INVESTOR'S LOAN GUIDE

A beginner's Guide to understanding what it takes to secure investors loan in today's lending environment.

By: Graham W. Parham

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A Beginner's Guide to Understanding what it Takes to Get a Loan in Today's Lending Environment.

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Introduction

My goal in writing this book was to share with new investors as well as seasoned landlords what takes to secure loans for 1 to 4 properties. I have been originating loans since 1997 and have focused strictly on investor loans since 2000. The lending world has changed quite a bit over the seven years, especially since the mortgage meltdown of 2008. Before the meltdown, obtaining loans for investment properties was much easier. The lending guidelines were not as tight as they are today and lenders were doing everything they could "To Do" loans for investors versus everything they can "Not to Do" loans.

Today most investor loans for 1 to 4 family properties are typically underwritten in accordance with Fannie Mae and Freddie Mac guidelines. Some lenders will put their own overlays in their guidelines depending on their flavor for risk. Most lenders view the non-owner occupied category for 1 to 4 lending as a "Hot Potato," which means they are red flagged immediately by most underwriters. The key is working with a loan originating company that embraces non-owner occupied loans.

Since 2008, the lending guidelines have become stricter for many reasons. Once the subprime and alternate lenders (Wall Street) were eliminated, the only way to get an investment property loan was through Fannie Mae or Freddie Mac. A good example is the number of loans that Fannie Mae and Freddie Mac would allow per borrower. For years they allowed borrowers up to 10 loans until the mortgage meltdown. Both reduced the number to 4 per borrower. Because of the demand for multiple loans per borrower, Fannie Mae chose to take that limit back up to 10. Many lenders will still only allow up to 4 loans per borrower in their underwriting guidelines. Once again the key is working with an originating company that delivers their loans directly to Fannie Mae which allows them to increase that number to 10.

In 2010 the Dodd-Frank Act was introduced to provide stricter guidelines for the loan originators. In January of 2014, the last component of the Dodd-

Frank bill was introduced with even more restrictive guidelines for lenders to perform in this marketplace. The term "Ability to Repay" has created more restrictions and greater liability for loan originators. Investors who are purchasing these loans on the secondary market through Fannie Mae and Freddie Mac are more cautious about making sure the loans are originated properly. What that means to the consumer is that we have gone from a fully documented loan originating process to an overly documented process. It seems like the secondary market has become so critical on all loans it makes the originator's job three times as hard to provide the documentation needed to satisfy these loans. In my opinion, these investors are asking for ridiculous things where two years ago they would have never asked for them.

The main reason for me writing this book is to let investors know that we are still providing loans for your portfolio needs. Are the loans just as easy to get as they were before 2008? NO, but we are still issuing loans. What most consumers don't realize is the amount of paperwork required from them as borrowers, and how the process has become more cumbersome than ever before. My goal as a loan originator is to educate my borrowers on what it will take from them to finalize the loan process. Good loan officers normally think like underwriters. This helps in the preparation process for the borrower to determine what items will be needed for the loan file. Even the great loan originators can never be exactly correct on what documents will be needed and what documents the underwriter will be wanting. After the gathering stage of information, the loan is turned over to the processor. They, in turn, will review the documentation and probably asked for more. Their job is to present the loan in such a way that the underwriter will understand every part of the loan without asking questions. Even the best processor strives to achieve a complete loan packet prior to submitting to the underwriter.

The underwriter's job is to review the file, perform a quality check, and to make sure that it is underwritten in accordance with the market requirements. With the ever-changing world of tolerances in the secondary market, guidelines are constantly being updated to adhere to this demand.

As much as I try to explain the requirements of what it takes to get loans in today's world, the consumer still doesn't understand why we do the things that we do. Hopefully, this book will help you understand what it takes to deliver these loans into the secondary market.

Why Should I get a loan for my Investment Property?

It depends on your short and long-term goals. Many people feel paying cash is the best option when investing in real estate, but when you get a loan on the property, you increase your returns substantially. The more leverage you use, the more properties you can buy. Leverage is the key when buying investment properties. Leveraging means you are not paying cash for the property, but using other people's money in order to use less of your own.

Why is Your Return Better when using Leverage?

The investors that pay cash for investor properties think their cash flow will be greater each month. This part is true, but let me show you how paying cash for one property versus getting loans on all five properties with a 20% down. (*See Down Payment Options*)

The key to investing your money is to know how to make it work for you in addition to obtaining the highest possible yield from your investment. Many investors look at their investment in several different ways. Some use the cash on cash method, others use the return on investment calculations, and some only look at cap rates. Yes, there are several ways to evaluate your investment. You have to use the one that you feel comfortable with.

What is an Investment Property Loan for Residential Properties?

Residential loans are designed for properties that provide housing for individuals and families that have four units or less on the property. These properties generally follow the same guidelines as a typical home mortgage with similar qualifying standards and processes. I will point out some guideline standards later on in the book.

What Types of Loans are Available for Residential Mortgage Lending?

Conventional Loans

Conventional lending is the most popular source for mortgage lending in today's 1 to 4 unit properties. Conventional lending can be either conforming or non-conforming. If it's conforming, it will be for an amount under a specified maximum. In most areas, this is $417,000 for a single family home, but the amount is higher in certain areas, like Hawaii or metropolitan cities. When you are purchasing a multi-family property will graduate up to $625,500. Non-conforming mortgages are for higher amounts usually called a jumbo loan.

The biggest difference between a conventional mortgage and other mortgage programs is the required down payment. Government-backed mortgages have low down payment requirements to help home buyers move into a primary residence. For example, you could get an FHA mortgage with just 3.5% down and a VA mortgage with no down payment. Banks have different requirements for the down payment on a conventional mortgage ranging from 3% to 20%. For investment property loans FHA or VA does not offer a non-owner occupied programs. Occasionally loan servicers that are reselling a previously funded VA loan that was inherited through foreclosure will offer a qualifying assumable option to investors to purchase that property. These types of transactions are very few and far between.

Most of your 1 – 4 unit property transactions are typically sponsored by Fannie Mae or Freddie Mac.

Portfolio Loans

Before the mortgage crisis of 2008, there were many portfolio lenders in the marketplace offering non-prime loans to investors. The most famous product that many seasoned investors utilize was the "Option Arm." The Option Arms typically offer a lot of flexibility from the standpoint of payment options as well as qualifying options. Many say that the Option Arm was abused in many ways which allowed loan officers to put families into homes that they really couldn't afford. This part is true in some cases, but for investors, it made a lot of sense on paper because of the flexible payment options. With the new Dodd-Frank Act in place, portfolio lenders were forced to eliminate these products.

Portfolio lenders act very much the same way as your normal conventional lenders, but with different guidelines. Most all their loans are underwritten manually. They do not rely on Fannie Mae or Freddie Mac's underwriting engine to approve their loans. Each loan is examined differently to make sure the loan falls within the portfolio guidelines. These lenders do have a niche in the marketplace because sometimes these loans do not fall into the normal conventional guidelines. These are not subprime lenders but make sense lenders. Their down payment and loan terms requirements may vary as well as their credit requirements.

Private Money Loans (Hard Money)

Private mortgages provide investors substantial returns at interest rates that are compounded several times annually. The rates on these types of loans are much higher than that of the traditional conventional loan, not to mention the upfront cost. Private mortgages (also called "Hard Money Loans," trust notes, private notes, etc.), are in my opinion, much safer than paper investments because they are secured by real property. I have personally seen settlement statements where hard money lenders that charge four & five points upfront at closing with interest rates anywhere from 10% to 20%.

It is completely legitimate for an individual to offer a private mortgage for a home purchase giving a buyer a non-bank option for financing. Many rehabbing companies will take advantage of hard money because of the short-term nature. It allows a rehabber to purchase the property and roll in the closing cost in addition to the rehab cost. Once the rehab is done, the property is sold for a profit, and the hard money loan is paid off. Traditional lending is

focused on the long-term loans, where private moneylenders can get a much higher interest rate and higher cost for easily accessible money to conduct their business on a short term basis.

Some of the main reasons why investors use hard money are that underwriting will not be as rigorous as conventional lending. However, in this new era of "The Ability-to-Repay," banks and mortgage companies are refusing more borrowers than ever before. These home buyers are coming in droves to private lenders to find the private mortgage they need to buy a home. Even though hard money loans are extremely expensive, they do serve a purpose in today's lending community.

Non-Recourse Loans (IRA Loans)

A non-recourse loan does not allow the lender to pursue anything other than collateral. For example, if you default on your non-recourse home loan, the bank can only foreclose on the home. They generally cannot take further legal actions against you. The bank is out of luck, even if the sale proceeds do not repay the loan. Most investors would prefer using a non-recourse loan over a recourse loan simply because of this fact. With both types of loans, the lender is allowed to seize any assets that were used as collateral to the secure loan.

The most popular type of nonrecourse lending for the 1 – 4 family property category is a self-directed IRA. Self-directed IRAs can purchase investment real estate as another form of tax-sheltered retirement investment. The IRS requires non-recourse loans for all real estate purchases that use leverage from within their self-directed IRA. Many investors will use their IRAs to purchase real estate in today's market. Some use self-directed IRAs to purchase real estate because they can't qualify in the traditional conventional lending. It could be for the fact that their credit profile does not meet today's standards or they've maxed out on the number of loans that Fannie Mae or Freddie Mac will allow. Specialty lending companies that support self-directed IRA transactions for real estate will require you to set up a separate entity into an LLC for each of property. These lenders will approve the loan the same way commercial lenders do which means they are underwriting the property more so than the borrower. Non-recourse loans typically require a larger down payment and a much higher interest rate. Even though the rates are higher than what they can get on the conventional side, it is still not as difficult as private money lending. Many real estate investors that utilize self-directed IRA's typically will have a shorter business plan and earlier exiting strategy, typically 5 to 7 years.

Getting Started with Investment Property Lending

So you choose to buy an investment property to enhance your overall retirement portfolio. Once you have decided on what type of investment property, now it's time to get your financing in place. Whether you are a first-time investor or a seasoned landlord, the mortgage process can seem a bit daunting with many lenders. At The Parham Team, we strive to provide you with the most upfront information required to make the best choice for your lending needs.

Since the mortgage meltdown of 2008, many lenders have closed their doors because of the demands that are required from loan originators. Lenders have found that delivering loans in today's secondary market can be very difficult and quite costly. Many lenders have created their own set of guideline overlays for their non-owner occupied loans which makes it very difficult to obtain loans with their firm.

The Application

The first step in the loan process is for me to obtain a loan application from you. Many of our investors choose to use the online application which is safe and secure. Others may choose to have the application information taken over the phone.

The Documentation Stage

Once we receive the application, our team will reach out to the borrower to verify accuracy and to discuss all phases of the transaction. We will provide each borrower their own unique documentation list that is required for underwriting purposes. The list will be sent via email. We recognize in today's world that borrowers are looking for a safe and secure environment to provide their private information. We understand this at The Parham Team. You can scan and email the documentation, fax all the documentation to our safe and

secure direct fax, or upload all the documentation to our loan originating system that is provided to them by our company.

Yes, I know you will hear me say this several times throughout the book, but things have changed since 2008. We've gone from a "No" documentation process to a streamlined process, to a fully documented process, and now to an overly documented process. This is a part of the transaction that you will wonder if it's even worth doing a loan. Why? Because all originators in today's lending world that deliver loans to Fannie Mae and Freddie Mac are required to get more documentation than they ever have before.

Sometimes I wonder if we are loan originators or loan valuators. It seems like we have to prove more about the borrower's personal assets and income which can be very offensive to them. We may request from some borrowers additional documentation 3 – 4 times during the loan process. It is the processor's job to provide a complete loan file to the underwriter. They are always going to have their own opinion about the documentation that is currently in the file and potentially request more.

Once the underwriter reviews the file, 99% of the time, they will also be requesting additional items that were never in the file. This is real-world "Guys." Take it or leave it. If you have an open mind going into the loan process knowing that additional items can be asked for many times over. It is not as if we are trying to make your life difficult but to make sure we have a complete loan to deliver to the secondary market. If the underwriter does not validate all of the information required and we fund and sell the loan into the secondary market, the investors buying these loans can easily send it back to us requesting those items again. It's not a fair world that we live in, but is, unfortunately, the way it is until underwriting guidelines loosen up again.

