National Pearson VUE Real Estate Exam Prep

Workbook

Second Edition

KAPLAN REAL ESTATE EDUCATION

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NATIONAL PEARSON VUE REAL ESTATE EXAM PREP WORKBOOK
SECOND EDITION

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Contents

Preparing for the Exam Prep Course

Welcome to Exam Prep! Take these steps to get the most out of the course:

1. Read this section ("Preparing for the Exam Prep Course") in its entirety.
2. Complete the true/false questions before you attend the course or view the online lectures.
3. Bring this workbook to class or use it with the online lectures.

It is very important to read this section before proceeding with the course.

Exam Prep is the most accurate predictor of whether you are ready for the actual licensing exam. The course consists of two full-length practice exams and two content review sessions. Each practice exam consists of the same two portions you will face on the actual licensing exam (a national portion and a state portion).

WHAT SHOULD YOU DO TO PREPARE FOR THE EXAM PREP COURSE?

Follow these steps to prepare for this Exam Prep course and to ensure a successful study program:

1. If you are taking the real estate licensing program in its entirety, you should complete and pass all coursework and exams in the program before starting this Exam Prep course.
2. Complete all of the true/false questions in this book.
   - Start with your weakest topic.
   - Conceal the answers on the right-hand side and try to determine whether each statement is true or false.
     - If the statement is false, see if you can change it to make it true. For example:

1.	Nevada is a country in South America.	F	Nevada is a state in the United States in North America.

     - Before revealing the answer, you should have answered "false" and changed the statement to "North America."
     - If you know a statement is false but do not know how to make it true, mark the question as missed.
   - When you are done with all the questions in a section, evaluate how you did on that topic. If you missed several questions, use the Exam Prep Strength and Weakness Indicator Chart on the following pages to find out where to review that topic.
   - Once you have completed all the true/false questions, retake the ones you got wrong. If you miss them again, mark them. Continue retaking the questions you got wrong until you don't miss any more questions and completely understand all the concepts.
     - The key is to always study what you do NOT know until you learn it.

3. Take the pretest. Classroom, OnDemand, and Home Study students will take it online.
   — View your results via the Performance Tracker to identify your strong and weak areas.
   — To improve on your weak areas, redo the true/false questions for those topics. For the true/false questions you answered correctly, make sure you got them correct for the right reason (not just a lucky guess). For the questions you missed, use your course materials to review the concept being tested. Keep taking these questions until you are confident that you understand the underlying concepts.
4. Attend the Exam Prep lectures (or view them online).
5. Take the posttest. Classroom, OnDemand, and Home Study students will take it online.
   — View your results via the Performance Tracker to identify your strong and weak areas.
   — Again, be sure to redo the true/false questions for the topics you need to brush up on. Keep taking these questions until you are confident that you understand the underlying concepts.

Register for your licensing exam with PSI at www.psiexams.com.

WHAT SHOULD YOU DO IF YOU SCORE 80% OR HIGHER ON THE PRETEST?

If you score 80% or higher on the pretest, you're doing well, but you may still need to focus on a few areas that you haven't quite mastered. You should do the following:

- View the Performance Tracker to identify the areas you still need to review.
- Attend the Exam Prep lectures or view them online, paying special attention to your weak areas.
- Take the Exam Prep posttest at the end of the course.

WHAT SHOULD YOU DO IF YOU SCORE LESS THAN 80% ON THE PRETEST?

If you score 75%–79% on the pretest, you're doing well, but you may need to focus on a few areas that you haven't quite mastered. You should do the following:

- View the Performance Tracker to identify the areas you most need to review.
- Attend the Exam Prep lectures or view them online, paying special attention to your weak areas.
- Take the posttest at the end of the course if you are ready; if not, wait and take it when you feel prepared.
- If you have already scheduled your exam, evaluate whether you will have enough time to study after the Exam Prep course or if you should reschedule the exam.

If you score less than 75% on the pretest, note that students who score below 75% on the pretest generally struggle to pass the actual licensing exam. But don't panic—you can pass it with more study:

- Consider waiting to complete Exam Prep. Often, spending additional time studying and completing or reviewing all the true/false questions will allow you to pass the posttest. If you decide that you want to wait, give yourself enough time to study and prepare (typically no more than three to four weeks). If you have already set a test date, remember you might need to cancel or reschedule it.
- Consult your Performance Tracker. This will help you identify the content areas in which you need to improve. Start your review with your weakest area first.
- Review real estate terms. Familiarity with real estate terms is crucial. If you're taking the complete licensing program, review the key terms in your study materials. If you do not know a term, make a flashcard for yourself. Once you have completed the process, you will have a stack of flashcards to review. If you are not enrolled in the entire licensing program, consider purchasing a good real estate dictionary. We have the best books in the industry available for sale on our website and at some of our school locations.
- Study the true/false questions in your Exam Prep book. You've probably reviewed these before, but try answering them again. If you've followed the preceding steps, the concepts tested in the true/false questions will be more familiar. Be sure to conceal the answers as you study the questions. For every false statement, try to change the information to make it a true statement. This will further ensure that you understand the concept being tested.

WHAT SHOULD YOU DO IF YOU SCORE LESS THAN 80% ON THE POSTTEST?

If you score less than 80% on either portion of the posttest, note that the posttest is an accurate predictor of whether you're prepared to pass the actual licensing exam. Scores lower than 80% generally indicate you are not yet ready for the actual exam. Consider these:

- You need to review the material. If you're enrolled in Kaplan's complete licensing program, reread the relevant units in your materials, attend (or view online) selected class sessions, and work through the review exams until you're ready to try the posttest again. Review all the sections and areas you missed using the Performance Tracker. Review the true/false questions for those areas.
- When you feel ready, retake the exam.

WE ARE HERE TO HELP

The faculty and staff are committed to your success on the licensing exam. Please contact us at any time throughout your studies to let us know how you are doing or how we may be of service.

Preface

NATIONAL SPECIFIC PORTION REVIEW

The National Specific Portion contains 80 questions and reflects the current real estate laws, rules, and regulations. Topics covered in the National Specific Portion are listed below.

Real Property Characteristics, Legal Descriptions, and Property Use (Sales—8 Items, Broker—8 Items)

Topics include real property versus personal property; characteristics of real property; legal descriptions; and public and private land-use controls—encumbrances.

Forms of Ownership, Transfer, and Recording of Title (Sales—7 Items, Broker—7 Items)

Topics include ownership, estates, rights, and interests; and deed, title, transfer of title, and recording of title.

Property Value and Appraisal (Sales—7 Items, Broker—7 Items)

Topics include concept of value; appraisal process; and methods of estimating value and broker price opinion (BPO).

Real Estate Contracts and Agency (Sales—16 Items, Broker—16 Items)

Topics include types of contracts; required elements of a valid contract; contract performance; sales contract; types of agency and licensee-client relationships; creation and termination of agency; and licensee obligations to parties of a transaction.

Real Estate Practice (Sales—18 Items, Broker—18 Items)

Topics include responsibilities of broker; brokerage agreements between the broker and principal (seller, buyer, landlord, or tenant); fair housing; and risk management.

Property Disclosures and Environmental Issues (Sales—6 Items, Broker—5 Items)

Topics include property conditions and environmental issues; and disclosure obligations and liability.

Financing and Settlement (Sales—10 Items, Broker—9 Items)

Topics include financing concepts and components; lender requirements; federal financing regulations and regulatory bodies; and settlement and closing the transaction.

Real Estate Math Calculations (Sales—8 Items, Broker—10 Items)

Topics include property area calculations; property valuation; commission/compensation; loan financing costs; settlement and closing costs; investment; and property management calculations.

