White Paper

Nexus Real Estate Advisors
Boldness. Creativity. Patience.

Advanced Finance and Purchase Strategies for Residential Real Estate

Synopsis: Ask not IF it can happen, but HOW it can happen. This is one of our guiding principles at Nexus. It is easy to say 'no' to an apparently complicated deal or situation. This is what most people do. This is also what helps set Nexus and our clients apart. The tips below are proven strategies for acquiring, refinancing and even leasing properties.

General Strategies

- Obtain >100% LTV Financing
  - $300k property. If seller carries 50% second on the property ($150k), a bank would never give a 50% primary because this would be a 100% LTV loan. Instead, offer the seller a $150k second mortgage on another property, then the bank will look at that as almost cash. Now, ask the bank for a 70% loan, for total financing of $360k. Sweeten it for the bank by promising to use the extra $40k for improvements to the property.

- Assumability
  - Assumables are usually qualifying, so there is no guarantee from the lender anyway.
  - If current interest rate is far below the one on the existing mortgage, the quid pro quo for the seller is usually a higher selling price for the house… IF it appraises at that new high amount.

- Capitalize on Low-APR Mortgage with a Wraparound
  - Maintain payments on mortgage, but offer a new mortgage to the buyer, that wraps a second mortgage around the first one. Owner quit claims title to new buyer. Problem is the due-on-sale clause on most deeds of trust. If new owner changes insurance, the new insurance company will send info to original lender, thus alerting them to the fact that ownership has changed hands. Lender could consider this alienation of title and execute Due on Sale.
  - Wraps can be dangerous to the seller, since they have given up ownership of the property, but still have liability for the mortgage. Owner could be in trouble if buyer does not pay, or if the bank executes a due on sale.

- Minimize PMI
  - 80/10/10 or 80/15/5, where 80=first mortgage, 10=second mortgage (purchase money second), 10=down

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- Tax Advantage Mortgage Insurance (TAMI) = lender increases interest rates in lieu of charging PMI. Usually does not work out as favorably as an 80/10/10.

- Maximize Debt-to-Income with Owner Financing
  - Owner financing allows the investor to accumulate many properties, as the loan will not show up on credit reports or against qualification ratios (e.g. debt-to-income), but the investor can claim the income from the properties.
- Negative Points
  - In order to minimize settlement costs, lender might quote I tradeoff between negative points and increase in interest rates: 8%/0 points, 7.5%/3 points, 8.75%/-2.5 points
  - When negative points are retained by the Mortgage Broker, they are called a “yield spread spectrum”

- Maximize Immediate Cash-flow (Minimize Constant Rate)
  - Interest-only loan, or negative interest loan. This will create huge cash-flow problems in later years, though. No equity buildup, though you still have appreciation effects.

- Reduce Term of Loan (Maximize Constant Rate)
  - Wipes out cash flow

- 2nd Mortgage Crank
  - After purchasing a property using an 80/10/10, refi the 2nd for 100+%LTV to free up the down payment cash. Rule of thumb: if you purchase 20-25% below market, there should be enough leeway to refinance the property at the end of the first year to free up the initial capital, as well as achieve a significant equity gain. Can further guarantee this by fixing up/rehabbing.

- Balloon Down Payment for OWC
  - For a $38k down, offer 8k at time of sale, 16k six months later, and the final 14k a year later. You could fix the property up and sell it before down pmt is even due.

- Full-price offer / zero down
  - Feeds off the principal that the more cash involved in a deal, the lower the price. For an OWC, offer full price, but with zero down or other favorable financing

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terms. Offer 100k all cash, or 115k with no cash down.

- Bring in investor to finance deal
    - Take a portion of appreciation in exchange for finding the deal (see next section)

- If owner has equity in run-down property: assume existing note, have seller carry back 2nd, and trade fix-up labor/materials for down payment

- Divide down payment into multiple years

- Flexible payments during rehab period

- Create your own wrap scenarios by making sure the original note has provisions for no Due on Sale, etc

- Seller financing, make sure:
    - Long-term payoff, Low interest rates, No Due on Sale, No prepayment penalty, No late fee, No other restrictive Ts&Cs, Ideally unqualified assumable

- Large down payment/high equity situation: Seller financing/subordination
    - Gets them top $ for their down payment, costs you nothing
    - Assume sellers existing loan, offer seller third mortgage (subordinate to existing financing), and take out second yourself (pay down out of loan proceeds). Works best if each is roughly 30%. Work in additional provisions, such as moratorium on payments.