Here is a detailed list of documents that you will need to provide to your loan originator when applying for the mortgage loan on your investment property. Some may apply to you; some may not. We at The Parham Team will make that determination.

Employment / Income

- Employment history for the last two years (address any gaps of employment).
- Copies of paycheck stubs for the last 30 days (most current). *The two most recent are required if borrowers are paid weekly, bi-weekly, and monthly. It just depends on the individual(s)*.
- A copy of the most recent **complete** signed 1040 Income Tax Returns with W-2's, and/or 1099's for most recent two years filed (All Schedules including K1's if applicable.) If real estate property is titled in an LLC. Limited Partnership, or S-Corp, please provide separate tax returns.
- If you have filed an extension on your recent tax filing, then provide a copy of the extension, proof of any tax payment, and provide the last two completed tax returns filed instead.
- If receiving social security income, please provide the current year's award letter showing future payment installments.
- Any pension income, please provide documentation to support future payment installments.

Self Employed Borrowers

- A copy of the most recent **Complete** signed 1040 Income Tax Returns with W-2's, and/or 1099's for two years (All Schedules including K1's if applicable.) If real estate property owned by an LLC, Limited Partnership, or S-Corp, please provide separate tax returns.
- If your business is incorporated, please provide the last two years of 1120's tax returns. (ALL PAGES)
- A copy of corporate/partnership tax returns for most recent 2 year period if owning more than 25% of the company -- copies of W-2's and/or 1099 forms.
- A copy of current profit & loss statement and balance sheet for the current year.

Assets to Close

- 2 months statements for ALL Bank Accounts, Investment, and Retirement Accounts. If quarterly, 1 statement required. (All pages of each statement). If it is an internet print-off, the statement has to include, the borrower's name(s), institutions name, account balance, and account number or an abbreviation of the account number.
- If using funds from a joint account with anyone other than borrowers on the loan application, an access letter will be required the joint account holder.
- If using a business account for the funds to close, please provide 12 months of account statements (Subject to Underwriter approval).
- If using funds from an H.E.L.O.C account, please provide a paper trail from withdrawal to deposits of funds into liquid accounts with ending balance.

Documents that may be required

- Relocation Agreement if the move is financed by the employer, i.e. buyout agreement, plus documentation outlining company paid closing costs benefits.
- If you're currently renting provide your landlord's name, phone number, and address. If you live with a family member, please have a letter stating that you live rent-free.
- If you own any real estate that does not have an escrow account for taxes and insurance for the loan servicer or if the property is free and clear, please provide the annual tax, insurance and any HOA statements for that property.
- If Homeowners Association Dues are excluded for any property owned, please provide a signed letter of explanation stating there are no HOA dues on the property.
- If you have had a bankruptcy in the last 7 years, we will need copies of the petition for bankruptcy and discharge, including supporting schedules. (All pages including the Judge's signature page)
- A **COMPLETE** copy of the divorce decree showing any alimony or child support obligations.
- If you want the property to be titled in your family trust, please provide **ALL** pages of your trust agreement.

- If you have student loans that have been consolidated, please provide updated balances and payment requirements.

Personal Identification

- A Copy of your Driver License
- A copy of your Permanent Resident Alien Card or Work Visa
- Social Security Card

Documentation for Investment Properties

- If doing a 1031 Exchange, please provide the sell HUD(s) and all documentation from the exchanger including the sales contract on the sold property, and warranty deed
- Current lease agreement on subject property
- All lease agreements, HUD's, tax, and insurance information on any property acquired that is not listed on your recent tax returns in Schedule E.

Processing

Now that you have the general list as a guideline let me go into greater detail about some of the items that processors and underwriters will be asking for over and beyond what is shown on the list.

Salaried Paid Employees

For that W-2 salary paid borrowers, income documentation may be simpler but different from a self-employed borrower. For years we would ask for pay stubs, and W-2's and that was all. Today we are asking for two years of W-2's and 30 days' worth of pay stubs, in addition to the last two years of the 1040 personal tax returns. But why? All lenders are required to submit signed 4506T IRS transcript request from to the Internal Revenue Service to validate the last two years of reported income for the borrowers. Even if the transcripts are off $10 compared to the tax returns and supporting W-2s, the numbers still have to match for the underwriter to approve the loan.

What would cause that? An incorrect filing on the accountant's part is typically the main one. Some borrowers have amended taxes even after they are submitted on or before April 15. The main reason why we get the complete 1040 tax returns from all borrowers is they probably did not realize that they had additional schedules that were completed by the accountant for various reasons, i.e. capital gains, unreimbursed business expenses, inheritance, etc. It's better to provide the complete 1040 tax return up front just in case something like this happens. This will save everyone a lot of time.

Self-Employed Borrowers

Self-employed borrowers are those individuals who own their own business. From that standpoint of tax returns, self-employed individuals will claim most of their income on Schedule C of the 1040 tax return unless their business is incorporated. Most schedule C borrowers typically are categorized as sole proprietors. Others choose to file Schedule C because they have not incorporated their business. Some schedule C borrowers may have a family-owned business, and the income is divided proportionately between each family member. If the borrower has more than 25% ownership of the business, it is required to get a copy of the business tax returns as well.

Most schedule C borrowers will typically wait until April 15 to file their tax returns, and it is more than likely they will have to pay the IRS. Schedule C borrowers try to maximize their tax advantages and write off as much as they possibly can for their business. This can create a double-edged sword when it comes to lending. What that means to you as a borrower is all lenders look at the net-net earnings of schedule C borrowers and not just the gross amount. If your expenses far exceed your gross receipts, chances are you'll have a negative income.

For those borrowers that have incorporated their company and the company is paying them a salary this doesn't mean that the gross income from the salary will only be counted as income. If the business is established, the lender will want to see a copy of the business returns, hopefully, the last two years. The lender will also take into account if the business is running in the red or the black. If the business is running in the black then yes, the W-2 salaried income will be counted in full, but if the business is running in the red (at a loss), then the differential of the company's loss of income will be subtracted from the W-2 earnings. Keep in mind this is for those who are self-employed that has more than 25% ownership of the business.

For those borrowers who have a small interest in certain companies as part of their portfolio typically will receive a tax statement at the end of the year referred to as a K-1. The problem with K1's is that they always show up much later than the required W-2s or 1099s. Because of that fact, this will delay the filing of your tax return. Once all the K1's have been accounted for, the information is filtered into your tax returns typically through Schedule E. The problem with that is you could probably have 10 to 20 different small K1's from portfolio investments which attributed to income for that year. In today's lending world the underwriter will want to see every K-1. Yes, every K-1! This is just part of the accountability that originators have to go through to make sure there's no additional liability associated to each of the K1's through the percent of ownership. If any of the K1's represents the borrower owning 25% or more of the business, then yes we have to get that company's tax returns as well.

As you can see for most borrowers who are self-employed, there's a lot of moving parts that have to be accounted for. Lenders asking for this type of information will drive the impatient borrower crazy. A piece of advice: just be prepared and be patient.

Social Security and Retirement/Pension Income

Yes, many people that are retired still want to invest their money in real estate. Just because they are on a fixed income does not mean they cannot qualify for an investment property loan. It's very simple. We use the same math for all borrowers by dividing their liabilities into their income to make sure they fit the qualifying ratios.

Social Security recipients are sent an award letter every January outlining their upcoming year's payment contribution. All we need from the borrower is the award letter and two months bank statements showing the direct deposit of these benefits. We also will gross up their monthly income by 125% to show a higher gross income. This is a benefit that has been recognized in the industry for years but also applies to child support and alimony. When validating retirement and pension income, we obtain a copy of the document provided by the company issuing these funds showing that the borrower will receive a continuance of these funds for at least 3+ years. Most of the time these funds are direct deposit, so two months bank statements showing these deposits will be enough for the underwriter to make a decision.

Once our setup team has completed their review, they will order out to third-party vendors for appraisals, title work, homeowners insurance, tax transcripts (4506T) and surveys for those states that require a plat survey. At this point, the processing task will begin. The processor's job is to put together a complete and accurate loan file for the underwriters to review.

Once we receive the appraisal report, the title commitment, and an insurance binder for the property the loan file will be submitted to underwriting.

Validating Assets

When approving the loan we always look at three categories, how much money you make, how is your credit profile, and how much money do you have in the bank. Once we validate those three categories the rest is simple. Just take a deep breath.

When we validate the assets, we want to see enough liquidity in the borrower's asset account to show proof of the down payment, closing cost and reserves. Many people misinterpret the term liquidity and want to show a boatload of retirement funds. Retirement funds are great if you're looking to withdraw funds from these accounts, but typically these accounts have large penalties for early withdrawal. The liquidity that most lenders are looking for is checking accounts, savings accounts, or money market funds. These types of funds represent pre-taxed funds that can be withdrawn at any point in time. Why is that important? Once we have proven that the borrower has the funds in their bank accounts, we don't care if they show up with sacks of pennies at the closing table as long as there is enough money to cover the down payment and closing costs. I know that seems a bit ridiculous, but once the underwriter has signed off on the loan recognizing the available cash for closing that's it.

One of the biggest challenges that we have as loan originators is to make sure there's not a lot of movement of funds from one account to the other to ultimately provide proof of funds. All lenders like to see two months of seasoned assets. Seasoned funds are typically funds that have been in the account for more than 60 days. The underwriter will also look at the two months' worth of bank statements for the same account to make sure there is not a lot of fluctuation with funds coming in and out, mainly in. Any large deposits that are greater than the normal monthly earnings (more than 50%) will have to be sourced by the borrower. Sourcing funds means you have to document where the funds were originated from by supplying account statements, check stubs,

wire transmissions, or deposit slips proving the transference of funds from one account to the other.

Be prepared, don't throw anything away, and don't rock the boat, save every receipt for the last 90 days of your life!

Business Accounts

We can use funds from the business account as long as we show proof that the extraction of funds from the business will not have a major impact on the business itself. The borrower will typically have to show the last 12 months of bank statements from the business. The underwriter will review the statements through their analysis to determine if these funds will have a major impact on the business if withdrawn. In addition, the underwriter may ask for a source of funds trail on any large deposits as a trail of funds. Be prepared!

Once we determine that these funds are being withdrawn from the business account, they ultimately will have to be transferred into the borrower's personal account showing a trail of funds.

Earnest Money Funds

This is one of the things I hate the most. Before the mortgage meltdown, we would get a copy of the EM check that was submitted to the title company and show their acceptance of the check. Now we have to prove that the check itself cleared from the bank. Yes, it is ridiculous, but it is what it is. If you write a check from an account other than the account you are using for the transaction, you will have to source that back to its original source of funds. The account statement would have to be provided and that to may be scrutinized where the underwriter may call for explanations of large deposits. Even if you are doing a 1031 exchange and exchanger sends an EM check to Title, the exchanger still has to show that the funds of cleared.

If you use funds from a business account, then the above would apply as well.

Using Funds from a newly formed LLC Account

If I had to narrow down the dos and don'ts and the mistakes that are made by borrowers who decide to become real estate investors, this would be the most important section of the book. In another section of this book, I will talk about forming LLCs and the pluses and minuses of using those for your real estate holdings. New investors just starting off building their real estate portfolio will often put their properties into an LLC or limited partnership. By doing so, their accountant will advise them to set up an asset account to support the business. I am certainly not discouraging this, but I am also encouraging you to take a look at all of your liquid assets as it pertains to qualifying for a new loan. Why is this important? Once again if the funds are in a Limited Liability Corporation business bank account, these are considered to be business funds and not the borrower's funds. Yes, the borrower may be 100% owner of the business, but the bank statements still show the business name and not the buyer's name. These funds are still considered business assets.

As discussed above we need to have 12 months of bank statements for the underwriter to review the impact on this business. The mistake that many new investors make is that they transfer all their savings from a personal account to the LLC account with anticipation of utilizing these funds for future acquisitions. The problem is the new accounts are not seasoned long enough for the underwriter to make a judgment call on the business. So, for these funds to be utilized for future acquisitions that do not have a 12-month history we have to source those funds into the account the same way we source large deposits. Yes, this can be quite painful.

