrong. Here is a little history with the horror.

Landlording History and Horror Story

Being a lord or a lady of the land has a noble heritage. In olden times there was a symbiotic relationship between the lords and ladies and their tenants. The tenants lived on the lords' and ladies' property, raised their families, and farmed the land.

In return the tenants paid rent to the lords and ladies in the form of most of the crops they grew. There was no money. Or, at least, most people did not have money, like the tenants, because there were no jobs. Everyone's job was working the land.

Unfortunately, this romantic symbiotic relationship from the Middle Ages has been shattered by the realities of today's world. As a landlord you are a target for other people's problems. As a target you become the recipient of a lot of crap. Here are some horrors. (We have so many.) Concrete in the toilet. Concrete in the kitchen sink. Concrete in the oven. Which one would you like to hear? On second thought, we think we will pass. Too many bad memories. Bottom line, we recommend you avoid landlording.

1. Quick Cash

The number one advantage of the quick cash strategy is quick cash. Cash is king! Long live the king! The problem with real estate investing for most people is that it takes far too long to make any money. Yes, we know that if you bought a two bedroom/one bathroom home in Anywhere, California, in 1968 for $20,000, like our friend John did, you would be sitting on a property worth $1 million today. But who has the time or the patience to wait? We do not; do you?

Flipping is your answer. When you are a real estate investor whose strategy is quick cash, patience does not have to be one of your strengths. In fact, being impatient becomes one of your strengths! You become impatient with the deal you are working on and want to get it done so you can get on to the next deal. The more foreclosure deals you get involved with, the more money you will make.

Long-Term Wealth-Building Strategy

We know some of you will prefer using a long-term wealth-building strategy to make money investing in foreclosures. Another way to describe the long-term wealth-building strategy is buying and holding property for income and appreciation.

Top 10 Advantages of Long-Term Wealth Building

We are going to give you the top 10 advantages of using the long-term wealth-building strategy. The long-term wealth-building strategy is also useful for foreclosure investing. Although we prefer the quick cash strategy, you may want to buy and hold your short-sale foreclosure properties. This may be dependent upon in what area of the country you are making your investments.

10. Depreciation

There are income tax advantages for real estate investors who materially participate in the management of their rental properties. You are able to take depreciation on the improvements and use this depreciation to offset the income the property produces.

Let's say you receive $1,300 in monthly rent for 12 months. This is $15,600 in yearly income. If you are able to take $10,000 in annual depreciation, then you will only have to pay taxes on $5,600 in yearly income.

Yearly Income	$15,600
Annual Depreciation	−$10,000
Taxable Income	$5,600

9. Rehabbing

Rehabbing can be an important component in the value of a property. Real estate investors who rehab a foreclosure property contribute not only to their own bottom line but also to the value of the surrounding community.

A property that is rehabbed generates $2 to $3 for every dollar spent rehabbing when you sell the property down the road. If you put $20,000 into rehabbing a property, you can count on a $40,000 to $60,000 value increase as long as you stay within market values for the area in which the property is located.

Rehab Amount	($20,000)
Value Increase	+$60,000
Profit	$40,000

8. Deductibility of Property Taxes

All of the property taxes you pay on the property are tax deductible. When you pay the property taxes, you are able to use this to offset the income the property produces.

Let's say you receive $1,300 in monthly rent for 12 months. This is $15,600 in yearly income. If you pay $5,000 in property taxes, you will have to pay tax on only $10,600 in yearly income.

Yearly Income	$15,600
Property Taxes	−$5,000
Taxable Income	$10,600

7. Deductibility of Mortgage Interest

All of the interest you pay on the mortgages you used to purchase the property is tax deductible. You are able to use the mortgage interest you pay to offset the income the property produces.

Let's say you receive $1,300 in monthly rent for 12 months. This is $15,600 in yearly income. If you pay $8,000 in mortgage interest, then you will only have to pay tax on $7,600 in yearly income.

Yearly Income	$15,600
Mortgage Interest	−$8,000
Taxable Income	$7,600

If we put depreciation, property tax, and mortgage interest deductibility together from our examples, we would have $10,000, $5,000, and $8,000 respectively. This totals $23,000.