- For normal buy-and-hold
    - Negotiate the lowest purchase price possible
    - Include seller-paid closing costs on behalf of buyer
    - Seller-carry second financing with long, long amortization period (40 years), and an X-year balloon
    - Immediately crank the second (if not seller-carry) for 100% LTV to free up cash

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Purchasing ‘Subject To’ an Existing Loan

In a “Subject to” deal, the seller deeds the property to you while leaving the existing mortgage in place. In this arrangement, you do not formally assume the loan… you simply start making payments. There are pros and cons to this strategy.

When taking subject to, make sure and:

- Get power of attorney so you can deal with his lender for payoff info, or in case you did something wrong with the original deed and can not get a hold of the Seller.

- Get Sellers last payment book/statement and send in change of address form.

- Have seller sign a Due on Sale Acknowledgement (Flipping Properties-Appendix) about the fact that you are not assuming the loan and it will remain on his credit until you pay it off..
  - If a prop is in foreclosure, it is easy to talk them into some cash, and the promise to pay off their loan.
  - If the loan is current, you could hurt his credit by not paying off the loan. Some options:
    - Tell him your honest intentions
    - Insert a clause in purchase contract that reads “Purchaser agrees to satisfy sellers loan with _________ bank loan #______ on or before _______, and further agrees to make timely monthly payments required by said lender, including tax and insurance escrows as they become due. The clause shall survive closing of title.”
    - Offer second mortgage on the prop, for $10. Gives them the right to foreclose on the home if you default.
    - Third party escrow collection company. Could also set up a direct deposit to lender. Paytrust.com
    - Land contract. Puts buyer in weaker position, though.

- If you plan on flipping, make sure and ask lender for Reissue Rate or Hold Open Policy

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Lease Options

Especially suited for Sellers who want a new house and who don't need cash from the sale of an existing home for the down payment, and also when now is a bad time to be selling their own home.

The basic structure of the option is:

- Offer the Seller/Landlord an X-year lease with option to purchase (at agreed upon price). A portion of lease (10-20%) goes towards eventual down payment/reduction is sales price, as well as does the option $ given to the Seller. Investor could then sell this option contract if things work out well for appreciation/rents/etc. Investor would have to be certain that future option price is under market. Build in a 1-year "rolling option" (for extra $) that allows you to extend the option one more year, just in case.

- For the Seller
    - Guaranteed 100% rent for 5 years with no headaches and hassles. Home will be treated well. Continued paydown of Principal. Tax-free option $ to use as they please for X years. If option is exercised, it just becomes a part of the Purchasers down payment. Likely purchase at appreciated rate. No Brokerage fees (possibly) upon sale of home.

- For the Investor
    - Lock up and control property with no cash. Mitigate risks of catastrophic property failure by living with it for X years first. No responsibility for paying taxes, etc. Pocket the rent spread in future years. Build instant equity through % of rent going to eventual property purchase. Experience 'virtual ownership' before fully committing. Purchase with instant equity.

Here is how Nexus recently approached an owner who wanted a new home in a more upscale neighborhood, had good equity built up in their existing home, but STILL NEEDED $ to purchase the new home. The basic strategy was for them to 1) do a cash-out refinance of their 2nd Mortgage on their home to bring their combined LTV up to 80%, thus freeing up cash for the down payment, and then 2) leasing the property to us under a 4-year lease option whereby all of their existing mortgage costs were offset by rental income paid by us.

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Here is the presentation to the Seller:

Hello John and Jane -

As we were discussing, a Lease Option might be a great scenario for you to put the other house you were describing under contract… especially with current state of the RE market for sellers.