Keep in mind when you are purchasing a 1 to 4 residential property using a Fannie Mae or Freddie Mac lender, they will "NOT" fund a loan in an LLC, LP or anything other than the borrower's name of family trust. These are still considered personal. My advice would be to keep those funds earmarked for future acquisitions in a personal account and keep enough in the LLC accounts to maintain the business.

Can I use my HELOC for funds to close?

Home Equity Line of Credit - HELOC's are great to have for all types of purposes. I personally have one just in case I need a large sum of money for emergency purposes or for something that I feel the need for on a temporary

basis. Many people will establish their HELOC's to extract money from the equity of their property and re-invest into more real estate. "Still not a bad play." This is not using borrowed funds. This is utilizing your equity. Cash advances from credit cards or non-secured loan cannot be used for sources of a down payment. HELOC's you can.

If you are planning on utilizing your HELOC for the upcoming real estate transaction, please take note of the things that the lender will be asking for. A copy of the mortgage statement showing the beginning balance before the withdrawal, a copy of the check written from the HELOC to your personal bank account, and a deposit slip showing those monies transferred into your personal account. Once this takes place, we want a copy of the new statement showing the new balance and a copy of the HELOC's promissory note showing the terms of the loan. The underwriter will review all of the information to determine that these funds are acceptable. Most HELOC's are pretty straightforward, but some may have some crazy terms where a few years into the note it could potentially come back to haunt the borrower.

HELOC FUNDS CANNOT BE USED FOR RESERVES!!!

New Fannie Mae Reserve Requirements for Investors with Multiple Properties Owned

There are many investors that still do not know that Fannie Mae requires additional reserves from borrower's that have more than one financed property.

The **Old** requirements were six months Principle, Interest, Taxes, and Insurance (PITI) on the subject property and two on all other properties up to 4 leveraged 1 – 4 family properties *excluding* the primary residence. Properties 5 – 10 would require six month PITI on all properties.

*The **New** requirements are based on a percentage of the unpaid principal balance on each loan excluding the primary residence.*

1. If a borrower has **2-4** financed properties, the reserves of **2%** of the unpaid principal mortgage balances are required, *excluding* the principal residence and the subject property.

Occupancy	Outstanding UPB	Monthly PITIA	Reserves Calculations	
Subject: Second Home	$78,750	$776	2 Months PITIA	$1,552
Principle Residence	$0	$179	N/A	$0
Investment Property	$87,550	$787	2% of UPB	$1,751
Investment Property	$142,500	$905	2% of UPB	$2,910
Total Balances	**$230,050**		**Total Reserves Required**	**$6,153**

2. If a borrower has **5 - 6** financed properties, **4%** of the unpaid principal mortgage balances are required, *excluding* the principal residence and the subject property.

Occupancy	Outstanding UPB	Monthly PITIA	Reserves Calculations	
Subject: Investment	$78,750	$776	6 Months PITIA	$4,656
Principle Residence	$0	$946	N/A	$0
Investment Property	$87,550	$787	4% of UPB	$3,502
Investment Property	$142,500	$905	4% of UPB	$5,700
Investment Property	$84,950	$722	4% of UPB	$3,398
Investment Property	$30,030	$412	4% of UPB	$1,201
Total Balances	**$345,030**		**Total Reserves Required**	**$18,457**

3. If a borrower has **7 to 10** financed properties, **6%** of the unpaid principal mortgage balances are required, *excluding* the principal residence and the subject property.

Occupancy	Outstanding UPB	Monthly PITIA	Reserves Calculations	
Subject: Investment	$78,750	$776	6 Months PITIA	$4,656
Principle Residence	$0	$179	N/A	$0
Investment Property	$87,550	$787	6% of UPB	$5,253
Investment Property	$142,500	$905	6% of UPB	$8,550
Investment Property	$84,950	$787	6% of UPB	$5,097
Investment Property	$30,300	$412	6% of UPB	$1,801
Second Home	$124,500	$837	6% of UPB	$7,470
Investment Property	$160,000	$1,283	6% of UPB	$9,600
Total Balances	**$629,530**		**Total Reserves Required**	**$42,427**

The aggregate **UPB** calculation does not include the mortgages and HELOCs that are on

- the subject property,
- the borrower's principal residence,
- properties that are sold or pending sale, and
- accounts that will be paid by closing.

The subject property will still have monthly reserve requirements based on the total mortgage payment (PITI). Reserves are funds that you have access to liquid or non-liquid. Reserves are funds you need to have after the closing your transaction. Funds for reserves cannot be your funds for down payment or closing cost.

Can I use Gift Funds for My Investment Property Loan?

A borrower of a mortgage loan secured by a principal residence or second home may use funds received as a personal gift from an acceptable donor. Gift funds may fund all or part of the down payment, closing costs, or

financial reserves subject to the minimum borrower contribution requirements below.

<u>Gifts are NOT allowed on an investment property.</u>

Good News

Non-Liquid funds can be used for reserve requirements."

- IRA's
- 401K's
- SEP Funds

Fannie Mae now will allow for 100% of the Non-Liquid funds, not 60%

Freddie Mac currently has different guidelines than Fannie Mae.

Funds for Closing

This portion of the mortgage process is often misunderstood. It is important to understand that **NO** portion of the down payment can be borrowed. This is actually a question on the loan application. We are required to verify the source of the cash to close and at least six months of house payments in reserve for each property owned. The obvious source of verification is from the borrower and co-borrower's last two-month account statements. If these statements reflect large and unusual increases over these two months it will be necessary to document and explain the "source of the deposits; these deposits cannot be from borrowed funds.

Although the source of funds cannot be borrowed for an investment property transaction, the seller is allowed to contribute up to and no greater than 2% of the sales price for closing cost and reoccurring charges. Be careful with this because another 3rd party interest may be contributing something toward the transaction which could influence the 2% cap.

The Underwriting Stage

The criteria for underwriting a mortgage loan involves several parts:

- *Credit History* – Borrower and Co-borrower credit history including credit scores.
- *Income to Debt Ratios* – Combined-stable gross incomes of borrower and co-borrower as a percentage of combined borrower and co-borrower's debt.
- *Property Appraisal* – An independent fee appraiser will prepare a Uniform Residential Appraisal Report (URAR)
- *Loan to Value* – What is the percentage of the loan to the value of the property
- *Landlord Experience* – Length of time the borrower has owned rental property
- *Funds to Close* – Must be borrower or co-borrower's own funds, cannot be borrowed funds.
- *Clear Title* on the subject property

Your Credit History

The Borrower and Co-borrower's credit history should demonstrate their past willingness and ability to meet their credit obligations. This will enable the lender to draw a reasonable conclusion about their commitment to making payments on the new mortgage obligation they are going to agree to pay.

In addition to credit history, credit scores are of equal importance in making the decision for this part of the mortgage process. Federal National Mortgage Association (FNMA, aka Fannie Mae) and Federal Home Loan Mortgage Corporation (FHLMC, aka Freddie Mac) both require a minimum mid credit score of 620 to qualify for their particular agency loan.

Your Credit Score

Before lenders decide on what loan terms to offer, they will first review your credit report. The most widely used credit scores are FICO scores, which were developed by Fair Isaac & Company, Inc. Your FICO score is between 350 (high risk) and 850 (low risk).

Credit scores only consider the information contained in your credit profile. They do not consider your income, savings, down payment amount, or demographic factors like gender, race, nationality or marital status. In fact, they do not even consider demographic factors, which is why they were invented in the first place. Credit scoring was developed as a way to consider only what was relevant to somebody's willingness to repay a loan.

Past delinquencies, derogatory payment behavior, current debt level, the length of credit history, types of credit and number of inquiries are all considered in credit scores. Your score considers both positive and negative information in your credit report. Late payments will lower your score, but establishing or re-establishing a good track record of making payments on time will raise your score.

Your credit report must contain at least one account which has been open for six months or more, and at least one account that has been updated in the past six months for you to obtain a credit score. This ensures that there is enough information in your report to generate an accurate score. If you do not meet the minimum criteria for getting a score, you may need to establish a credit history prior to applying for a mortgage.

1. **Equifax (800) 685-1111**
2. **Experian (888) EXPERIAN (397-3742)**
3. **Trans Union (800) 916-8800**

Since the credit score is derived from a credit history, there must be a minimum of 2 years in order to get an accurate score. Before a credit report can be obtained, you must have a minimum of one account that has been open for at least six months, and current activity within the most recent six months.

Different portions of your credit history are given different weights. Thirty-five percent of your FICO score is based on your specific payment history. Thirty

percent is your current level of indebtedness. Fifteen percent each the time you open credit has been in use (ten years old accounts are good, six months old line items aren't as good) and the types of credit available to you (installment loans such as student loans, car loans, etc. versus revolving and debit accounts like credit cards). Finally, five percent is pursuit of new credit — credit scores requested.

Debt to Income Ratios

When you apply for a mortgage, your lender will analyze your debt-to-income, which is also known as your debt-to-income ratios, or DTI. Lenders calculate DTIs to ensure you have enough income to comfortably pay for a new mortgage while still being able to pay your other monthly debts. There are two debt-to-income ratios that your lenders will analyze: The Housing ratio, which is the "front-end ratio" and the "Total" DTI, which are the back-end ratios that are the most important. Your lender will add up your anticipated monthly mortgage payment plus other monthly costs of homeownership. Other costs of owning rental property could include homeowner association (HOA) fees, property taxes, private mortgage insurance, and homeowner's insurance. Normally, some of these expenses are included in your monthly mortgage payment. To calculate your housing ratio or front-end ratio, your lender will divide your anticipated mortgage payment and property expenses by the amount of your gross monthly income.

In addition to calculating your housing ratio, a lender will also analyze your total debt ratio. At this time your other installment and revolving debts will be analyzed and added together. Installment and Revolving debts will appear on your credit report. These payments are expenses like minimum monthly credit card payments, student loan payments, alimony, child support, car payments, etc. Your lender will add up all your monthly installment and revolving debts in addition to your estimated monthly mortgage payment and housing expenses and divide that number by your monthly gross income.

With the New "Ability to Repay" in force, Qualified Mortgages are required to have a back-end ratio no greater than a 43% to be eligible to deliver the loan to the Fannie Mae or Freddie Mac. Fortunately, we have a temporary reprieve that allows qualifying ratios to exceed 43% DTI as long as the automated underwriting system approves the loan. This temporary exception will be in place until Fannie and Freddie come out of receivership, or seven years whichever comes first.

This part of the mortgage loan process reflects the total of the proposed new house payment as a percentage of the borrower and co-borrower's "combined-stable, gross monthly income." FNMA, Freddie Mac has definitions of combined-stable gross monthly income. This ratio is known as the housing ratio. A conservative percentage for the house payment to income ratio is 29%. An example would be a combined-stable gross monthly income of $5,000 a month would afford a house payment of $1,450.

The second portion of the income to debt ratios is the total obligations including the new house payment, into the combined-stable gross monthly income. The percentage commonly accepted by FNMA and Freddie Mac is 45%. (An example of this is a house payment of $1,450 per month plus car payments, and credit card payments should not exceed $2,250.00). Although it is important to understand that both of these ratios must be taken into consideration, sometimes these ratios may be exceeded depending on the strength of the borrower(s).

As of July 2017 Fannie Mae just changed their backend ratio to 50%. Some lenders may not allow for the change some may.

A big part of the mortgage process is knowing how to compute combined-stable gross monthly income sufficient to meet Fannie Mae and Freddie Mac standards. The experienced staff at The Parham Team knows this information and will guide you through this part of the mortgage process.

Loan to Value Percentage

The loan to value is another ratio used by lenders to discover their risk on the property based on how much equity they have in the property if they had to foreclose. The loan to value, as the name suggests, is determined by comparing the total loan amount to the total fair market value of the property. In the height of the last real estate bubble, many lenders were allowing a borrower to take a loan up to 125% of the value, but today, 70-80% is much more likely on investment properties.

Property Appraisal

A property appraisal is generally required by the lender in order to establish that the value of the home will be sufficient collateral for the amount of the loan. The appraisal fee is generally paid by the buyer, and many sometimes required at the time of the loan application, but typically paid at the loan closing.