UNIT 1

Real Property Characteristics, Legal Descriptions, and Property Use

LEARNING OBJECTIVE *When you have completed this unit, you will be able to*

- **describe** the characteristics of real property versus personal property and **identify** the three legal descriptions and the use of property.

I. REAL PROPERTY VS. PERSONAL PROPERTY

A. Fixtures, trade fixtures, emblements

1. Includes land plus improvements and appurtenances, which includes rights, privileges, and fixtures
    a) Surface rights
    b) Air rights
    c) Subsurface rights, including mineral rights
2. Improvements
    a) Items affixed to the land with the intent of being permanent
3. Appurtenances—includes rights, privileges, and fixtures
    a) Fixtures are items attached to improvements with the intent to become real estate, as evidenced by any of the following:
        (1) Attachment or annexation
        (2) Adaptation
        (3) Agreement
4. Emblements
    a) Annually cultivated crops that belong to the party who rightfully planted the seed
5. Trade fixtures
    a) Tenant-installed additions to a property for use in a trade or business
6. Land cannot be a fixture.

B. Attachment, severance, and bill of sale

1. Severance
    a) When real property becomes personal property
    b) Transfers in a bill of sale

II. CHARACTERISTICS OF REAL PROPERTY

A. Economic characteristics

1. Scarcity
    a) Although there is a substantial amount of unused land, supply in a given location can be limited.
2. Improvements
    a) Placement of an improvement on a parcel of land affects value and use of neighboring parcels.

3. Permanence of investment
    a) Sale of a particular parcel of land may take considerable time.
    b) Land is not a liquid asset.
4. Area preference
    a) People's choice and desires for a given area make one site more desirable than another.

B. Physical characteristics

1. Immobile—cannot be moved
2. Indestructible
3. Nonhomogeneous—unique in that all parcels differ geographically

III. LEGAL DESCRIPTIONS

A. Methods used to describe real property

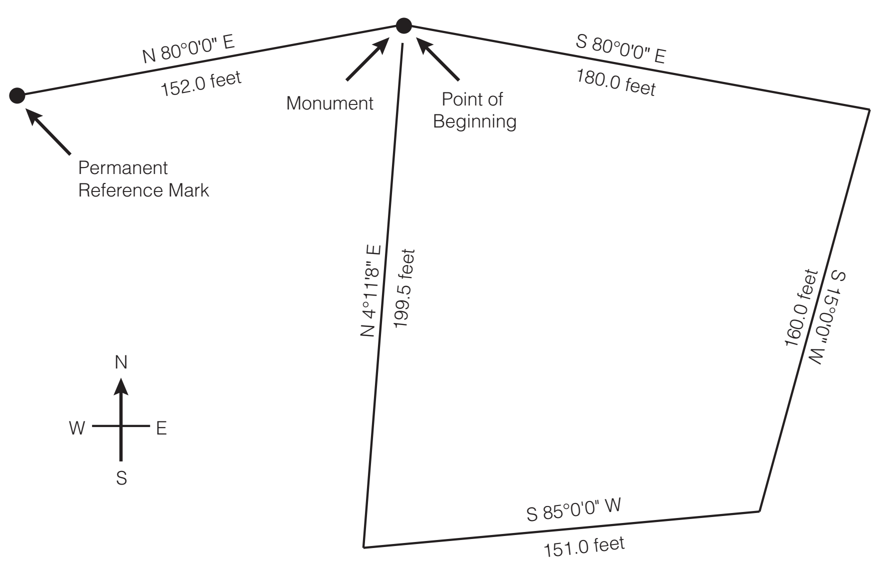
1. Metes and bounds
    a) A description using distances and compass degrees moving in a set direction
    b) Starts and ends at point of beginning (POB) referenced from a monument
    c) Measure clockwise

(See Figure 1.1)

For example:

"Commencing or starting at the street sign at the corner of Ridge and Ash (point of beginning), go South 80° East 180 feet, then South 15° West 160 feet, then South 85° West 151 feet, then North 4° 11'8" East 199.5 feet to the point of beginning."

FIGURE 1.1: Metes and Bounds



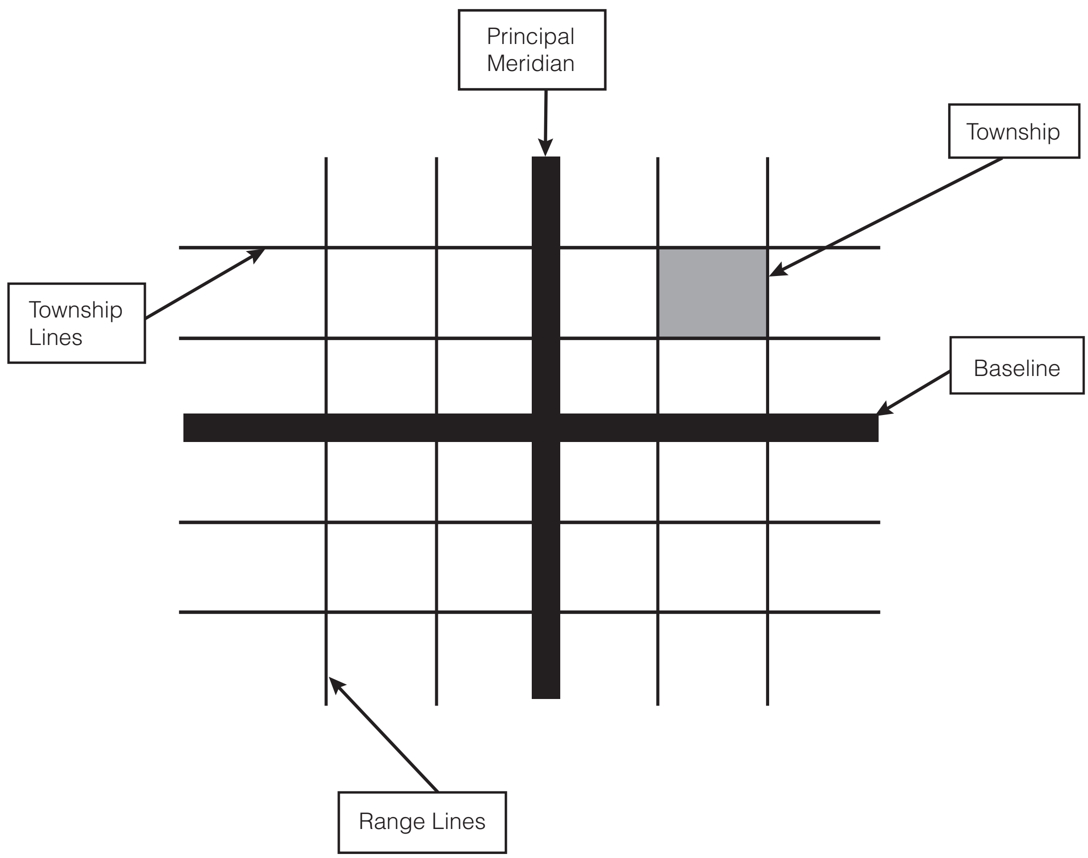
2. Rectangular survey/government survey

   a) Uses imaginary reference lines—meridian lines (north/south)and base lines (east/west)

   b) Range (north/south) and tier (east/west) lines make up townships

   (See Figure 1.2)