Here is basically how it works:

- (First, you meet with a Mortgage Broker to make sure you could refinance your 2nd into a cash-out refi… for instance take out enough $ to get to a combined 80% LTV on your 1st and 2nd loans, then ask for financing to be structured as a fixed 30 year am with 15 year balloon).
- I give you a few $k for an X-year option to purchase the house (at a price we both agree on). I can purchase the home anytime in that time period for that amount. If option is exercised, it just becomes a part of the down payment.
- In the meantime, I rent the house from you at a 100% rental rate. Being an expert landlord, I would then lease the property to tenants and manage the property. The good part here is you have guaranteed 100% rent for X years with no headaches and hassles and know the home will be treated well. This income would start coming into you fairly immediately.
- You continue to enjoy all of the tax deductions as well as principal paydown.
- Upon purchase, there are no realtor fees.
- A small portion of rent (typically 15%) is applied to eventual purchase price.

From your perspective, it becomes a win in that you are most likely going to sell the house at a good price, will still enjoy all of the tax benefits, and not have the hassle of managing the home. You also save Y% in Agent fees upon sale of the property. In the event the house is not purchased during the option period, you will be able to sell it in a better real estate environment down the road without losing $ in the meantime. The best part is that you can put in an offer on the other property immediately (with a contingency on obtaining your 2nd financing), or whenever you have the 2nd financing secured.

Sounds too good to be true, but this is just one of those times in the RE cycle that lease options work out well for both parties.

I have been playing with some different scenarios, and have come up with a few good options that might work well for you:

Option period (years)	3	3	4
Purchase price	$ 210,000	$ 213,500	$ 215,000
Option $ amount	$ 2,000	$ 2,000	$ 2,000
Monthly rent amount	$ 1,300	$ 1,200	$ 1,300
% of rent towards down pmt	12.0%	12.0%	12.0%

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Using the first scenario, here are the #s from your perspective:

	Sell Now	**Lease Opt**
Sales Price	$195,000	$210,000
RE Commission	$(11,310)	$ 0
Principal Paydown	$ 0	+ $6,000 (~ based on your current loan over 3 years)
Rent Prepay	$ 0	$ (5,686)
TOTAL Gain	**$183,690**	**$210,384**

Difference from Sellers perspective: +$26,694

Also, you add to the Lease Option gain the tax write-off from other expenses (e.g. misc maintenance or PMI).

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Investing Partnership Strategies and Tax Implications

In a partnership situation where we the Partner is sole financier, there are a number of structures, depending on relationship to Partner, and type of investment:

- Scenario 1: Family funded
  - In this scenario, we are not on title, and in exchange for services throughout the ownership period, we are entitled to one or more of: financial compensation for finding the deal, financial compensation for duties performed, future net appreciation $ for duties performed.
  - Compensation/Taxes: For net appreciation, once home sells, you and Partner must agree on exactly WHAT net appreciation means. Typically future sales price minus original sales price minus long terms capital gains taxes on future sales price (this simplistic approach eliminates the complexities of the various tax rates your Partner will pay upon sell of the property). Compensation could be paid to you in the form of non-taxable gift contributions (in 2006, a person can give $12k to anyone tax-free once per year---IMPORTANT NOTE-money given to either related party has to be out of the "goodness of their heart" and not in exchange for anything. Tax implications: None for us, since the $ they give us will already have long-term cap gain taxes taken out.

> Sidebar: Taxes on Passive Investment activities
>
> Upon sale of an investment property (as a passive investment activity), different tax rates apply towards different elements of the property:
>
> - Ordinary Income
>   - Personal property depreciation
> - Long-term capital gains (~25%)
>   - Building / improvement depreciation
> - Short-term capital gains (~15%)
>   - Everything else
> - Other items:
>   - PMI
>   - Points
>   - Origination
>   - Other fees: raise the basis at time of sale

- Scenario 2: Partner funded – we are not on title and have no interest
  - In this scenario, the Partner has funded project and is entitled to all deductions and tax write-offs. In exchange for Y services, we are entitled

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to X% of appreciation upon sale. In this scenario, we do not own an interest in the property, thus are not Partners by IRS definition.