A property appraisal is done by an independent appraiser who will generally visit the property and inspect the interior and exterior. However, the appraiser is not performing the same service as a home inspection. Home improvements or the cleanliness of the interior will not add to or diminish the appraisal value. The appraiser considers many other factors beyond the inspection, to establish the fair market value such as comparable values, historical sales and market demand for that area.

Market values fluctuate over time and also vary from neighborhood to neighborhood causing appraisals to become outdated. Most lenders will require a new appraisal if any refinancing is done and tax assessors generally re-assess the property annually. The value established by your lender's appraiser will not change the assessment set for property taxes as county tax assessors do their own property evaluations.

In either case, investors should monitor the appraisals for fair treatment in relation to similar properties in the surrounding area and in view of the standards set for appraisers by state licensing boards. For tax purposes, there is often a protest deadline. In the case of a loan, the buyer should be comfortable with the appraisal before committing to closing the loan. Any concerns or complaints should be brought to the attention of the appraiser, the lender or the state regulatory board. Although the appraisal primarily protects the lender, it can also benefit the investor by:

- Providing assurances that the home is not over-valued
- Justifying the amount of the loan

- Qualifying you for certain terms
- Evaluating equity to remove Private Mortgage Insurance (PMI)
- Protecting against negative home equity
- Helping in tax and estate planning
- Helping determine insurance valuations
- Determining the feasibility of home improvements, refinancing or additional financing

The requested loan amount is calculated as a percentage of the sale price of the property and the appraisal, whichever is less, to determine the loan to value ratio. A licensed fee appraiser, approved by the lender, must complete the appraisal. The appraiser invoices the lender and lender pays the invoice upon delivery of the appraisal report. Standard industry practice is to collect the appraisal fee from the applicant at the loan application. The standard fee for a residential investment appraisal is $450.00 to $550.00 for a single family and approximately $650.00 for 2-4 unit properties. Your lender will furnish an original copy of the appraisal to the borrower prior to the loan closing.

Borrower's Landlord Experience

While previous landlord experience is not a requirement to obtain an investment property loan, it can affect your ability to qualify for future loans. You will find this out as you attempt to obtain multiple loans for investment properties. Your debt to income ratio climbs very quickly, even though that debt is being paid by a tenant. To help increase your income, a bank can add your rental income to your regular monthly income but usually will only do so after you have been a property investor for more than two years. This requirement can differ greatly between lenders. Keep in mind that even with landlord experience, a lender will typically only apply 75% of that rental amount toward your income to protect themselves against losses.

Clear Title on Subject Property

When you purchase a rental property you want to be sure that there are no issues with the property’s title and that the seller owns the property? Problems with the title can limit your use of the property, as well as financial loss. That is why it is good to have a title search and title insurance.

The Title Search

After your sales contract has been accepted, a title professional will search the public records to look for any problems with the property's title. This search typically involves a review of land records going back many years. More than 1/3 of all title searches reveal a title problem that title professionals fix before you go to closing. For instance, a previous owner may have had minor construction done on the property, but never fully paid the contractor. Or the previous owner may have failed to pay local or state taxes (See below for some other common title problems). Title professionals seek to resolve problems like these before you go to closing. What happens if a problem arises after you purchase the property? Read on.

The Owner's Title Policy

Sometimes title problems occur that could not be found in the public records or are inadvertently missed in the title search process. To help protect you in these events, it is recommended that you obtain an Owner's Policy of Title Insurance to insure you against the most unforeseen problems.

Owner's Title Insurance, called an Owner's Policy, is usually issued in the amount of the real estate purchase. This is purchased as a one-time fee at closing and lasts for as long as you or your heirs have an interest in the property. Only an Owner's Policy fully protects the buyer should a covered title problem arise with the title that was not found during the title search. Possible hidden title problems can

include:

- Errors or omissions in deeds
- Mistakes in examining records
- Forgery
- Undisclosed heirs

An Owner's Policy provides assurance that your title company will stand behind you monetarily and with legal defense if needed. The bottom line is that your title company will be there to help pay valid claims and cover the costs of defending an attack on your title. Receiving an Owner's Policy is not always an automatic part of the closing process, and is paid for by the buyer or seller. Be sure you request an Owner's Policy and ask how it is paid for where you live. No matter who pays for the Owner's Policy, the fee is a one-time fee paid at closing. The Owner's Policy protects you for as long as you or your heirs have an interest in the property.

You also have the option of purchasing a policy with expanded coverage. This is called the Homeowner's Policy, and it covers more things than the Owner's Policy. Ask your local title company for an explanation of the expanded Homeowner's Policy so you can decide which policy is the best one for you.

Source: www.homeclosing101.org

What is TRID?

TRID, which stands for TILA RESPA Integrated Disclosure, is the culmination of several years of discussions between CFPB and members of the banking and title industries. TRID consolidates the existing disclosures required under TILA and RESPA for closed-end credit transactions secured by real property into two forms: a **Loan Estimate** that must be delivered or placed in the mail no later than the third business day after receiving the consumer's application, and a **Closing Disclosure** that must be provided to the consumer at least three business days prior to consummation.

First, the Good Faith Estimate (GFE) and the initial Truth-in-Lending disclosure (initial TIL) have been combined into a new form, the **Loan Estimate**. Similar to those forms, the new **Loan Estimate** form is designed to provide disclosures that will be helpful to consumers in understanding the key features, costs, and risks of the mortgage loan for which they are applying, and must be provided to consumers no later than the third business day after they submit a loan application.

Second, the HUD-1 and final Truth-in-Lending disclosure (final TIL together with the initial TIL, the Truth-in-Lending forms) have been combined into another new form, the **Closing Disclosure**, which is designed to provide disclosures that will be helpful to consumers in understanding all of the costs of the transaction.

How will this affect the consumer? Since October 1st, 2015 these new forms have been a part our life in the conventional lending world. **"TRID"** gives borrowers three days to think about whether they want to proceed with the mortgage or not. Are the "Know Before You Owe," TILA-RESPA reform changes impacting consumers?

Lenders must provide the **Loan Estimate** form to consumers within three business days of applying for a loan – which means three business days after the consumer provided the lender with their name, income, Social Security number, property address, property value estimate and mortgage loan amount sought.

The **Closing Disclosure** form must be provided at least three business days before loan consummation (the time the consumer becomes contractually obligated to the mortgage, which is usually at closing).

Any significant changes to the loan terms (the annual percentage rate (APR) becomes inaccurate, the loan product changes or a prepayment penalty is added) will restart a new three-business-day waiting period.

Both the **Loan Estimate** and **Closing Disclosure** forms can be delivered in person, by mail or electronic delivery. Additionally, this new process will **NOT** impact cash sales, private money, commercial loans or those financed using HELOCs, and so the current processes will still exist as well.

Before **TRID**, once the lender had "Clear-to-Close', their closing department would send closing instructions to the title company so they could prepare the "HUD." Once the HUD was approved, the borrowers could close on their loan that same day. Now with the three-day waiting period, the consumers have to wait before they consummate the transaction. Needless to say, this can cause many delays for buyer and sellers.

The smart lenders take advantage of the TRID guidelines and prepare and deliver the **Closing Disclosure** to the borrower themselves even before closing instructions are sent to the title companies. This helps shorten the closing process versus waiting on the title company to prepare the CD and deliver it to the consumer.

Our attitude at Highlands Residential Mortgage is continuing education and focusing on providing consistent and timely communications to all parties

to help ensure the client receives maximum value, and that is what it's all about.

The Underwriting Stage

Pre-Closing

At this juncture, your loan is approved, and the financing details are finalized. Before the new TRID requirements, the file would be submitted to the closing department. Now, we as the Lender have the ability to send the borrower the Closing Disclosure to the borrower even before the file makes it to the closing department. The New Closing Disclosure will take the place of what the industry has used for years as the HUD-1 Settlement Statement.

Our Goal is to close the loan on time without any last minute "Surprises." As the Lender having control over this process will allow us to have the Closing Disclosure in the borrowers had three business day before loan consummation to have plenty of time to review. We will still have the closing department will send the title company the loan "instructions" and a copy of our Closing Disclosures. , Below is an outline of what to expect and what you need to know to ensure a smooth closing.

Closing Disclosure: The CD will be sent to the tile company with instructions from our closing department. This document will outline every cost in the loan and provide an exact amount that will be due at closing. The CD has to be in the borrower's hands three business days before loan consummation.

Verification of Employment: 24 to 48 hours before closing we will contact your employer to verify that you are still employed. (So don't turn in your two-week notice the day before closing).

Credit Report Update: within five days of closing we will update your credit report (with a soft pull) to reflect the most recent balances and provide a list of any new credit inquiries. Underwriting will ensure that you still qualify with any new balances (so don't go buying that new refrigerator until after closing). The list of credit inquiries will reveal if any new "credit pulls" have occurred since the initial credit report in the file – any new inquiries will require an explanation and additional documentation may be required before the file can be assigned to a Closer.

Last Chance for Updates: please let us know ASAP if there are any updated amendments to the contract (i.e. additional concessions, reduction in price, etc.). We don't want to delay the closing for another three days.

How Long Will Closing Take?

Closing typically takes 45 minutes; however, we recommend you plan for an hour since the title company will provide you copies of the signed documents before you leave. Some title companies will offer you a paperless medium for your copies: such as a CD, flash drive, email, etc.

Where Will The Closing Be and Who Schedules It?

Your Realtor may be scheduling the details for closing; however, you're welcome to reach out to the title company directly to ensure the time and location of closing fits your schedule. You don't have to close at the title company office listed on the contract. Often times you can close at a "sister" title/escrow office OR a place of your choosing (like your office or home). If you choose to close remotely, there may be a fee charged for the mobile notary so be sure to ask the title company. Please let us know the details of closing so we can plan accordingly.

What to Bring to Closing

Driver's License or ID: You will need to bring your driver's license (or some form of government-issued ID such as a passport, identification card, etc.). If you're not a U.S. Citizen, then you need a copy of your Visa and/or Green Card as well.

Funds for Closing: If money is due at closing then you will need either a cashier's check or a wire transfer. See "Acceptable Funds for Closing" below for more details.

POA Originals: If you are doing a Power of Attorney then you will need to bring the original Power of Attorney to closing (or provide it to the title company in advance). Also, please note that the absent party MUST be

available via phone at the time of closing to provide identification and consent that they still want to proceed with the transaction.

Final Conditions: In rare cases, there may be an outstanding underwriting condition that needs to be brought to closing for funding to occur. This may include a letter that needs to be signed, an amendment to the contract needs to be initialed, etc. We will let you know if this applies to you.

How does a Mobile Notary Work?

The mobile notary is a bonded/licensed individual that will come to your place of business or home when it is convenient for you to arbitrate the consummation. They will have all of your closing documents and a copy of the CS. They will review the closing documents with you and notarize them accordingly. Most of the time, once everything is signed will be responsible for getting the closing documents back to the title/escrow company for funding.

Funding

Once the closing documents have been signed by all parties (i.e. you and the sellers), the title/escrow company sends the necessary documents to our Closers for funding authorization. Once our Closers review the signed docs and clear any funding conditions, they will provide the title/escrow company with the "funding number" to access the money for funding. The title company will then receive the funds and provide the official notification to you that the loan has funded (and you're now in a ton of debt).

Special Note

All lenders today will want "All Pages" of the documentation required for the loan. When providing documentation (asset accounts, family trust, divorce decrees, and employment contracts), please provide every page in the statement, even if it is blank. Most of the statements will let you know what the page number is out of the total number of document pages.

One of the best ways to get your loan approved with all conditions met, and closed is to be PREPARED. Get all of your documentation lined up to begin with and your loan originator will have a much easier time getting your loan completed for your investment property. Always be quick to respond when asked for any additional documentation by your loan originator or anyone on his staff. The sooner the documentation turnaround, the quicker your loan can be closed.

After going through this list of documentation for the loan application, can you see why having an experienced loan officer is such a benefit?

Prepare to Write Letters

Lenders these days scrutinize every corner of your financial life, and if something looks funny, even just a little, they will want to know why. That means you will have to write letters explaining the oddity.