FIGURE 1.2: Rectangular Survey



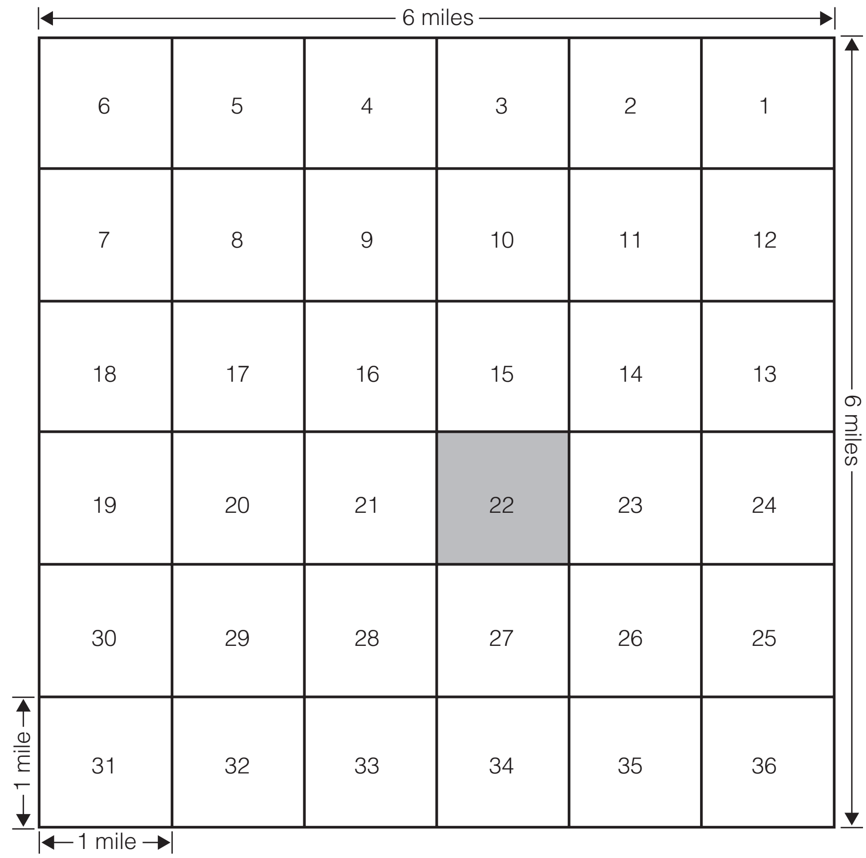
   c) Each township contains 36 sections.

   d) A section equals 640 acres, or 1 mile by 1 mile.

   e) An acre equals 43,560 square feet.

   (See Figure 1.3)

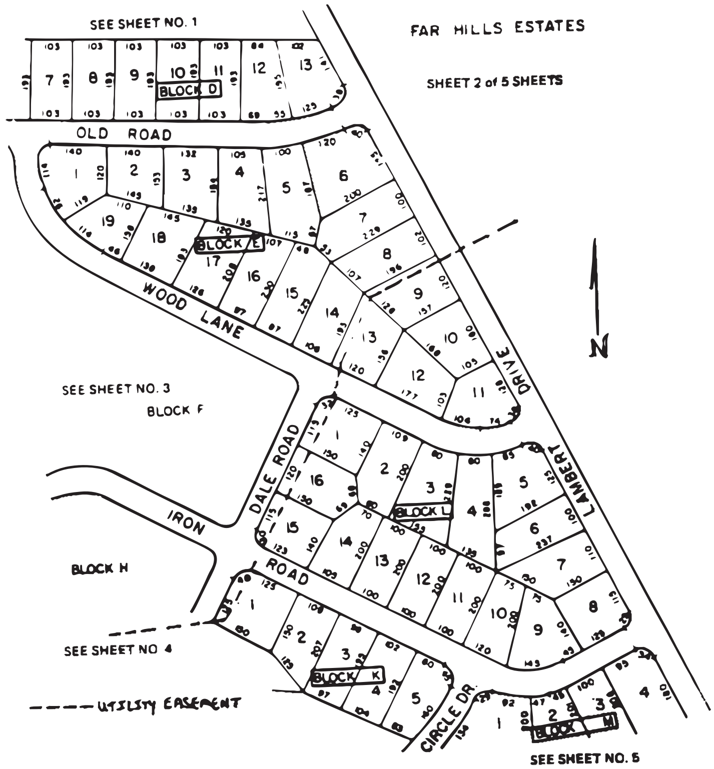
FIGURE 1.3: Township



3. Recorded plat (lot, block, subdivision)—urban/residential
   a) The survey shows the lots and boundaries.
   b) The second step involves recording the map.
   c) Recording is done before obtaining building permits.

   (See Figure 1.4)

FIGURE 1.4: Plat Map



B. Survey

1. An on-site measurement of property lines and the position of the property improvements and easements
2. Used to create or verify a legal description and to create a plat map
3. Uses monuments, which are markers used to help establish property boundaries
4. May reveal encroachments or zoning violations
5. Improvement location certificate/title survey
    a) It is similar to a survey but only locates improvements on the lot.
    b) It will find encroachments.

IV. PUBLIC AND PRIVATE LAND-USE CONTROLS—ENCUMBRANCES

A. Public controls—governmental powers (PETE)

1. Police power
    a) Enacts and enforces laws governing land use
    b) Regulates the use of public land

   c) Includes zoning, building codes, planning, and safety codes
   d) Enforced by requiring building permits, building inspections, certificates of occupancy, and so on
2. Eminent domain
   a) Eminent domain is the right to "take" private land for public use.
   b) Condemnation is the process.
   c) Fair compensation includes the property value plus damages.
   d) Inverse condemnation involves an owner initiating a court action seeking fair compensation from the government because the owner's property has been substantially interfered with.
3. Taxes and special assessments
   a) Property taxes
      (1) Ad valorem (at assessed value) taxes are based on assessed value, not on current market value.
      (2) The tax rate may be expressed as a mill rate, percentage rate, or decimal.
      (3) Typically, properties are reassessed on an annual basis.
      (4) Property owners who believe their assessment is incorrect may appeal to an assessor's appeals board.
   b) Special assessment
      (1) This is a lien against specific properties that benefit from a public improvement.
      (2) Special assessments are paid with property taxes and enforced by a lien.
      (3) Property taxes and special assessments take priority over other liens.
4. Escheat
   a) This is a government's reversionary right.
   b) Abandoned property or property of intestate owners with no heir may revert to the state.

B. Zoning ordinances

1. Set at a local level
2. A master plan
   a) Used to control growth
3. Zoning determines the type of use, such as residential, commercial, industrial/manufacturing, agricultural, or mixed.
   a) Special land types include floodplains, coastal preservation, and other special designations.
   b) It uses classifications that may be regulated at the county, state, or federal level.

4. A <u>buffer zone</u> is an area of land (e.g., a park).
    a) It separates two drastically different land-use zones.
5. A rezoning or an amendment
    a) A zoning change for an entire area
6. <u>Nonconforming use</u>
    a) This allows an owner to continue present use that no longer complies with current zoning (grandfathering).

       Example: A retail store surrounded by residential property would have been grandfathered in when the zoning changed.
    b) Grandfathered properties typically can't expand or rebuild as the nonconforming use if <u>destroyed</u>.
7. <u>Setbacks</u>
    a) In the front, side, and/or rear
    b) Restricts and limits the location of improvements in relation to the boundaries of the property
8. A <u>variance</u>
    a) Used when a property owner wants to vary or deviate from building codes, or build into a setback, to prevent economic hardship
9. Special—or conditional—use (also called a special exception)
    a) A specific type of variance
    b) Allows a different use (e.g., day care in residential zoning)
    c) Allows the owner to deviate from zoning regulations, not from deed restrictions or building codes
    d) Buyers who wish to continue the use or who are not sure if a use is allowed should check with the zoning department before buying.
    e) Any special-use zoning must be disclosed to buyers.

       Example: tax districts or airport flight paths
10. Building codes or standards and certificates of occupancy
    a) Building codes deal with the structural integrity and safety of a building.