- Compensation/taxes: Upon sale, Partner can pay us pre-tax dollars, and claim them as an operating expense (thus raising their basis). For us, the $ is then treated as ORDINARY INCOME! So where we would essentially be paying taxes at long-term cap gain rates in the above Family scenario (~15%), we are now paying at 30%+.

  So why not just have the Partner 'gift' us as in the Family scenario? When two unrelated parties have a contract in place (services in exchange for X), a Partnership exists between them, whether a formal Partnership was created or not. Moving $ around tax-free in a Partnership is generally frowned upon by the IRS.

- Scenario 3: Partner funded – we are on title as TICs and have Partnership
  - In this more complicated scenario, Partner funds project, and we are both on title. In exchange for Y services, Partner pays us X% net appreciation (or whatever) upon sale. In this situation, we have a Partnership by IRS definition (since we both have an interest in the property).
  - Compensation / taxes: In this scenario we are trying to avoid paying taxes at ordinary income tax rates on our cut of the appreciation (a 'la the partner cutting us a check in the scenario above). So now we are Partners (we need to form a Partnership), and in our operating agreement, we dictate that Partner has rights to all rents received, all deductions, etc (see below). Also in this scenario, we can only deduct losses up to the amount of our basis in the property, therefore paying a portion of operating expenses without owning anything would not be deductible.
    - Upon sale of the property the amount that we would be taxed on (as receiving X% of the appreciation) would be taxed the same way as the gain on the sale (i.e. personal property recapture at ordinary income rates, real property recapture at 25% and capital gains at 15%) because all of the gain would have to retain its original character. Otherwise people would structure these deals so that they would only have to claim 15% capital gains rates. Using the phrase "X% of appreciation" as opposed to "X% of gain"

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(the two are not the same thing) would not change how you report the income.

  - As a non-financial Partner, our capital account [in the Partnership] would be handled just like any other. What we put into the business would increase our capital account, our share of the income or loss (in this case zero until the sale) would increase or decrease the capital account and any distributions would decrease the capital account. In the way WE want to set this up, our capital account would not change until the property sold. Then it would increase by our share of the income. If we take that money out of the Partnership then our capital account decreases. Even if we don't take the money out of the Partnership we would still be taxed on our share.

- Other considerations

  In this scenario, we must form a Partnership, do taxes, etc. Costs will be roughly $500 to have CPA form Partnership (not incl. Partnership Agreement), $450 for year-end accounting.

  In the Partnership agreement, we must include a number of 'Special Allocations' that prove 'substantial economic effect':
  - Income/expenses taken by Partner
  - If property sold, appreciation divided as x%/y%
  - The partnership must maintain its capital accounts in accordance with the rules found in section 1.704-1(b)(2)(iv) or the treasury regulations. (This is the section of the regulations that lay out how contributions, distributions, etc are handled. The attorney who writes the agreement should know about this).
  - Upon liquidation, liquidating distributions must be made in accordance with the positive balances in the partners' capital accounts.
  - If after liquidation any partner has a deficit in his/her capital account, he/she must be unconditionally obligated to restore that deficit.

- Misc Taxes

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- In 2007, self employment tax=15.3%.   After 81k, that income source stops paying into SS (at 12.4%), yielding a tax rate of 2.9 %.

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About Nexus

The power of experience.

Nexus Real Estate Advisors
Boldness. Creativity. Patience.

Anybody can read a book on real estate investing. But until one actually begins the process, and repeats it year after year, do they become a profitable real estate investor.

Nexus has the experience to get our clients to the next level step… no matter how high.

- Nexus was created by the founder of Nexus Property Management, acquired by GK Homes in 2019. Nexus was awarded the #1 position as “Fastest Growing Private Company” by the Denver Business Journal in both 2010 and 2011. Nexus understands the rental business, and what makes a successful income property.

- Proven experience and track record of building personal wealth with residential RE investments.

- After managing nearly 10,000 properties across the Front Range over a decade… we know the winners and losers, often down to street-level.

- We are experts in RE purchasing… from identification to negotiation to inspection to close.

- Experience in real estate and business management, taxes, Fed/State requirements.

- Access to best-of-breed vendors, and playbook for how to identify and vet new vendors.

Our services are generally free of charge.

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