For example, they may want a letter explaining why a credit card issuer pulled your credit three months ago when you applied for a store credit card. Or, why your mother gave you a check for $1000 around Christmas. Lenders also may want you to explain why you changed jobs a few months ago or why you moved around several times in the past year. Don't fight it. Write the letter, sign it and send it back as soon as possible. There may be several letters that you may have to write depending on your personal situation and the complexity of the file. Be prepared.

My wife and I are both salaried employees. Why can't we you use her income?

Although she is employed in the same line of work for many years, she has been out of the workforce for more than 12 months. We would have to have her on the new job for the last 12 months before her income to be counted. Yes, even if it is a salary and will have continuation; she still has to be there for a minimum of 12 months.

What about my secondary job or my side business?

Yes, we can use both, if you have been doing those jobs for over two years and it is reported on the tax returns. This side business would typically be reported on Schedule C on the tax returns. All Schedule C income typically will have income and expenses. We always take the net-net between the two and if it is a positive number we will give you credit for that business. The net-net number will be averaged from the last two years only if the last year is higher than the previous year. If the last year is lower than the previous year, we will only give you the lower number from the previous year's net-net earnings.

As far as the second job is concerned, you would have to have been on the job for at least two years or more; we will average that income over the last two years. Anything less than two years will not be counted.

Any additional income that is represented on the 1040 tax returns regardless of what schedule it shows up on, we will always average the last two years. This includes dividend interest, capital gains, and oil and gas royalties. These items are typically shown on Schedules A & B.

I have a strong W-2- salary and my wife has her own business and reports her earnings as a self-employed individual. Should I use her on the loan application?

Yes and no. If her net-net earnings are a positive number and you need that additional income from her to qualify, then yes we will always use the co-borrower's income. If the income is a net-net loss on the Schedule C tax returns, then chances are we don't want to use her income on the loan application. It's all Math.

Can she still be on the loan application even though she has negative earnings?

Yes, if it does not affect the qualifications of the loan. No, if it does, but we can still add her to the title. Fortunately, on investment property loans, the spouse is not required to be on the loan even though they reside and/or are purchasing the property in a community state. Many investors love this for many reasons especially when trying to spread out their real estate portfolio between the two of them.

What about the income from my Rental Properties?

Income from the properties typically shows up on Schedule E. Each property is judged individually from the standpoint of gross annual income as well as annual expenses such as property taxes, hazard insurance, repairs, and any management fees. The IRS will allow you to depreciate the property and that part is given back as a credit. Prior to the 2008 mortgage meltdown, most lenders would take the total gross rents (minus expenses) and add back the depreciation. If the math resulted in a positive or negative number, that number would be represented on your loan application for that particular properties income.

Today with the Dodd-Frank Act requiring lenders to prove their "Ability to Repay," a whole new mathematical formula is in place. Each lender has their own proprietary formula, but for the most part, it is the same in accordance with the Fannie Mae formula. Quite frankly, I have examined this formula

backward and forwards, and I still cannot come up with the rationale where they justified this math. It doesn't matter; this is what lenders have to go through regarding each property. All lenders will require a copy of the mortgage statements for each property owned, annual property tax statements, annual insurance statements, and any Homeowners Association dues.

Many investors feel the need to put their properties into a limited liability corporation and/or limited partnership to create asset protection as well as running it like a true business. If that's the case and the borrower has 25% or greater ownership in those real estate holdings, we will want the last two years of that LLC tax return. The information from this tax return will typically be funneled into Schedule E as a net-net number. Many times we use that number only as a positive or negative as it pertains to that particular property. That information once again will go on the loan application.

Any rental property owned that was acquired in the current calendar year but is not showing up on the previous year tax returns, we will also give rental income to the borrower. As a general rule of thumb, if you have a real estate property in a place that's generating rental income and is supported by a rental agreement, all lenders will give you 75% of the gross monthly rent as a positive or negative number depending on landlordship (Seasoned). We will still want to see a copy of the settlement statement, the promissory note if there is a lien against it, a copy of the annual tax bill, and a copy of the annual insurance bill. These numbers will also be accounted for in the formula.

Many borrowers tried to run their own mathematical calculations as it pertains to debt to income. I will explain debt to income further in another section of this book. From time to time I will have borrowers come to me and say "My debt load is this number my income is another number which gives me my DTI of this percentage? Can you do the loan? The answer is always "Maybe." They may think they have the math correct, but 99% of the time it's based on how lenders look at income on tax returns.

My best recommendation is: always to supply everything the lender requires to evaluate your families overall income to support a new loan. We, unfortunately, do not live in a black and white world, until determined by the lender.

What does it mean to be a Seasoned Landlord?

For years Fannie Mae and Freddie Mac have always viewed a seasoned landlord showing proof of ownership for income properties for at least two years. This has been the benchmark for many things as far as qualifying for a loan and being allowed to use rental income and when.

I can remember in the old days (before the meltdown) if a first-time investor needs the income on the subject property, some lenders will allow it if there was a lease in place or the appraisal showing average market rent for the property. If we were able to show that the borrower was ensuring the property with a "Rent Loss" added to the premium, we would allow for this income on the loan application. Many lenders used that formula, but others did not. It seems like it changed every day depending on the lender.

Where landlord seasoning requirements really come into play is when the borrowers are acquiring their seventh plus property. Both Fannie Mae and Freddie Mac have a 1 to 6 underwriting guideline. Although Freddie Mac will not do more than four loans per borrower, Fannie Mae will do up to 10 loans. Once the borrower falls into the "Multi-Property" category, many of the guidelines will change, i.e. down payment requirements, credit score requirements, reserve requirements as well as the length of time the borrower has been a landlord.

Although Fannie Mae's guidelines are pretty straightforward, each lender will look at this category differently than the 1 through 6 property purchases. Most lenders will put their own internal overlays on top of the Fannie Mae guidelines. These overlays are additional requirements that certain lenders will require over and beyond the normal Fannie Mae requirements simply to address their flavor for risk.

Many borrowers see a tremendous opportunity in investing their money in real estate. Once they get a few properties under their belt, they want to buy more as fast as they can. Unfortunately, this is where some investors get into trouble. Before the mortgage meltdown, investors could buy rental properties for virtually zero down. Many non-seasoned investors look at this is a great opportunity to own multiple properties without putting any of their own money into the transaction. Yes, the risk was all on the lender to underwrite these types of loans which made the potential for foreclosure very high. This is known as "Rapid Acquisition." Many lenders frown on rapid acquisition until the borrower has proven themselves to be a responsible landlord. This is why

many of the lenders will put the brakes on many investors until they are seasoned.

Other problems that exist for borrowers that are not a seasoned landlord is being able to use the rental income from the properties they currently own. Most lenders will want to see the income documented on their tax returns from the previous year. Some lenders would require two years of seasoning, where others may only require one. Even though the Fannie Mae underwriting engine may not that require seasoning the lenders, the lender's overlays will most likely require that income.

How many Loans Can I get for My Investment Properties?

Most lenders including the large banks will only allow up to 4 loans per borrower in their portfolio. Fannie Mae will allow up to 10 financing properties per borrower. The interpretation of this has changed over the years. At one time we would just count the number of loans showing up on the credit report and call it a day... Now it is the number loans the borrower is a guarantor of any mortgage loans regardless of whose name is on title on a 1 – 4 residential property. If you are trying to build your inventory between you and your spouse or partner, keep this in mind.

Investors owning 1 – 4 residential properties in an LLC, Partnership or S-Corp and the property would not be counted against them as far as the number of loans if they are not obligated to pay the mortgage on the property. It does not matter if the loan is NOT listed on the credit report. If the property is financed with any type of loan, we would count that against the borrower for a 1 – 4 unit property. Only a multi-family (5+units), commercial real

estate or unimproved land is excluded from these limitations as well as properties owned free and clear.

Good News is October 26, 2015, Freddie Mac issued changes which positively affected real estate investors. Freddie Mac increased their number of allowed financed properties from 4 to 6 when financing an investment property or second home. Also, Fannie Mae followed Freddie's move in September 25, 2016, and increased the tolerance for risk to allow investors to purchase up to 6 loans on SFR's at 20% down. With these new changes, investors now can put 20% down on an SFR up to 10 loans. In addition, they can also do cash out loans on 10 properties without any timing constraints. Another great advantage is borrowers with less than 720 FICO scores can also do an additional two loans as long as Fannie Mae's and Freddie Mac's underwriting engine approves the loan.

The next major change with Freddie Mac was the removal of the two-year landlord history experience requirement which affected the utilization of rental income. Now that this has been removed, borrowers will be able to utilize 75% of the gross rental income with a lease agreement or 75% of the average market rent analysis provided on the Fannie Mae appraisal report.

If my wife is not on the loan, does it count against her as far as the number of real estate properties owned?

No. For years Fannie Mae's cutoff point for the number of properties with loans you can own has been 10. Because of that, a husband-and-wife would make use of their maximum leverage by splitting up the acquisitions equally. The husband would buy 10 and the wife would by 10. In a perfect world this seems realistic, but let me caution you on how lenders interpret the count these days. Before the meltdown, the lenders would look at the number of loans against the borrower and make a determination. Today some lenders still take that into account for the true ownership of the property, regardless of whose name is on the loan. As explained above, if the wife is NOT a guarantor of the mortgage loan, the property is not counted against her as far as the loan count. Today lenders look at that as ownership regardless of the number of loans against each other.

What about the Primary Residence?

If the husband or wife purchased their primary resident and the loan in just in their name only and not their spouse, but the spouse's name is in title, we will not count that obligation to the spouse. Although we will not count the obligation to the non-borrowing spouse, we will count ½ of the tax and insurance monthly payments against them if they are doing a loan in their own name. Even thou it appears that the spouse is living rent free on paper, they still reside in the property.

I am moving to a new Primary Residence and want to rent my current one out. Can I use the rental income on a new loan?

For conventional Fannie Mae and Freddie Mac loans, rental income is allowed with a bonafide lease agreement showing the monthly income to the borrower. The borrower does not have to prove a certain equity position on the property. If a borrower is purchasing a primary residence and not an investment property and wants to use an FHA loan, a 30% equity position is required on the existing property.

How Capital Expenditures counted toward my DTI?

Capital expenditures are sometimes common for real estate holdings or partial investment into syndicated businesses. Typically capital expenditures are a one-time expense that is usually within the first year of that entities business. These can be very large numbers that are represented on your tax returns that could potentially give you a net loss on Schedule E of your tax return. Some lenders will count that expenditure against you; some may not. It all depends on how the borrower justifies these expenditures as a one-time expense so that it won't haunt them on the loan application.

Timing on filing your tax returns and how does that affect you as a borrower

From January to April each year borrowers are required to complete their 1040 tax returns to be filed with the IRS. Many borrowers take advantage of extensions which give them a temporary reprieve to file before October 15 of that filing year.

Each year employers and contractors are required to issue year-end earnings statements to their employees or subcontractors for the previous year. Whether it is a W-2 form or a 1099 form both need to be mailed by January 31 of the following year.

With this in mind, lenders have certain requirements for income documentation required for all loan transactions. If you're closing a loan before January 31 of the following year, chances are your year-end paystub and a current paystub will only be required for the loan file. After January 31, the W-2 form will always be required for all loan files. Most lenders will require two years of W-2 forms regardless of what the automated underwriting system requires from Fannie Mae or Freddie Mac. They want to make a comparison that the income is not declining. If it is declining, they probably want some additional information. If you're self-employed, the 1099s may or may not be required in the loan file depending on when the individual tax returns were filed.

The most important thing to know about doing a loan during tax season is when should you file your returns or should you do an extension. I cannot tell you when to file your tax returns. I can only explain to you that there are potential hurdles involved when doing a mortgage loan. The biggest hurdle is authenticating tax return information through the IRS. We do that with the IRS form 4506T.

What is a 4506T?

The US Department of Treasury and Internal Revenue Service require the form 4506T to be utilized by lenders to request tax transcripts for those borrowers that have filed their tax returns. The tax transcripts are mainly an abbreviation of the 1040 tax returns. All the numbers are the same as the 1040 tax returns but in a different form. Many have asked me over the years why we ask for the IRS to send us the tax returns again? Well, it's not your tax returns, it's only the transcripts. The transcripts are used to validate the information that has been provided on the 1040 tax returns from the borrower to be the same as what is reported to the IRS. Before the mortgage meltdown of 2008, the transcripts were utilized maybe 10% of the time. Now all lenders will order 4506T's a 100% of the time for fully documented loans. The reason before the meltdown: there was more fraud committed on the rental property loans than any other category.