       Example: minimum number of bathrooms per square foot in a commercial building
    b) They determine the types of construction that can be used.
        (1) Sets standards for types of materials and how they are used
        (2) Provides separate codes for plumbing, electrical, fire, and so on

11. A certificate of occupancy
    a) Issued when a new building is ready for occupancy
    b) Confirms that the building meets <u>minimum</u> standards

C. Private controls, restrictions, and encroachments

1. Covenants, conditions, and restrictions
    a) Privately created <u>controls</u> on land use
    b) Might control style of improvement or use of property
    c) Must be legal

       Examples: No RVs are allowed in driveways, houses must be painted in certain colors, fencing must be of a certain type, and garages must be a certain shape and size.

    d) May not violate fair housing laws
        (1) Cannot refuse to sell based on race or national origin
    e) Used by <u>developers</u> to protect property values and the interests of property owners in a subdivision
    f) Binding on all present and <u>future</u> owners
    g) Property owner subject to injunction if deed restriction is violated
    h) Application of rules
        (1) When there is an issue between a government restriction and a private restriction, the <u>strictest</u> will apply.

            Example: The deed restriction in a subdivision allows RV parking on driveways, while the zoning does not. RVs would not be allowed to park on the driveway.

2. Easements
    a) The right to use land of another for a specific purpose
        (1) May or may not be paid for
        (2) Must be in writing
        (3) Is not <u>revocable</u> once given
        (4) <u>Transfers</u> with the land at closing unless released by the holder
    b) Types of easements
        (1) <u>Appurtenant</u> easement
            (a) Has a dominant tenement and a servient tenement
        (2) <u>Easement in gross</u>
            (a) Has no dominant tenement, only servient

                Example: utility easement

(3) Easement by necessity

(a) May be granted to a homeowner to avoid landlocked property

Note: This easement is available to private owners, not to government, utility, telephone, or gas companies.

(4) Ways of termination

(a) By merger

(b) By release

(c) By abandonment

3. Licenses

a) Revocable permission to use the land of another without creating an estate in land (may or may not be paid for)

4. Encroachment

a) Unauthorized use of another person's land

b) Pointed out by a survey or found by an improvement location certificate (ILC)

c) Title insurance or an attorney's opinion will not protect against it (visual inspection)

REVIEW QUESTIONS

1. Economic obsolescence results from an inharmonious land use in a neighborhood.
   a. True
   b. False
2. A consideration in determining whether or not an object is a fixture includes the adaptation of the object.
   a. True
   b. False
3. An encroachment can be found on the deed.
   a. True
   b. False
4. Rita Smith leases a restaurant to Diego Jones for five years. Jones installs his own ovens, booths, counters, and other equipment. These items are considered personal property and can be removed at the end of the lease.
   a. True
   b. False
5. The sellers removed the attached microwave, which had not been excluded in the sale. The sellers are in breach.
   a. True
   b. False
6. A shared driveway and a party wall are both examples of easements in gross.
   a. True
   b. False
7. The right of ingress and egress over the land of another is classified as an encroachment.
   a. True
   b. False
8. A storage building that extends over the boundary line between the property of the building's owner and an adjacent property is an example of encroachment.
   a. True
   b. False
9. The recipient of an easement appurtenant enjoys an increase in the amount of property owned.
   a. True
   b. False
10. An easement by prescription is a right acquired by an adverse user for limited use or enjoyment of the land of another.
    a. True
    b. False

2

UNIT

Forms of Ownership, Transfer, and Recording of Title

LEARNING OBJECTIVE *When you have completed this unit, you will be able to*

- **summarize** the various forms of ownership as well as how real property is conveyed and title is recorded.

I. OWNERSHIP, ESTATES, RIGHTS, AND INTERESTS

A. Forms of ownership

- An attorney for the buyer should determine the appropriate form of ownership.
  - — License holders should never give advice on how to take title.

1. Sole ownership/estate in severalty
   a) When property is owned solely and separately by one person or one entity, it is called an estate in severalty.
2. Concurrent/multiple ownership
   a) Tenants in common—co-ownership with no right of survivorship
      (1) Interests passed to heirs or devisees upon death
      (2) If no form of ownership is indicated, law presumes tenancy in common
      (3) May have unequal shares of ownership
      (4) Each tenant responsible for taxes as an individual or as a group
   b) Joint tenants—co-ownership with the right of survivorship
      (1) Interests pass to co-owners/co-tenants upon death without going through probate
      (2) Overrides a will
      (3) Four unities of title—possession, interest, time, and title (PITT) required in some states
   c) Tenancy by the entirety
      (1) Applies exclusively to married couples in some states
3. Common interest ownership properties
   a) Condominiums and town houses
      (1) Condos and town houses are real estate, portions of which are designated for separate ownership (units), with the remainder—including the physical structure—designated for common ownership and use (common elements).
         (a) Common elements are owned by all current property owners as tenants in common.
      (2) Purchasers own and finance their own units.
      (3) Properties/units are transferred by deed.
      (4) Each unit and its common element percentage are taxed as a separate parcel.
      (5) The owners association establishes the budget and assessment for the maintenance of the common elements.
         (a) Does not build, develop, or rent units

b) Cooperatives

(1) Cooperative ownership is ownership of the building by a corporation, which in turn, leases space to shareholders who own stock in the corporation.

(2) Buyers receive corporate bylaws, <u>shares of stock</u>, and a <u>proprietary</u> lease for their unit and their share of the common elements.

(3) Because there is no ownership of the unit, the buyer does <u>not</u> receive a deed.

(4) The owner pays assessments and association fees.

(5) Just as in a condominium association, owners may have to get permission from the other owners to sell their unit (first right of refusal).

c) Time-shares

(1) A time-share is a common interest ownership form in which multiple owners have interest in a property for a certain period each year.

(2) Time-shares are most commonly used for <u>resort-type</u> properties.

B. Freehold estate

1. Fee simple absolute

a) Lasts <u>forever</u> and features the maximum rights of ownership

2. Fee simple defeasible: determinable, and condition subsequent

a) Fee simple subject to has an executory limitation or interest

(1) An estate that ends when a specific condition is met, the grantee loses the interest, and the third party gains it automatically

b) Fee simple determinable

(1) An estate that will end automatically when the stated event or condition occurs; the interest will revert to the grantor or the heirs of the grantor

c) Fee simple subject to a <u>condition subsequent</u>

(1) Does not end automatically upon the happening of the condition

(2) Holder must take substantial steps to recover <u>possession</u> and <u>title</u>, for example, by filing a lawsuit

d) Life estate

(1) In a life estate, <u>life tenants</u> have ownership and use of the property for the duration of their life or the pur autre vie life.

(a) Upon the death of the life tenant, the holder of either the reversionary or remainder interest will own a fee simple absolute estate at death.

(b) <u>Pur autre vie</u> (according to another's life) is based on the life of someone other than the holder of the life estate.

(2) A <u>legal</u> life estate can create ownership rights. Dower, curtesy, and homesteads are examples.

e) Bundle of rights

(1) Right of possession

(2) Right to control the property within the framework of the law

(3) Right of enjoyment

(a) To use the property in any legal manner

(4) Right of exclusion

(a) To keep others from entering or using the property

(5) Right of disposition

(a) To sell, will, transfer, or otherwise dispose of or encumber the property

C. Leasehold estates and types of leases

1. Elements

a) Leasehold estates have a definite duration and may be terminated.

b) The lessee (tenant) holds a leasehold estate; the lessor (landlord) holds a leased fee estate.

c) If it is an estate for years or periodic tenancy, a new buyer will be *subject to the lease* with the tenant in possession until the lease expires.

2. Types of leasehold estates

a) Estate/tenancy for years—has set terms and a predetermined termination date; definite period with no notice

b) Periodic estate/tenancy—renews from period to period, such as month to month, with the same terms and conditions upon payment of rent until notice is given

c) Estate/tenancy at will—continues until terminated by the owner or the tenant; tenancy is at the owner's consent

d) Estate/tenancy at sufferance

(1) This occurs when a holdover tenant stays beyond termination without consent.

