Topic No. 12: Step 8 - Financing The Build Job

Topic objective: To educate home buyers on the advantages and disadvantages of the different types of construction loans.

Two factors should be considered when deciding what type of loan to use to finance the building of your new home. How can non-refundable earnest deposits be avoided? How can costs associated with the loan be reduced? Both questions can be answered by exploring the use of a "construction perm loan."

When securing a construction perm loan, the buyer closes on the loan and purchase contract before any construction begins. With this type of loan, the buyer purchases the lot, financed by the loan company. The builder then builds the home as the specifications state. The loan company pays the builder as certain phases of the construction are completed. During this process, the buyers own the lot and the home as it is being constructed. When the builder presents invoices for completed work, the loan manager and buyers will review the completed work and approve payment of the invoice. When the project is completed, the appraiser will visit the site to ensure all work specified in the contract has been completed. A final meeting is held with the builder and loan manager to close out the contract and the loan.

During the construction phase, the buyers pay interest on the money that was used to pay for the lot and invoices. When the project is completed, these costs are rolled over into the loan, which will be amortized over 15 to 30 years.

The advantages to the construction perm loan are:

1. The buyer does not risk the loss of any non-refundable earnest money.
2. There is a savings of costs associated with financing the building.
3. The buyer may incur additional finance charges that can be deducted on their personal tax return.

The savings on loan costs result from the builder's avoidance of closing on a loan to finance the purchase of the lot and the building project. In addition, buyers will generally get a lower interest rate than builders would, which results in additional savings. While some buyers may choose to claim these financing costs during construction as a deduction, the Internal Revenue Service may reject these deductions.

The disadvantage to the loan is, the builder may delay construction to work on other building projects to cut costs on projects he is financing. To avoid delays and additional financing costs, the buyer will need to include a clause that will require the builder to reimburse the buyer for all financing costs beyond a mutually agreeable date.

If the buyer chooses to use the construction perm loan, the agent will want the builder to provide a contract price with the builder financing the project and another price with the buyer financing the building. When a builder finances construction, they will normally require non-refundable earnest deposits ranging from five to 10 percent of the contract costs. When this happens, if a builder collects this money and goes bankrupt or leaves the project prior to completion for some other reason, the buyers will have a difficult time recovering their earnest deposits. Very few builders will carry performance insurance coverage. The only recourse the buyers may have is to take the case to court, which is very costly, and there is no guarantee that all costs will be recovered.