Each lender has to receive the tax transcripts back from the IRS to validate the two years of tax returns in the loan file. Needless to say, the first two weeks of April may be a very busy time for the IRS because everyone is trying to get their returns submitted before the 15th. Even after the 15th for the next several weeks the IRS is trying to catch up with a large number of submissions being filed. This does affect the borrowers if they filed on April 15 and want to close on the 16th. Chances are they will have problems closing. This has been an ongoing problem for years. Many lenders will develop workarounds to overcome this problem.

What does that mean to the borrower? They will not close their loan until the transcripts are received by the lender. Having explained this many times to my borrowers and stress the sense of urgency of getting the tax returns filed sooner than later, especially if they're trying to close on a loan during tax season. Unfortunately, most of them don't pay attention and needless to say their loan is delayed. Don't make that mistake.

Tax Extension

The majority of the borrowers who are self-employed will typically file an extension through October 15 for many reasons, but mainly for the convenience of having the additional time to put together a very complicated tax return. We as lenders do not have a problem with borrowers utilizing a tax extension.

If the loan file is closing after April 15 and before June 15 of the following year, the underwriter will approve the file from the average of the previous two years average income, but not including the last year of taxes. As long as they can show proof of a filed tax extension, we will take that 24-month average (Filed) and use that as income. After June 15 there is a strong probability that underwriters will ask for the previous year's profit and loss statement as part of the underwriting decision. Fortunately, it does not have to be an audited P&L. Audited P&L's can be quite costly, just as much as a full tax return fee.

Down Payment Options

Before you decide on what down payment is best for you, first decide on the strategy of why you are investing in real estate. Buying and holding real estate is subjective to how long you want to hold the property and why. Most borrowers that I deal with are looking to buy and hold the property mainly as a retirement asset. They want the asset to generate a passive income today as well as when they retire. Even with that strategy, some people feel they need to put at least 50% down when purchasing real estate to give them greater peace of mind knowing that they only have a 50% leverage on the property. Leverage is leverage. It all depends on the payment option that you feel comfortable with, but not to get too greedy. You need to be smart with your money. You work hard for money and want to see it grow for you.

I've been working with investors for over 17 years and have been fortunate enough to be an investor for the last 10. I personally feel that real estate investing is always the best way to go regardless of the economic environment. I enjoy having discussions with some of my very seasoned landlords that have been investing since the early 80s. To hear them talk about the difficulties of finding loans over the years and also accepting higher rates where today's new investors would not even think about. Most of the investors that I work with have the same strategy that I do, "Buy-and-Hold." The sweet spot for down payment is typically 20%. The main reason for 20% down is they don't want to have private mortgage insurance and have the option to escrow their tax and insurance payments. Most proformas that you will be presented when purchasing investment property will typically have a 20% down and 80% loan to value scenario.

Can you put less down 20%? Yes, we do have a 15% down payment option available, but keep in mind; it does require private mortgage insurance and your cash flow will not be as good.

Here is an example of the benefits of putting a full 20% down versus 15%.

Price	$150,000.00	$150,000.00	**Difference**
Interest Rate	5.000%	4.750%	25.000%
LTV	85%	80%	0.05%
Down Payment	$22,500.00	$30,000.00	**-$7,500.00**
Loan	$127,500.00	$120,000.00	
Monthly Payment (P&I)	$684.45	$625.98	$58.47
Private Mortgage Insurance	$71.00		$71.00
Total Monthly Payment	$755.45	$625.98	**$129.47**

As you can see in the chart, for a measly $7500 more in a down payment, you would eliminate having to pay PMI for the next 44 months (44 X $71.00 = $3,124), as well as the cost of money is 0.250% better with 20% down ($7,500 @ .250% over 44 months is $951.57). You do the Math!

The next example will show the benefits of using 20% down leveraging for properties versus buying one property and paying **CASH**.

Price	$150,000.00	$150,000.00
Interest Rate	Cash	5.000%
LTV	0%	80%
Down Payment	$150,000.00	$30,000.00
Loan	$0.00	$120,000.00
Monthly Payment (P&I)	$0.00	$644.19
Monthly Rent	$1,500.00	$1,500.00
Vacancy 8%	$1,395.00	$1,395.00
Management 10%	$150.00	$150.00
Net Cash Flow - (P&I)	$1,245.00	$600.81

If you pay $150,000 in cash for one property, your net cash flow is ***$1245.00.*** By putting 20% down with an 80% loan to value and a 5% interest rate, your net cash flow is reduced to $600.81. Let's not stop there. Keep in mind that 20% down payment on a $150,000 home is only $30,000. If you bought **FIVE** $150,000 homes and put 20% down on each with the same loan terms and monthly rents, you could increase your return on investment by ***$1759.05*** a month to ***$3004.05***. Invest your money wisely.

The net cash flows do not take into account the annual city, county and state property taxes and the annual hazard insurance. The numbers may vary considerately by the taxing authorities. You will have to include that information in your bottom line.

Additional Loan Products

Since the mortgage meltdown, loan choices for investment properties are very narrow. Most investors that I deal with typically are looking for long-term performance from their properties, which means they are looking for greater peace of mind from a fixed rate loan product. Other investors may only be looking at a 5 to 7-year strategy and would prefer to choose an intermediate arm product. These products are amortized over 30 years just like a 30 year fixed rate, but the start rate is only fixed for a given period of time i.e. five years, seven years, or 10 years. Each of these products is conventional loan products that are still delivered to the secondary market.

Some investors that are buy-and-hold don't need the immediate cash flow that a 30 your product would provide over a shorter term loan. Shorter-term loans are great for paying down the loan quicker in addition to getting a better interest rate. If you can afford the shorter-term products during the course of the loan to ultimately have a free and clear property come retirement age, this is also an excellent strategy. No, you cannot have "Your cake and eat it too."

Specialty Loan Programs

Fortunately, I work for a company that provides a full range of products and programs that can help investors with most of their financial needs.

Short Term Escrow Holdback Program

Real estate investors who are buying distressed properties are constantly running into structural issues that the seller will not correct for prospective buyers. Most of the structural issues of distressed properties are roofs and foundations. The majority of lenders today will not lend on any property that has structural problems. This creates a "Catch 22" for both buyers and sellers. The majority of your distressed properties are bank-owned REO's or FHA foreclosures. Sometimes HUD will cure these issues prior to putting the property on the market and sometimes they will not. The same is true for bank owned properties.

For years investors have had to pay cash for these properties because no lender would fund the loan on a ***"Non-Habitable"*** property.

Now with a Short Term Escrow Holdback Program, we can lend on these properties and correct any issues after closing. This is not a rehab program. Either the buyer or the seller will have to bring the additional funds to the table for these repairs to be held back in escrow. In the past, most Fannie Mae and Freddie Mac lenders would not allow for escrow holdbacks on non-habitable properties. Now we can.

Program Highlights:

- All holdbacks will require a mechanics lien
- All repairs have to be completed within 30 days
- All the funds will be held by WJ Bradley and released upon completion
- A certificate of completion will be required from an appraiser
- We will hold back 150% of the bid amount for repairs
- No more than $15,000 of repairs will be allowed
- All repair bids will have to be approved by the lender

Items that can be included in the escrow holdback:

- Foundations
- Roofs
- Electrical
- Plumbing
- HVAC

This program is designed to allow short-term repairs done to the property to make sure that there are no problems for a habitable property for renters. If

you need more than $15,000 for your repairs, ask about the Fannie Mae Homestyle Rehabilitation Program.

Fannie Mae Homestyle

I personally like this loan program because it is a make sense program. If you are not looking to purchase from a turnkey provider, but want to buy distressed properties this product is perfect. Now investors can purchase a distressed property, bank-owned, foreclosure or short sales home and roll the repairs into the mortgage. If you currently own a rental property and it is in need of repairs or a total rehab, then look no further. The Homestyle Investor Rehab Loan Program is designed to help the overall cash outlay that investors would have to invest to bring the property to a habitable condition for their future tenants.

This single-close loan provides funds to purchase plus the funds to complete major or minor renovations with one loan and one set of closing cost. Loans are based on the after-improved value determined by the appraisal.

This Renovation loan can be used for virtually any type of renovation improvement. The only renovation requirement that must be met is as follows:

1. Improvements must be permanently affixed to the property
2. Improvements must add value to the property

The program's features include:

- 20% down payment
- Repair costs can be a maximum of 50% of the "As-Is" completed value
- Fees for up 5 draws are included
- Single-Family Homes
- 30 & 15 year fixed mortgage
- No prepayment penalty

- The cost consultant fee may be rolled into the loan
- Mortgage payments may be included if the property is not habitable

Examples of Renovations that Qualify

- New Roof
- Remodel kitchens and baths
- Room addition
- New HVAC
- New Appliances
- Replacement of windows
- Energy conservation improvements
- Structural repairs (Including Foundations)- Upgrades to electrical or plumbing
- New carpet and paint
- Landscaping improvements
- Installation of hardwoods

Is it better to purchase a $100,000 property using a conventional loan with a 25% down payment at a rate of 5.000% or Homestyle loan that requires only 20% down at a rate of 5.500%? The advantage of using the Homestyle program allows the investor to roll in $20,000 worth of renovation cost.

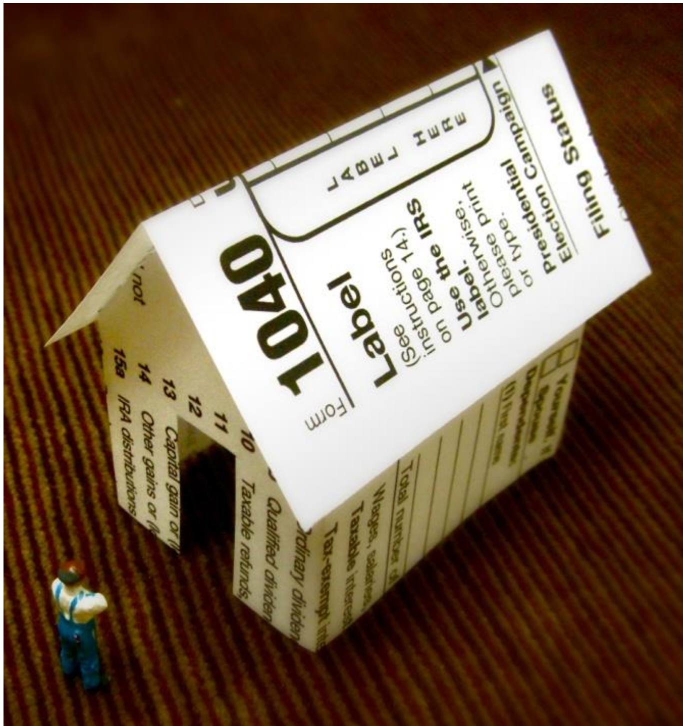
Non-Season Cash-Out Investor Loan Program

The non-seasoned cash out program is referred to as the Fannie Mae delayed financing program and was introduced a few years ago which makes a lot of sense to investors. The program allows for an investor to purchase an investment property for cash and turn right around and pull equity out of it and put a permanent loan against the property. Most refinance programs require that the borrower owns the property for at least 12 months before doing a cash-out loan on the property. This program allows them to do it day two of ownership.

There are many reasons for investors to pay cash for investment properties, but the most common reason would be the lack of time to secure a mortgage loan on the property in a short period of time. Another good reason is the property is a good deal but requires additional work, which is needed to pass the lender's appraisal requirements. Most common issues are roofs and foundations. Once the properties are acquired, and the investor has completed all of the renovations needed for the property to be considered a habitable property, then they will refinance the property and pull as much equity out at as they can. The 1 to 6 month refinance requires proof of where the funds came from for the acquisition. After 6 month, there is no requirements to prove the funds.