(2) If the landlord accepts payments, it becomes a periodic tenancy.

(3) It is the lowest estate.

3. Types of leases

a) Gross lease/fixed lease—tenant pays fixed rent; landlord pays all expenses

Examples: utilities, taxes, special assessments

(1) Typically used in residential properties but can be used for commercial or industrial properties

b) Net lease—tenant pays fixed rent plus expenses; most common for commercial properties

Examples: utilities, taxes, special assessments

c) Percentage lease—tenant pays a percentage of income as rent

d) Index lease—rent is adjusted based on an economic index

e) Sale-leaseback—converts equity to capital without giving up possession

f) Land lease—all tenant improvements become the land owner's at the termination of the lease

D. Liens and lien priority

1. A lien is a claim that attaches to and is binding on property to secure debt repayment.

   a) Property tax/special assessments lien: specific lien

      (1) This takes priority over all other liens, even those previously recorded, such as a mortgage.

   b) Mechanic's lien: specific lien

      (1) If one is found before closing, the seller is responsible for clearing the lien.

   c) Mortgage lien: specific lien

   d) Condominium/town house association assessments lien: specific lien

   e) Judgment or IRS lien: general lien

      (1) It attaches to all real and personal property.

E. Surface and subsurface rights

1. Surface rights

   a) Ownership rights in a parcel of real estate to the surface of the earth

2. Subsurface rights

   a) Rights to the natural resources below the earth's surface, such as minerals

3. Air rights

   a) Rights to use the space above the earth; can be sold independently or with one or both of the above

4. Water rights

   a) Riparian rights

      (1) Incidental to ownership of land abutting flowing water (stream or river)

   b) Littoral rights

      (1) Incidental to ownership of land abutting water that is not flowing (lake or ocean)

5. Doctrine of prior appropriation

   a) Certain states rely on the doctrine of prior appropriation, which means the first user diverting to beneficial use has the first claim on the water.

II. DEED, TITLE, TRANSFER OF TITLE, AND RECORDING OF TITLE

A. Elements of a valid deed

1. Competent grantor—age 18 and of sound mind
2. Executed by grantor(s)
3. Identifiable grantee
4. Delivered and accepted by grantee(s)—title and possession of property (unless otherwise agreed) pass at this point
5. Legal description
6. Consideration—money or something of value
7. Words of conveyance—granting clause

B. Types of deeds

1. Warranty deed/general warranty deed
    a) Best for grantee
    b) Five covenants and a guarantee of title
        (1) Covenant of seisin
            (a) Grantor has right to convey
        (2) Covenant of quiet enjoyment
            (a) Grantee will not be disturbed by others
        (3) Covenant against encumbrances
            (a) There are no unspecified encumbrances
        (4) Covenant of further assurance
            (a) Cooperation in signing additional documents
        (5) Warranty forever
            (a) Guarantee of defense
2. Limited (special) warranty deed
    a) Warrants only those defects and encumbrances that occur during the grantor's period of ownership
    b) Used in HUD and REO foreclosure sales
3. Bargain and sale deed
    a) No express warranties
    b) Contains only implied warranties that the grantor has title and holds possession of the property
    c) Used in tax and HOA foreclosure sales

4. Quitclaim deed (best for grantor)
    a) Used as <u>problem-solver</u> and to terminate deed restrictions
    b) No promises, no <u>guarantee</u>
    c) Has no liability for the grantor
    d) Gives the grantee <u>no</u> right to future claims
5. Trustee's deed
    a) Property managed, owned, and sold in a <u>trust</u>
6. Deed executed pursuant to a court order
    a) Properties sold through probate of a <u>will</u>
        (1) Executor or administrator oversees the court order of sale
    b) The actual sales price is stated
7. Public grant
    a) The <u>government</u> transfers ownership by a land patent to a private party.

C. Title transfer

1. <u>Voluntary alienation</u>
    a) Transfer of title during the property owner's lifetime
        (1) By making a gift
        (2) By selling the property
2. <u>Involuntary alienation</u>
    a) Transfer of title without the owner's authorization
    b) By operation of law
    c) Condemnation
    d) Foreclosure of a loan
    e) Delinquent tax
    f) Liens
    g) Owner dies <u>intestate</u> (without a valid wiland no heirs are identified
    h) Acts of nature:
        (1) <u>Accretion</u>
            (a) Increase in an owner's land from deposits of soil by the action of water
        (2) Erosion
        (3) Earthquakes

(4) Hurricanes

(5) Sinkholes

(6) Mudslides

(a) Avulsion—a sudden loss of land from being washed away or through a violent act

3. Adverse possession

a) Ownership granted by the courts due to open, continuous, actual, notorious (hostile), and exclusive possession of another's land for a minimum statutory period

4. Easement by prescription/prescriptive easement

a) Prescribed by the courts due to open, continuous, actual, and notorious (hostile) use of another's land for a minimum statutory period

b) Remember the memory aid OCEAN: possession or use must be open (visible), continuous, exclusive (distinct), actual, and notorious (hostile)

(1) Hostile implies that it is without the owner's permission

5. If all parties recognize, accept, and permit the possession of the property or use of the easement, it cannot be adverse possession or an easement by prescription.

D. Recording the title

1. Places the document in public record according to each state's specifications

a) Constructive notice

(1) A document in public record serves as notice to the world

b) Actual notice

(1) Information of an interest in property is available as well as that someone is aware of it

2. Generally not required for validity

3. Gives constructive (legal) notice to protect interests

4. Determines priority (first in time, first in right)

a) A deed that is not recorded creates the risk that a latter interest could take priority.

b) An unrecorded deed does not have constructive notice of ownership.

5. State laws govern specifics of recording and usually include these requirements:

a) Recorded deeds/mortgages must be executed by grantors/mortgagors.

b) Documents must be dated.

c) Signatures should be acknowledged (notarized).

(1) A signature is required in most states to record.

(2) Acknowledgment (notarizing) shows the signature is genuine and was not made under duress.

6. Buyer's goal is to obtain marketable (merchantable) title
   a) Marketable title must
      (1) disclose no serious defect,
      (2) not expose a purchaser to hazards of litigation,
      (3) not threaten the quiet enjoyment of the property, and
      (4) convince a prudent purchaser that the property could sell at a later time.
7. Cloud on title
   a) A gap in the chain or other dispute of ownership
8. Abstract with a title opinion
   a) An abstract of title (title abstract) is a historical summary of all conveyances and encumbrances against the property.
   b) The title opinion is done by an attorney after reviewing the abstract.
9. Title insurance—the best way to insure marketable title
   a) The title examiner checks and traces the chain of title for the history of conveyances.
   b) Title commitment/report lists the current title status and title defects (mortgages, easements, etc.) but does not have a history of documents.
   c) The title commitment/report is the promise to insure the title; it will not cover items listed as exceptions and defects.
   d) A standard title insurance policy protects against defects discovered in the title after closing, not before closing.
   e) If a title issue is found before closing, it will need to be cleared, or the buyer will have the right to terminate the contract (or accept a clouded title).
   f) The types of policies include:
      (1) Owner's policy—protects owner (buyer) and heirs while they have an interest
         (a) Negotiable items that the seller may provide for the new buyer
      (2) Mortgagee's policy—protects lender giving them title coverage
         (a) Buyer often pays this premium for the lender
   g) Premiums are paid once at closing. The policy is issued at or after closing.
10. Quiet title action
   a) This is used to clear title problems found in the abstract or title report.

11. Special processes

    a) Conveyance at death

        (1) Probate is the process of distributing all of a deceased's assets.