Annual Depreciation	$10,000
Property Taxes	$5,000
Mortgage Interest	+$8,000
Total Deduction	$23,000

This easily offsets our $15,600 in rental income. In fact, the $7,400 excess deduction may be used to offset other income. Check with your tax adviser.

Yearly Income	$15,600
Total Deduction	($23,000)
Excess Deduction	($7,400)

6. Long-Term Capital Gains

You receive long-term capital gains tax treatment for property held longer than one year. This can be a huge tax savings compared to being taxed at ordinary income tax rates. Comparing an ordinary income tax rate of 28 percent with a long-term capital gains rate of 15 percent, you can see that you practically cut your tax bill in half.

Let's say you have a profit of $50,000. At a 28 percent ordinary income tax rate you would pay $14,000 in income tax. At a 15 percent long-term capital gains rate you would pay $7,500 in income tax. You save $6,500 in taxes.

Ordinary Income Tax Rate (28%)	$14,000
Capital Gains Tax Rate (15%)	−$7,500
Tax Savings	$6,500

5. 1031 Tax Deferred Exchanges

You can defer income tax consequences by doing a 1031 tax deferred exchange. Even with favorable long-term capital gains treatment, your tax bill can still be quite substantial.

Let's say you have a long-term capital gain of $200,000. At a 15 percent long-term capital gain tax rate, your tax bill will be $30,000 if you sell the property.

Long-Term Capital Gain	$200,000
Long-Term Capital Gains Tax Rate	×15%
Taxes You Owe	$30,000

By doing a 1031 tax deferred exchange you will defer having the $200,000 long-term gain recognized. Because the gain is not recognized, there is no tax consequence to you at the time of the sale. You have an additional $30,000 in your pocket to make another real estate investment.

4. Economies of Scale

A nice advantage of long-term wealth building is being able to use the economies of scale as a landlord. When you have accumulated 5, 10, or 15 properties, you can begin a cookie-cutter property management style.

If there is a sale on paint, you buy paint for all your properties. If there is a sale on carpeting or flooring, you buy carpeting or flooring for all your properties. By buying in bulk you save money. It is like buying wholesale instead of retail.

3. Cash Flow

People who use the long-term wealth-building strategy want to build in cash flow for any properties they are going to keep. Cash flow contributes to your overall bottom line.

When your income exceeds your expenses, you have positive cash flow. This is a good thing. When your expenses exceed your income, you have negative cash flow, which is, of course, a bad thing.

2. Appreciation

When the market is hot, the market is hot! Like our example of the two bedroom/one bathroom home in Anywhere, California, that our friend John bought in 1968 for $20,000 that is now worth $1 million. Every real estate market appreciates. Some markets appreciate at a much higher rate than others. Take a look at the net differences between these various market appreciation rates.

If you are in a market that appreciates at 4 percent annually, property values will double every 18 years. If you are in a market that appreciates at 7 percent annually, property values will double every 10 years. If you are in a market that appreciates at 12 percent annually, property values will double every six years. Consider what your investment goals are when choosing the market area for your long-term wealth building.

1. Long-Term Wealth Building

The number one advantage of the long-term wealth-building strategy is long-term wealth building. You are building a future nest egg by using this strategy. By holding property, you are compounding your equity year after year without any income tax consequence.

Although the quick cash strategy brings you quick cash, unless you are disciplined enough to save or reinvest some of your quick cash, it will disappear as quickly as it came. The future is going to come no matter which investment strategy you choose. You have to decide if long-term wealth building or quick cash will work best for accomplishing your real estate foreclosure investment goals.

We are now going to get into the foreclosure arena. Starting from the basics, we will show you how to apply the quick cash or long-term wealth-building strategy to your foreclosure investing. For those of you who are knowledgeable about foreclosures, we recommend you go to Chapter 3, "What Is a Short-Sale Foreclosure?" For those of you who are new to the foreclosure game, we recommend you read straight through the book, continuing with Chapter 2, "What Is a Foreclosure?"