The Non-Seasoning (Delayed Financing Program) allows for a market value appraisal with a loan amount of 75% loan to appraised value (LTV) as long as the loan amount does not exceed the original sales price. After 6 months, the borrower is eligible to take up to the full 75% of appraised market value

Understanding a 1031 Tax Exchange



A 1031 exchange, otherwise known as a tax deferred exchange is a simple strategy and method for selling one income property, that is qualified, and then taking those funds and applying them to the acquisition of another property (also qualified) within a specific time frame. The logistics and process of selling a property and then buying another property are practically identical to any standardized sale and buying situation. A "1031 exchange" is unique because the entire transaction is treated as an exchange and not just as a simple sale. The difference between "exchanging" and simply buying and selling is in the end. Using an exchange allows the taxpayer(s) to qualify for deferred capital gains. So in simple terms, sales are taxable with the IRS, but not if you use 1031 exchange.

Due to the fact that exchanging a property represents an IRS-recognized approach to the deferral of capital gain taxes, it is very important for you to understand the components involved in such a tax-deferred transaction. It is within the Section 1031 (IRS. US CODE: Title 26, §1031) of the Internal Revenue Code that you can find the appropriate tax code necessary for a successful exchange.

Why Do a 1031 Tax Exchange?

Any Real Estate property owner or investor of real estate should consider an exchange when he/she expects to acquire a replacement "like kind" property subsequent to the sale of the existing investment property. Anything otherwise would necessitate the payment of a capital gain tax which is currently 15% but may go to 20% in future years. Also, include the federal and

INVESTMENT STRATEGY

state tax rates for your given state when doing a 1031 exchange. The main reason for a 1031 is that the IRS depreciates capital real estate investments at a 3% per year rate as long as you hold the investment until it is fully depreciated. When you sell the capital asset, the IRS wants to tax you on the depreciated portion as an income tax and that would be at the marginal tax rate.

What Property Qualifies for a Like-Kind Exchange?

Both the relinquished property and the replacement property must meet certain requirements.

Both properties must be held for use in a trade or business, or for investment. Property used primarily for personal use like a primary residence or a second home, or vacation home does not qualify for like-kind exchange treatment.

Both properties must be similar enough to qualify as "like-kind." Like-kind property is property of the same nature, character or class. Quality or grade does not matter. Most real estate will be like-kind to other real estate. For example, real property that is improved with a residential rental house is like-kind to vacant land. One exception for real estate is that property within the United States is not like-kind to property outside of the United States. Also, improvements that are conveyed without land are not of like kind to land.

Real property and personal property can both qualify as exchange properties under Section 1031, but real property can never be like-kind to personal property. In personal property exchanges, the rules pertaining to what qualifies as like-kind are more restrictive than the rules pertaining to real property. As an example, cars are not like-kind to trucks.

Finally, certain types of property are specifically excluded from Section 1031 treatment. Section 1031 does not apply to exchanges if:

- o Inventory or stock in trade
- o Stocks, bonds, or notes
- o Other securities or debt
- o Partnership interests
- o Certificates of trust

Source: *https://www.irs.gov/uac/Like-Kind-Exchanges-Under-IRC-Code-Section-1031*

I would like to point out that like-kind has been misinterpreted by lenders for many years. If you stick to the simple principle of income generating property to income generating property you should not have a problem with executing a proper 1031 exchange without penalties. Over the years I have done many exchanges for borrowers who have successfully exchanged out of a like-kind property to a residential property. Example: someone is selling a gas station and exchanging it into single-family rental properties. Let's think about it, the gas station was generating income, and now the rental properties are generating income. Sounds strange, but it met the like-kind property exchange rules.

Why is Entitlement So Important?

Anytime someone tells me, "I am doing a 1031 tax exchange, can you help me?" First thing out my mouth is "Have you already sold the property? If the answer's yes, I will ask how the property was titled when sold. Why is that so important? The above section reference "like-kind," now we are dealing with entitlement that has to be the "same as." If you sold the business in the name of the business and not in your individual names, then you would have to buy the properties in the same name. This is very difficult to execute an exchange for residential property with conventional lending. Once the sell property is sold, the funds go directly from the escrow company to the qualified intermediary. The settlement statement will show that the property was sold in the business name and not in the name of the individuals. Being that many 1031 exchange companies will require that the new property or properties being purchased would have to go with the same title that the previous business was sold. I see this happen all too often where investors purchase several properties and decide to asset protect their properties into an LLC, limited partnership, or S-Corp., not realizing that the exchange

companies potentially may not issue their funds for the new transaction because the title is different. Fannie Mae and Freddie Mac will not allow for “Entity Vesting,” consequently, exchange companies will not release the funds. The 1031 exchanging industry is not regulated nor has any governing party dictating how they do business. Their job is to try to facilitate the transaction in accordance with the 1031 exchange laws.

Avoiding the “Boot”

There are two types of tax boots to avoid when doing a 1031 tax exchange “Mortgage Boot and Cash Boot.” The main purpose of 1031 exchanges is to allow investors to grow their portfolios without paying any capital gains. So the rules are very clear.

Cash Boot

The total purchase price of the replacement "like-kind" property must be equal to, or greater than the total net sales price of the relinquished, real estate, property. All of the equity received from the sale of the relinquished real estate property must be used to acquire the replacement, "like kind" property.

1. Example: Sold one property for $200,000 and purchased three properties at $75,000 each which equals to a total of a $250,000 purchase price. Because the combined sales prices for all three properties are above the sell property of $200,000, there is no capital gains tax.
2. Example: Sold one property for $200,000 and purchased two properties at $90,000 each which equals a total of $190,000 purchase price. Because the combined sales price for both properties was lower than what the sell property was sold for $10,000 less, there would be a capital gains tax on the $10,000.

Mortgage Boot

The second fundamental rule is that the 1031 exchange requires that the replacement property must be subject to an equal or greater level of debt than the property sold or as a result the buyer will be forced to pay the tax on the amount of the decrease. If not they will have to put in additional cash to offset the low debt amount on the newly acquired property.

1. Example: Sold one property for $200,000 with a remaining loan balance of $100,000 on the loan. Purchased three properties at $75,000 a piece and putting three loans on each for $60,000 which equals to a total loan amount of $180,000. Because the combined loan amounts for all three properties were above what the sell property loan balance there is no capital gains tax.
2. Example: Sold one property for $200,000 and purchase with a remaining loan balance of $100,000. Purchasing three properties at $75,000 a piece and putting three loans on each of $30,000 which equals to a total loan amount of $90,000. Because the combined loan amounts for all three properties were lower than the sell property loan balance there would capital gains tax on $10,000.

The simplest way to avoid this is to be aware of what your debt requirement is from the beginning and factor it into the replacement property you're acquiring. One unique aspect of mortgage debt is that it can be offset by additional cash, meaning in the scenario above, if you were to bring $10,000 worth of non-exchange related funds to the closing, it would satisfy your obligation. Cash can offset debt, debt however cannot offset cash.

1031 Exchange Rules and Timelines

The Identification Period

This is the crucial period during which the party selling a property must identify other replacement properties that they propose to or wish to buy. It is not uncommon to select more than one property. This period is scheduled exactly 45 days from the day of selling the relinquished property. This 45-day timeline must be followed under any and all circumstances and is not extendable in any way, even if the 45th day falls on a Saturday, Sunday or legal US holiday.

The Exchange Period

This is the period within which a person who has sold the relinquished property must receive the replacement property. It is referred to as the Exchange Period under the 1031 exchange (IRS) rule. This period ends at exactly 180 days after the date on which the person transfers the property relinquished, or the due date for the person's tax return for that taxable year in which the transfer of the relinquished property has occurred, whichever situation is earlier. Now according to the 1031 exchange (IRS) rule, the 180-day timeline has to be adhered to under all circumstances and is not extendable under any situation, even if the 180th day falls on a Saturday, Sunday or legal (US) holiday.

What Cost Can be Deducted?

A frequently asked question is "What expenses can be deducted from the exchange proceeds without resulting in a tax consequence?" Although the IRS has not published a complete list of qualifying expenses, there are some rulings that provide general parameters. Brokerage commissions can be deducted from the exchange proceeds (Revenue Ruling 72-456). Other transactional costs may also be able to be deducted if they are paid in connection with the exchange. (Letter Ruling 8328011).

What are Exchange Expenses?

Transaction costs that are referred to as "exchange expenses" on Form 8824 are not specifically listed but should generally include costs that are:

A direct cost of selling real property, which typically includes:

- Real estate commissions.
- Title insurance premiums.
- Closing or Escrow fees.
- Legal fees.
- Transfer taxes.
- Notary fees.
- Recording fees.

Costs specifically related to the fact the transaction is an exchange such as the Qualified Intermediary fees.

Items that are NOT "Exchange Expenses"

Although not a complete list, the costs related to obtaining the loan should not be deducted from the proceeds.

These "Non-Exchange Expenses" Can Include:

- Mortgage points and assumption fees
- Credit reports
- Lender's title insurance
- Prorated mortgage insurance
- Loan fees and loan application fees

Other "Non-Exchange Expenses" Can Include:

- Property taxes
- Utility charges
- Association fees

- Hazard insurance
- Credits for lease deposits
- Prepaid rents and security deposits

These rough guidelines do not address every potential cost. Exchangers should review their specific transaction and closing costs with their tax and/or legal advisors.

In conclusion, my advice would be to plan accordingly for tax exchanges.

- Consult with your tax attorney or accountant and discuss your strategy
- Find a credible 1031 exchange intermediary
- Determine what you want to buy once you sell the property
- Consult with a knowledgeable real estate agent and/or a turnkey provider if you're looking to exchange into single-family housing and review what inventory is available
- List the sell property for sale
- Once you secure a contract on the sell property, make sure the deal is solid before making offers new properties.
- Once the sell property closes, the 1031 clock starts ticking. (45 days)
- Not knowing if your offer will be accepted on all properties, you might want to consider over identifying.
- Once all the offers are accepted on the identified properties, it's now time to determine which ones you want.
- Most states will allow you to cancel the contract during the option if needed.
- Once you have solid commitments on the buy properties, it's time for the lender to do their job.
- The good thing about the exchanges is that they do allow for 180 days to close.
- Make sure that your lender can close all your transaction at the same time. Many times it is very difficult to do all at the same time because they could be owned by different sellers.

The Chapter in this book is to be used as information. All parties doing a 1031 exchange must consult their tax advisors or attorney for this information. Consult a good loan officer that understands exchanges, so you will not have any last minute surprises.

Using a Power of Attorney

A power of attorney is a legal document that gives someone else legal authority to enter into transactions and sign documents on your behalf. The other person's signature is legally binding to the same extent as if you had signed the document. There are legal requirements for using a POA for real estate transactions. The purpose of the POA is to allow someone else, called the attorney or attorney in fact, to fulfill the administrative role of entering into agreements for you so that you do not have to sign every document. Your attorney, in fact, is essentially a legal replica of you. They can bind you to legal contracts and sign your name for real estate transaction.

POAs have been used for years to help buyers and sellers when they have a difficult time showing up at the closing table. There are many reasons to use a POA, but I must warn you, if you do not trust the person assigned a power of attorney, it could get you into trouble legally.

Before the mortgage meltdown, many fraudulent investors would use these instruments to wrongfully conduct a real estate transaction. The most common one was "Straw Buying." Scam artists who wanted to cheat the system would pay money to people to allow them to use their credit to get a mortgage loan. Most of the scams where the individuals who elected to have their credit used were foreign nationals, people too ignorant to determine that they were breaking the law. These people would give power of attorney to the scammer to completely conduct the transaction from beginning to the end. Once the loan closed, they would collect the rents, but never paid the mortgage, which resulted in a foreclosure.

The mortgage industry frowns on POA's, especially if it is for an investment property transaction. Most lenders will still do them, but are very cautious about who they will allow as a POA. Relatives are the most commonly accepted

POA. Many lenders will require proof of relationship. Most POA documents will have to be approved by the lender legal staff to make sure they are comfortable with the language.

HUD Closings

Many agents, as well as investors, don't realize that most HUD appointed Title Companies will not allow closing documents to be overnighted to a buyer for closing. Non-seasoned agents are more focused on getting the contract accepted from HUD for that out of town investor; they neglect to tell them they have to be at the closing table to close. I would assume less than 2% of out of state buyers will spend the money to travel to the closing. If the borrower does not have a relative or an approved POA in that market to sign, then getting the loan closed can be a problem. I have personally been involved in over 300 HUD closings, and this has been a problem more times than I can count.