            (a) A will must go through probate for real and personal property to be distributed.

            (b) Joint tenants do not go through probate to claim title to the property.

        (2) Devise is the act of transferring the deceased's interest in real estate to another by a will (hook to deed).

        (3) Bequest is the act of transferring a deceased's interest in personal property to another (hook to bill of sale).

        (4) If a person dies intestate (without a will), the laws of descent and distribution will determine the heirs/descendants.

REVIEW QUESTIONS

1. Recording documents, such as deeds, create actual notice.

a. True
b. False

2. Freehold estates have an indefinite duration.

a. True
b. False

3. The owner of the property in a life estate is called the life tenant.

a. True
b. False

4. Water rights based on first beneficial use are called riparian rights.

a. True
b. False
c. The statement is false. Riparian rights refer to river and streams, whereas the doctrine of prior appropriation states that the first beneficial user of water will have senior rights.

5. A deed of trust is the *BEST* deed for a purchaser to use to take title.

a. True
b. False

6. A married couple owns a property as joint tenants. The husband's will leaves his share in the property to their daughter. Upon the husband's death, the surviving spouse and daughter will own the property as tenants in common.

a. True
b. False

7. The right to sell, will, or transfer interest held in real property is known as the right to control the property within the framework of the law.

a. True
b. False

8. A deed to title is one way to prove marketable title.

a. True
b. False

9. Pur autre vie means that the life estate is based on the life tenant's life.

a. True
b. False

10. Sam inherits a family ranch and discovers that the title is clouded. A quitclaim deed may need to be filed to clear the title.

a. True
b. False

UNIT 3

Property Value and Appraisal

LEARNING OBJECTIVE *When you have completed this unit, you will be able to*

- **identify** the concept of value and the three approaches of an appraisal.

I. CONCEPT OF VALUE

A. Market value vs. market price

1. Market value is the most probable price, in terms of cash or its equivalent, that a property will bring.
2. Market price is the actual price paid in a transaction.

B. Characteristics of value

1. Demand
2. Utility (usefulness)
3. Scarcity
4. Transferability

C. Principles of value

1. Highest and best use
2. Produces greatest net return over time
3. Is not necessarily the present use
4. Must show current highest and best use in an appraisal, which would not be included in a CMA
5. Substitution
   a) If several similar properties are for sale, the lowest-priced property has the greatest demand.
   b) It underlies all approaches to value, especially the sales comparison approach.
6. Supply and demand
   a) Sets rental and listing prices
   b) Supply
      (1) Prices move opposite of supply
      (2) More properties than buyers (buyer's market)
   c) Demand
      (1) Prices move with demand
      (2) More buyers and fewer properties (seller's market)
7. Contribution
   a) Value of improvement based on increasing or decreasing return
      (1) Increasing return
         (a) Improvements add more value than cost
      (2) Decreasing return
         (a) Improvements add less value than cost

8. Conformity
   a) Values tend to move toward surroundings.
      (1) <u>Regression</u>
         (a) Value of over-improved property declines
      (2) <u>Progression</u>
         (a) Value of under-improved property increases

II. APPRAISAL PROCESS

A. Purpose and steps to an appraisal

1. The purpose of an appraisal is to give an unbiased <u>opinion of value</u> in an impartial and objective manner. (The type of value being estimated would be found in the Statement of Purpose section of the report.)
2. Steps in the appraisal process:
   a) State the <u>purpose</u>
   b) List the data needed and its sources
   c) Gather, <u>record</u>, and verify the data
   d) Gather, record, and verify the <u>specific data</u>
   e) Gather, record, and verify the data for each <u>approach</u>
   f) <u>Analyze</u> and interpret the data
   g) <u>Reconciliation</u> process
      (1) Reconciliation is the final step in the valuation process. It is used to weigh the three approaches to determine the final value.
      (2) The appraiser <u>analyzes</u> and weighs estimates of value from the market, cost, and income approaches.
      (3) The appraiser arrives at a <u>final estimate</u> of value; it is not an average of the value estimates.

B. Federal oversight of the appraisal process

1. Title XI of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) was enacted in the wake of the savings and loan crisis of the 1980s.
2. Licensure is at the <u>state</u> level.
3. Licensing criteria must conform to the Federal Financial Institutions Examination Council (FFIEC) provisions.
   a) The Appraiser Qualifications Board (AQB) recommends the subcommittee members.
   b) Appraisers must follow the <u>*Uniform Standards of Professional Appraisal Practice (USPAP)*</u>.
   c) The Appraisal Standards Board (ASB) updates and revises the USPAP.

III. METHODS OF ESTIMATING VALUE AND BROKER PRICE OPINION (BPO)

A. Sales comparison approach (market data)

1. Primarily used for residential or vacant land
2. Never adjust the subject property
3. Adjustments are made to the comparable.
   a) If comparable feature is better than the subject, subtract.
   b) If comparable feature is worse than the subject, add.
4. Market cycles often create the need for a time-of-sale or days-on-market adjustment.
   a) A date-of-sale adjustment might be made in an appreciating or depreciating market.
   b) Use the most current comparable in a rapidly changing market—preferably within six months but no longer than one year.
5. An appraiser should adjust for date of sale, location, and square footage, but not for capitalization.
6. The value of the item being adjusted is determined by comparing properties with and without the item.

   Example: The value of a fireplace would be determined by the difference between the sales of comparable homes with and without a fireplace.

B. Cost approach

1. Improvements and depreciation
2. Physical deterioration, and functional and economic obsolescence
   a) Physical deterioration (obsolescence and deferred maintenance)
      (1) Wear and tear, such as peeling paint or worn carpet
      (2) Usually curable
   b) Functional obsolescence
      (1) Design or other inadequacies, such as obsolete equipment or poor floor plan

      Example: outdated lighting or electrical and plumbing fixtures, or a four-bedroom home with one bathroom

      (2) May or may not be curable based on cost to cure

      Example: Out-of-date commercial properties are often incurable.
   c) Economic obsolescence or external obsolescence
      (1) External factors/location/surroundings

      Example: The property is in a flight path from the nearby airport.

      (2) Outside the property boundary(ies) and typically incurable

3. Reproduction or replacement costs
    a) Most effective method for new construction and special purpose property
    b) Purpose or single-purpose buildings
        (1) Cost to build new
            (a) Cost of material and labor – accrued depreciation + land = estimated value
        (2) Reproduction cost new
            (a) Replica with same or highly similar materials
        (3) Replacement cost new
            (a) Same function or utility

C. Income approach

1. Primarily used for income-producing properties such as apartments, office buildings, or shopping centers
2. Based on the principle of substitution
    a) Estimate the value of land
    b) Estimate the current cost of construction
    c) Estimate the amount of accrued depreciation (loss in value)
    d) Deduct the accrued depreciation from the construction cost
    e) Add the estimated land value to the depreciated cost of the construction

D. Gross rent and gross income multipliers

1. Capitalization
    a) Conversion of future income to present value
2. Gross rent multiplier (GRM)
    a) Alternative to capitalization that takes into account gross income but not expenses
3. Gross income multiplier (GIM)
    a) Potential gross income – vacancy and credit loss = effective gross income (EGI)
4. Calculating net operating income (NOI):
    a) Effective gross income – operating expenses = net operating income

E. Comparative Market Analysis (CMA)

1. Focuses on properties similar to the subject property in size, location, and amenities for the purpose of deriving a likely listing price or offering price
2. Based on:
    a) Recently closed properties (sold properties)

b) Properties currently on the market (competition for the subject property)

c) Properties that did not sell (expired listings)

F. Broker Price Opinion (BPO)

1. An alternative to evaluating property often used by lender working with home equity lines, refinancing, portfolio management, loss mitigation, and collections

2. May include drive-bys, interior analysis, and pictures

3. Cannot be used for <u>federally</u> related transactions

G. Assessed value and tax implications

1. Assessed value

   a) <u>Ad valorem</u> (according to value) property taxes are based on assessed value, not on current market value.

   b) The tax rate may be expressed as a <u>mill rate</u>, percentage rate, or decimal.

   c) Typically, properties are reassessed on an annual basis.

   d) Property owners who believe their assessment is incorrect may <u>appeal</u> to an assessor's appeals board.

