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What Real Estate Investors Should Know About Local Customs

By David V. Tran

As a commercial real estate investor, there is a good chance that you will invest in a property located in another state in which local customs may be very different from where you live. Knowing some of these customs may help you avoid mistakes that may cost you money. While people often say when you are in Rome, do what Romans do. However, there is often disagreement about whether the seller or buyer is in Rome. This article discusses some of the common customs that you should know. It may or may not explain why these customs are what they are which could be a very long story.

Independent Consideration

You often see this independent monetary consideration in contracts in Texas (TX), Georgia (GA), and North Carolina (NC) but not in California (CA) where love and affection are acceptable consideration. Listing brokers in these states often insist that you pay the seller $1000-$5000 as independent consideration for the right to cancel the contract during the typical 30-day due diligence period. As an out-of-state investor, you have to pay for air fare, hotel, food, and car rental to visit the property as part of your due diligence. So if you decide that the location is not as good as it appears from satellite map or whatever reasons, it does not make sense to pay another $1000-5000 to cancel the contract. While the law in these states requires an independent monetary consideration, it does not say what that amount must be. So you should pick $10 as independent consideration to make the contract legal.

Nonrefundable Earnest Deposit

In CA, there is no such thing as nonrefundable deposit per a CA court ruling. Most if not all real estate contracts in all states have a paragraph addressing damages due to contract breaching by either party. This is often sufficient. However, some listing brokers and sellers outside of CA often insist that all the earnest deposit "going hard", i.e. becoming nonrefundable and released to the seller, after the expiration of due diligence period. While the purpose is to make sure you think twice about breaching, it could be difficult to get any of earnest deposit back if

- You, for unforeseeable position, e.g. hit by a truck or have a heart attack and go to heaven or wherever, cannot close the transaction.
- The property is partially damaged, or even burned down by arson.

The seller spends it all and your loan is not approved due to soil contamination discovered later on!

You are in a bad position to negotiate with nothing to offer when the money is in possession of the seller. It is therefore advisable to keep the deposit in escrow until closing. However, sometimes you have to make a tough choice, especially when there are multiple offers so you can buy a desirable property.

Property Taxes

In CA, the property is automatically reassessed at the purchased price. The property tax rate is about 1.25% of the purchased price. Due to the Proposition 13, property taxes can only increase by a small percentage annually unless there is change

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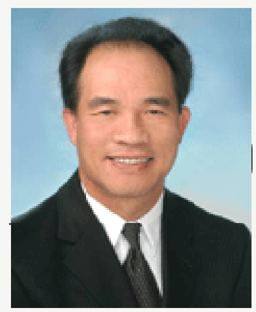

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in ownership.

In TX, the property tax rate is about 3% of the assessed or taxable value. However, the taxable value may or may not be the purchased price which is often higher. If the higher purchased price is reported to the county then you will pay property taxes based on the higher purchased price. So it's a good idea not to report this higher purchased price since you are not required to disclose it. Lately in TX, the local government tries to raise revenue by aggressively reassess the property values. The new assessed value could be significantly higher than, e.g. 100% higher than the old assessed value. Should this happen to your property, you may want to hire a professional company to protest this property taxes increase even on a property with NNN leases. The success rate appears to be fairly high. As an investor, it's wise and prudent to keep the NNN expenses as low as possible for your tenants. You definitely want your golden goose to keep laying eggs.

In Florida, there is a monthly state sales tax for commercial properties, so make sure you know who is supposed to pay it.

In Cook County, Illinois, the property taxes rate is fairly steep at about 9% of the assessed value. The property taxes for the current year are also not due and the amount is not known until next year. And so, per local custom the seller normally will give buyer credit for property taxes for the current year equal to 105% of the most recent taxes bill.

The property tax rate for NC is about 1.45% of the taxable value which is determined by the assessor once every 8 years.

Attorney States

In CA, an escrow company can handle the closing of a real estate transaction. In GA, FL, or NC, escrow companies can only hold the deposit for you and you must hire an attorney licensed in that state to do the closing. These states are often called "attorney states". The proponents say that a real estate transaction is very complex so it must have an attorney to assist you. For opponents, it's all about job security for lawyers! If you invest in a property in an attorney state, you want to hire an attorney who charges a flat fee since the amount of work is very much predictable. You will receive an estimate based on what you need the attorney to do. He or she won't start working until you authorize him or her in writing to do it. The attorney will review all the documents and give the blessing before you sign them. It is advisable to avoid an attorney who charges you by the hours. Most likely you are dealing with a lawyer looking for a big pay day!

In CA, the buyer automatically receives the Preliminary Title report which shows the owner and various information, e.g. liens and loan amount on the property. If you cancel the transaction, you normally don't pay escrow any fees. In attorney states, the attorney will do the title search and review. The title company then issues a title commitment to insure against any title defects. Should you cancel the transaction, the attorney and Escrow Company may charge a fee for the work done.

Closing Costs

When you make an offer, you often state that buyer and seller split closing costs based on the custom in the county where the property is located. In CA or TX, the sellers customarily pay for owner's title insurance premium based on the purchased price which guarantees the buyer of a clear title (technically you should not have to buy owner's title insurance when you refinance the property because the title was already insured when you bought the property.) The buyer pays for the lender's policy premium based on the loan amount. This lender's policy is required by the lender to protect it against losses resulting from claims made by others against the property. Of course, if you pay cash for the property then there is no lender's policy. However in GA and TN, it's customary for the buyer to pay for both owner's and lender's policy. There is often transfer taxes paid to the city or county. The city of Chicago probably highest transfer taxes rate in the nation: $10.50 per thousand in which the seller pays $3 and buyer $7.50 per local custom.

Deeding Instruments

In CA, the sellers often transfer his interest to the buyers by a grant deed. In other states, the seller will transfer his interest to the buyer by a general or special warranty deed.

- General warranty deed is used to convey the seller's interest in real property to the buyer. The seller certifies that the title on property being conveyed is free and clear of defects, liens, and encumbrances. The buyer may sue the seller for the damages caused by the defective title.
- Special warranty deed is also used to convey an interest in real estate. However, the grantor does not warrant against the defects arising from conditions that existed before he/she owned the property. So the special warranty deed is not as good as the general warrant deed. And so most sellers will use special warrant deed to limit their liabilities.