POA approvals can also be a challenge if you have never had one prepared. Most POAs are prepared by a legal staff at the title company or the borrower and chooses to have it prepared by the family attorney. Either way is fine as long as they know what type of verbiage HUD requires of the POA. Hands down, HUD is the pickiest on what they will approve. I have never seen a POA get approved the first time out from a family attorney. Many HUD appointed title companies will prepare one for you but will charge you $175 - $400 to do so.

Notarizing Power of Attorneys

All powers of attorney are legal instruments that are required to be notarized for the authenticity of the signers. Keep in mind when presenting your power of attorney to a title company or a lender their legal staff will not even look at the document until it is officially notarized. If the instrument is not prepared correctly in accordance to the title company or the lender, the borrower is required to have the corrections made and re-notarized.

If you are living abroad and trying to conduct a real estate transaction, a POA is essential. All POA's that are used for buying or selling real estate in the United States must be notarized by a US notary. The only way that these documents can be notarized for a real estate transaction for people living out of the country is to have the documents notarized at the US Consulate in the perspective country. All lenders will require signatures from the borrower on all the initial loan disclosures. Fortunately, most of the documents do not necessarily have to be wet signatures, but still the borrower's original signatures. A power of attorney cannot be used for these documents, but only for the final closing documents.

Warning

A POA could get you in trouble if it were used inappropriately. When your representative signs on your behalf, the POA binds you to whatever they sign. You could be responsible or legally liable for transactions, mistakes or even negligence that you were not even aware of. For that reason, you must choose carefully a person you trust to act with your POA.

Types of POA's

A power of attorney is essentially a contractual document, which means you can control the full extent of the powers given to your attorney in fact. Some POA's are general and leave all matters to the discretion of the attorney in fact. However, most POAs expressly limit the powers of the attorney in fact. A narrower POA is safer because it restricts what the attorney, in fact, can bind you to. Most POA's that involve real estate typically will want to be specific in nature. General POAs do not necessarily work because it is not address specific. In my years of working with title companies and attorneys, they generally want to see the address and property description on the POA.

Recording

Most states require that all real estate transaction documents generally be recorded at the courthouse. Recording requires that the signatures on the document be verified or acknowledged by a notary public. The notary will require a copy of the POA form before they will verify or acknowledge the attorney in fact's signature on the document. In some cases, title companies will not recognize a copy of the POA, but only the original. So keep in mind, when preparing a POA and getting these instruments notarized you can forward copies of these documents to the title companies and lenders for approval, but the original needs to stay with the POA.

Why Put Your Rental Properties into an LLC?

The Advantages and Disadvantages of titling your Rental Properties into anything other than your personal names

The Advantages of having an LLC

The main reason investors prefer to have their rental properties in an LLC is for asset protection. For many years, lawyers, financial advisors, and tax accountants have been teaching asset protection to rental property owners. The more novice investors are worried about losing everything if a tenant or someone gets injured on their rental property. Other investors like to think of their rental properties as a business, therefore putting it into an LLC legitimizes a business entity. In most cases, rental properties will create a passive income. This income can be funneled through to your 1040 tax returns on Schedule E as personal investment property or through the LLC that you set up. Both ways have tax advantages.

Legal Benefits

The primary reason to form an LLC is for legal protection. Legal counsel generally has a tough time breaking through the LLC wall. Should any tenets, their guest, or anyone on the property sustain any injuries and the property is owned in the investor's name only, their personal assets are at risk.

Tax Benefits

From a tax perspective, and LLC formed with two or more members is classified as a "Pass-Through Company." A "Pass-through" means the income is passed through to its owners and claimed on those owner's individual tax returns. The LLC is subject only to capital gain rates on the ownership shares of the member, and not to the corporate capital gains taxes, therefore no double taxation. LLC's with just one owned-member however, are taxed as a sole proprietor, and no separate tax return is required. Actually tax dollars from holding real estate in an LLC opposed to personal holding the properties is zero. As of 2011, if you own income property and actively participate in the management of the property in your adjusted gross and less than $100,000, you can write off up to $25,000 of rent losses. The amount of the rent losses that you can write off is proportionately phased out between 100,000 and 150,000. Also, remember that although the loss is disallowed for that particular tax year, it is not completely lost. When you sell your income property, you can write-off any unused rental losses that have accumulated while you have owned the property.

The Disadvantages of having an LLC

Up Front and Ongoing Expense

When setting up an LLC, there are costs involved that are generally charged by an attorney or tax accountant for the preparation of your LLC charter. Those fees can vary depending on the source but is highly recommended versus doing it yourself online. Depending on what state you reside in even if your LLC is set up in another state, there could potentially be an annual fee that is paid to the state. Another fee would be the cost of filing separate tax returns for the LLC if you use an account, which I absolutely recommend if you're dealing with rental properties. In addition, the state franchise fees would also be another cost incurred depending on the gross profit of the LLC. The IRS has certain thresholds that they use for these franchise fees. Many investors starting off do not realize the reality of the impact of any fees against their bottom line until it's too late.

How it affects your financing

To me, this is the biggest hurdle for most lenders to overcome. Many investors "Miss the forest for the trees" and don't realize that owning properties in an LLC can create problems for future financing. Most 1 to 4 residential loans are delivered to Fannie Mae and Freddie Mac. Fannie Mae and Freddie Mac's guidelines do not support "Entity Vesting." Entity Vesting is when the rental property is titled in anything other than the individual borrower's names i.e. LLC's, S-Corps, or Partnership. First-time investors that have been educated to set up an LLC for their new real estate business do not realize that this can be

a problem. In addition, the same investors will set up individual asset accounts in their LLC names to support future purchase transactions. These funds cannot be honored as personal assets because they are in a business. There are special circumstances that these funds can be honored, but this requires a complete 12-month analysis of the LLC's profit and loss. This is totally up to an underwriter's discretion.

I highly encourage any investor that is looking real estate investing to keep the bulk of their assets in their personal account for underwriting purposes.

Due on Sale Clause

Most Fannie Mae and Freddie Mac notes originated today will have a "Due on Sale" clause. Most "Due on Sale" clauses prohibit you from transferring the title of your property. What does that mean to the investor? It means that if the loan servicer has knowledge of the property being retitled into an LLC, they could potentially call the note due. At that point, the investor would have to pay the loan off immediately or refinance it with another lender. Many investors will take the risk of retitling their properties into an LLC. The chances servicer finding this information out are quite small, but still possible. Please consider this before retitling your property into your personal LLC.

What are my choices if I Don't Establish an LLC for My Rental Properties?

This will strictly depend on your situation and what you want to be accomplished by forming an LLC. Some investors will title their rental properties into their family trust. This is acceptable by all Fannie Mae and Freddie Mac lenders as long as the trust is a revocable trust. Typically the trust will have to

be reviewed by each lender and their legal counsel to be able to finance the loan into a family trust. In addition to the trust, they will simply protect their assets by getting an umbrella insurance policy. These policies are very inexpensive and have great coverage in case of any occurrences that happen on your property.

What are Turnkey Properties?

In simple terms, turnkey properties are the easiest way to get started as an investor. All of the hard work that is involved with acquiring properties, fixing them up and finding tenants is already completed. Turnkey property companies have expert staffs that handle every aspect of property investment. If you are new to real estate, working closely with a turnkey property company is a normal first-time investment strategy.

Pros of Turnkey Property Investing

- One of the biggest resources that are used when you are involved in real estate is your time. It takes many hours of research to find properties, do title searches, contact attorneys to review real estate documents and get a property inspected. If a property is in a well populated area, many times it will be sold quickly to someone that knows how to expedite the legwork required. Many times new investors that have not achieved a smooth workflow will miss out on would-be properties due to the time-consuming nature of the research. Turnkey property companies have already done this research saving you a huge amount of time.

- A reputable turn-key company will know where to buy and where not to buy in a particular market. This is especially important for an out-of-state investor that may not have any local knowledge of the real estate market.
- A turn-key company can sell a house that has already been rehabbed. This is a huge benefit to an investor who does not want to pay for repairs out of pocket.
- A larger turn-key company typically has economies of scale when it comes to rehab costs. These savings are typically passed on to the buyer.
- Working through a turn-key company eliminates the hassle of trying to manage multiple contractors (i.e. plumber, electrician, roofer, HVAC, handyman, painter, etc.)
- Most turn-key companies have relationships with lenders who are familiar with their product and know how to get an investment loan closed. There are very few lenders who can consistently get investor loans closed. Having a good lender already in place is a huge benefit to an investor.
- Turn-key companies almost always have property management in place. With so many fly-by-night property managers out there, having a property manager you can trust to place a quality tenant, collect rent and take care of your property is crucial to an out-of-state investor.
- Having a relationship with a turn-key company gives you direct access to a vested party when any sort of need arises with the property. Turn-key companies operate off of referrals from their investors and as such, are very willing to stay involved with any investor throughout the life of their investment.

Cons of Turnkey Property Investing

- An investor may pay a slight premium for purchasing through a turn-key company rather than managing the entire process on their own.
- If you are a do-it-yourself investor, a turnkey property might not be the right choice for you. You have no say so in the acquisition, property management or previous construction that took place. You buy properties "as is" and might not love the decor or the interior or exterior. If you prefer to dig in and do things all by yourself, a turnkey property might not satisfy your need to have your hands involved in every aspect of property ownership.
- Before you choose a lender, you might want to ask them, do they have a problem working with turnkey providers, especially the ones that own

their own management company. Many lenders view these real estate transactions as "Non-Arm's Length" transactions. Non-arm's length transactions are purchase transactions in which there is a relationship or business affiliation between the seller and the buyer of the property. This relationship may add additional risk by masking of insufficient cash equity or down payment, promoting a sales price that is not indicative of actual market conditions, disposing of unsold builder inventory in unfavorable market conditions or masking occupancy fraud.

What is Fannie Mae's Definition of an ARM's Length Transaction

"Non-arm's length transactions are purchase transactions in which there is a relationship or business affiliation between the seller and the buyer of the property. Fannie Mae allows non-arm's length transactions for the purchase of existing properties unless specifically forbidden for the particular scenario, such as delayed financing. For the purchase of newly constructed properties, if the borrower has a relationship or business affiliation (any ownership interest, or employment) with the builder, developer, or seller of the property, Fannie Mae will only purchase mortgage loans secured by a principal residence. Fannie Mae will not purchase mortgage loans on newly constructed homes secured by a second home or investment property if the borrower has a relationship or business affiliation with the builder, developer, or seller of the property."

Many lenders may interpret the Fannie Mae guidelines differently than others. Don't assume that all lenders can lend on turnkey properties.

About The Author

Graham W. Parham Mortgage has been a Loan Officer since 1997. As an accredited investor himself, Graham has been working with real estate investors national for the last 23 years. He is a leader of financial expertise in the investment residential real estate market, developing a significant following among investors. Known and respected industry-wide, Graham's production consistently ranks him as a top producer nationally.

Graham offers invaluable insight into a purchaser's likely requirements, providing an exceptional business ethic of customer service and respect, catering to their needs from pre-qualification to closing. He is a truly dedicated person, who strives to ensure that each transaction is handled in a timely and stress-free manner. By employing these standards, Graham has established a solid reputation for going the extra mile to put together the absolute best financing available for his clients. Graham prides himself on staying ahead of the curve, keeping up to date with the latest products and industry trends.

Graham stays current of changes within the mortgage lending industry. He has gained a working knowledge of systems management and automation, giving him special insight to the rapidly changing world of real estate financing. In addition, his financial background gives him the ability to asses each client's financial situation and determine the best available mortgage loan program for their individual needs.

"My goal is to continue assisting my clients for life and help them meet the ever-changing needs life throws our way!"

Graham Parham's team mission is to assist every first time and repeat investor reach their financial potential based on those individualized situations and goals. Whether you are buying your first home or investment property, we carefully look at your options that will give you the best opportunity for success. Because we know how important your financing strategy is, our extensive research and knowledge of those programs will be brought forward in educating you as a homeowner, throughout the lending process.

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