2. Capital gains

   a) Capital gains are assessed on the principal residence.

   b) There is no tax on the first $250,000 of gain (single) or $500,000 of gain (married) from the sale of a <u>principal</u> residence.

   c) The owner must have lived in the property for two of the past five years (does not have to be consecutive).

3. Deductible items for owner occupants

   a) Mortgage interest, property taxes (ad valorem taxes), discount points, and certain loan origination fees are deductible.

   b) Remember, POIT (pronounced *poet)* is deductible.

      (1) <u>P</u>oints

      (2) <u>O</u>rigination

      (3) <u>I</u>nterest

      (4) <u>T</u>axes

   c) To obtain a deduction, taxpayers must use an itemized return.

   d) Principal, homeowner's insurance premiums, owner's association fees, and repairs to the property are <u>not</u> deductible.

4. Investment property—1031 tax-deferred exchange

   a) A 1031 exchange is used by investment property owners to defer payment of capital gains taxes.

   b) It allows an investor to sell one property and buy another without paying capital gains tax.

   c) The investor will not have to pay taxes at closing on the first property and can defer the taxes owed to the new property.

   d) The investor will not have to pay taxes until selling the second property.

   e) There are many rules for how the exchange must be carried out.

5. Depreciation tax deduction for investment property

   a) Tax advantages, such as depreciation, often offset the disadvantage of liquidity.

   b) Depreciation is treated as an expense and is a line item on an income statement.

   c) Depreciation can only be applied to the building and not the land because land does not wear out over time.

   d) Residential income property must be depreciated over a 27½-year period using straight-line depreciation.

   e) Straight-line depreciation requires that an asset must be depreciated by equal amounts each year over its useful life. (Variable, accrued, and passive depreciation are not used for this deduction.)

   f) To determine how much an improvement has depreciated, divide the value by the number of years being depreciated and multiply it by the number of years already taken.

      Example: How much will a property with improvements that is valued at $390,000 and is being depreciated over 39 years have depreciated after 10 years?

      Solution: $390,000 ÷ 39 × 10 = $100,000

REVIEW QUESTIONS

1. Property taxes are based on market value.
   a. True
   b. False
2. It is the function of the appraiser to establish market price.
   a. True
   b. False
3. Physical, local, economic, and social are the four elements of value.
   a. True
   b. False
4. Replacement cost is the present cost of replacing an improvement with another having the same utility.
   a. True
   b. False
5. A property with outdated electrical service and plumbing is suffering from physical depreciation.
   a. True
   b. False
6. The principle of substitution underlies all approaches to value.
   a. True
   b. False
7. Rotting wood is an example of functional obsolescence.
   a. True
   b. False
8. A BPO completed by a salesperson or broker may be used for appraisal purposes.
   a. True
   b. False
9. James built a $150,000 home in a neighborhood where the average price range is $60,000–$75,000. James's home value will suffer due to progression.
   a. True
   b. False
10. Capitalization is used to determine the value of unique properties.
    a. True
    b. False

UNIT 4

Real Estate Contracts and Agency

LEARNING OBJECTIVE *When you have completed this unit, you will be able to*

- **identify** the major components of contracts and **explain** the terminology, concepts, and disclosure requirements associated with agency relationships.

I. TYPES OF CONTRACTS

A. Express vs. implied

1. Express contracts can be oral or written.
2. Implied contracts are created by actions and are not in writing.

B. Unilateral vs. bilateral

1. Unilateral—promise is exchanged for performance
   a) Alice promises to perform ("I will sell you my house") if Bill decides he wants Alice to perform ("I may buy your house; let me decide").
2. Bilateral—promise is exchanged for a promise
   a) Alice: "I promise to sell you my house and deliver a deed."
   b) Bill: "I promise to buy your house and pay you money."

II. REQUIRED ELEMENTS OF A VALID CONTRACT

A. Required elements of a valid contract

1. Voluntary
   a) No one may be forced into a contract.
2. Promise/agreement
   a) The contract is a promise or set of promises.
3. Competent parties/contractual capacity
   a) The age of majority is 18; a contract with a minor is voidable.
   b) The parties must be mentally sound.
      (1) A contract with someone who has been declared incompetent by a court is void. That person can enter a contract only if the court appoints a guardian to act on the person's behalf.
4. Lawful objective/legal purpose
5. Consideration/money or something of value
   a) This is not earnest money (which is not required).
6. In writing and signed (certain contracts, based on statute of frauds)

III. CONTRACT PERFORMANCE

A. Executed vs. executory

1. Executed—duties are completed by both parties; they are fully performed
2. Executory—one or both parties need to complete part of the contract; the duties are yet to be performed

B. Valid vs. void

1. A valid contract contains all essential elements, is binding on both parties, and is enforceable by the courts.

2. A void contract is not enforceable because it fails to contain all of the essential elements.

C. Voidable vs. unenforceable

1. A voidable contract appears to be valid, but one party may disaffirm it because

   a) the party is a minor; or

   b) the party was subject to duress, fraud, or misrepresentation.

2. An unenforceable contract appears to be valid, however, neither party can sue the other to force performance.

   a) An oral agreement for the sale of real property is unenforceable; the defaulting party could not be taken to court to be forced to perform.

D. Breach of contract, rescission, and termination

1. A breach of contract is when one party violates any of the terms or conditions of a contract.

2. Rescission returns the parties back to their original positions prior to the contract, and any monies or property must be returned.

3. Termination of a contract is due to

   a) operation of law,

   b) partial performance of the terms,

   c) substantial performance,

   d) impossibility of performance, or

   e) mutual agreement.

E. Liquidated, punitive, or compensatory damages

1. Liquidated damages, such as money, are given to the nondefaulting party as compensation.

2. Punitive damages are usually issued through court; typically, the sum is an amount to punish or deter repeated offenses.

3. Compensatory damages/actual damages cover the loss the nondefaulted party incurred due to the defaulting party.

F. Statute of frauds (and statute of limitations)

1. Statute of frauds

   a) This requires that certain contracts for the transfer of real estate be in writing to be enforceable.

b) The law does not apply to leases of 12 months or less.

c) The purpose of the statute of frauds is to prevent problems with oral real estate contracts.

2. Statute of limitations

a) The statute of limitations sets the length of time to file a claim or a lawsuit.

G. Time is of the essence

1. Each of the elements of the contract must be performed within the specified time promised.

IV. SALES CONTRACT

A. Offer and counteroffer

1. Offer and communication of acceptance must be made before offer has been withdrawn

a) Offer may be withdrawn by either party before communication of acceptance to the party who made the offer

b) Qualified acceptance or counteroffer is a rejection and terminates original offer

c) If a counteroffer is initialed by both parties, it is accepted.

d) A buyer who receives a counteroffer is not obligated to respond and may make an offer on a new property without an obligation to the seller who countered the first offer.

e) A seller who counters and then receives an offer from another party must withdraw the counteroffer before accepting the new offer.

B. Earnest money and liquidated damages

1. Earnest money

a) An amount agreed upon by the parties to discourage the buyer from defaulting or cover expenses the seller might incur if the buyer defaults

b) Is not consideration and is not required to create a valid purchase contract

2. Liquidated damages

a) The parties may agree on an amount of money that will compensate the nondefaulting party.

b) The contracts may specify that the earnest money is to serve as liquidated damages for the seller.

C. Equitable title

1. At contract stage, the buyer (vendee) has equitable title (also known as an equitable owner).

2. At contract state, the seller (vendor) retains legal title.

D. Contingencies

1. Conditions that must be satisfied before the contract is fully enforceable

E. Disputes and breach of contract

1. Disputes
    a) Occur when any party in a contract has a disagreement regarding any of the contract terms or definitions
        (1) Remedies for disputes
            (a) Can be settled by <u>mediation</u>
2. Breach of contract
    a) One party fails to perform as promised in the contract
        (1) Remedies for default
            (a) The nondefaulting party can terminate the contract and receive earnest money, thereby releasing both parties from the contract.
            (b) Suing for specific performance and/or actual damages is another option.

F. Options contracts and installment sales contracts

1. Option contract
    a) An <u>optionor</u> (owner) gives an <u>optionee</u> (prospective purchaser/tenant) the right to buy or lease the property for a set price and term.
    b) An option fee is paid by the buyer for this right.
    c) The owner/seller retains the option fee if the buyer decides not to buy.
    d) It is a unilateral contract, but it becomes bilateral when the option is exercised by the buyer.
2. Lease purchase
    a) A lease purchase is two <u>contracts</u>: a purchase agreement and a lease.
    b) A portion of the lease payments can be applied to a down payment.
3. Installment contract
    a) This is also known as a <u>land contract</u> or <u>contract for deed</u>.
    b) The buyer agrees to pay the seller the purchase price plus interest in installments over a set period of time.
    c) Once the seller has received all the payments, the deed is released to the buyer.

V. TYPES OF AGENCY AND LICENSE HOLDER-CLIENT RELATIONSHIPS

A. Types of agency

1. <u>Special agency</u>
    a) Created when a brokerage firm/agent is authorized to perform a particular act without the ability to bind the principal

b) Seller contracts with a brokerage firm using a listing contract

c) Buyer contracts with a brokerage firm using a buyer brokerage contract

2. General agency

a) Created when a brokerage firm/agent is authorized to perform a series of acts associated with the continued operation of a particular business (limited power to bind the principal)

(1) A sales agent is licensed to a broker.

(2) A property manager is employed by a property owner.

3. Universal agency

a) Created when a brokerage firm/agent is authorized to perform in place of the principal (total power to bind the principal)

b) Created through a power of attorney form used to appoint the attorney-in-fact

B. License holder-client relationships

1. Agent/fiduciary

a) The broker/fiduciary is someone who is employed to represent a principal.

b) A sales agent signing a listing will not have the agency relationship with the principal.

c) It is between the firm (brokerage) and the principal.

2. Subagent

a) To represent a client of another broker/brokerage

3. Third party—customer

a) A third party to a transaction who is not a party to the particular agency agreement.

b) The agent (broker/brokerage) owes honesty and fair dealing to the third party.

c) At first contact with customers, license holders must disclose that customers should not give confidential information to them.

(1) Agents' fiduciary duties would require them to share that information with their principal.

VI. CREATION AND TERMINATION OF AGENCY

A. Fiduciary responsibility

1. Fiduciary responsibilities to clients:

a) Obedience

b) Loyalty

c) Disclosure

d) Confidentiality

e) Accounting

f) Reasonable care and skill

2. License holders always owe fiduciary duties (obligations) to the principal who employed them.
3. Agents must keep confidential the price, terms, and motivation (PTM) of the principal.
4. Accounting includes accounting for all money and personal property given to the broker or sales agent.

Note: Most states define agency relationship by statute; you may see common laws of agency on the national portion of the exam.

B. Creation of agency

1. Express agency
   a) Brokerage is hired by a principal to act on the principal's behalf
   b) Created through an oral or written listing or buyer representation agreement
2. Implied agency
   a) Created through the actions of the parties and should not be used for listings because it is not in writing
3. Ostensible agency
   a) Created when either principal or agent leads a third party to believe that an agency relationship exists
      (1) Ostensible means for all apparent purposes.
4. Agency by ratification
   a) Created when the principal ratifies the previously unauthorized acts of the agent
5. Agency by estoppel
   a) Created when the principal cannot deny that the agent was acting on their behalf
6. Nonagent
   a) Known also as a facilitator, intermediary, transaction broker, transaction coordinator, or contract broker
   b) Assists one or both parties with the transaction without representing either party's interests and often is subject to specific statutory responsibilities
7. Gratuitous agency
   a) Agency relationship exists, however, no compensation is involved

C. Termination of agency

1. The termination of agency occurs by
   a) completion, performance, or fulfillment of purpose of the agency,
   b) destruction or condemnation of the property,

c) expiration of the terms of the agency agreement,

d) mutual agreement of all parties,

e) breach by one of the parties, who may be liable for damages, or

f) operation of law, as in bankruptcy of the principal.

VII. LICENSE HOLDER OBLIGATIONS TO PARTIES OF A TRANSACTION

A. License holder obligations to parties of a transaction

1. Verify information and statements made by the buyer and the seller, especially if they appear to be untrue.

2. Complete a CMA to verify the value, even if the brokers or sales agents believe they know the current value.

3. Material facts must be disclosed immediately to all parties, even on properties being sold "as is."

   Example: hail damage or roof issues

4. Complete a visual inspection of the property for material defects and request a seller's property disclosure.

   a) Strongly suggest that the buyer get an inspection done to check for latent defects and environmental issues.

   b) Point out any red flag issues that may represent potential problems (e.g., sagging floors, water stains).

5. Answer third-party questions with honesty and clarity.

6. A listing agent has a duty to present all offers to the client, unless otherwise specified in writing.

   a) Multiple offers should be presented simultaneously.

7. A license holder may not inflate the sales price in hopes of securing a listing and then lower the price later.

   a) This is an example of unethical behavior.

   b) Real estate professionals are expected to fully disclose

      (1) whom they represent in the transaction,

      (2) whether they are a principal in the transaction,

      (3) the obligations of all parties regarding the disclosure of material defects, and

      (4) any environmental, material, or other issue requiring disclosure that might impact the property.

REVIEW QUESTIONS

1. A contract can be discharged when it cannot be legally accomplished based on impossibility of performance.
   a. True
   b. False
2. A contract with a minor is voidable by either party to the contract.
   a. True
   b. False
3. When a person leases land on which the person has agreed to allow the tenant to construct an office building, the lease is termed a ground lease.
   a. True
   b. False
4. Most real estate contracts are implied.
   a. True
   b. False
5. The statute of limitations requires that a real estate sales contract be in writing.
   a. True
   b. False
6. An oral real estate sales contract is *NOT* enforceable in a court action.
   a. True
   b. False
7. A counteroffer is a rejection of the original offer.
   a. True
   b. False
8. In an open listing, the agency authority of all brokers is terminated when the house is sold by any broker or the owner.
   a. True
   b. False
9. An owner lists her home for $100,000, and the listing broker tells the prospective buyer to submit a low offer because the seller is desperate. The buyer offers $95,000, and the seller accepts. In this situation, the broker was unethical, but because no one was hurt, the broker's conduct is *NOT* improper.
   a. True
   b. False
10. The listing agreement is considered to be terminated once the seller accepts an offer.
    a. True
    b. False

5

UNIT

Real Estate Practice

LEARNING OBJECTIVE *When you have completed this unit, you will be able to*

- **describe** the responsibilities of the brokerage to both the license holders and the consumer as well as **identify** the fair housing laws and the brokerage risk management tools.

I. RESPONSIBILITIES OF THE BROKER

A. Practicing within scope of expertise

1. A broker is required to notify the license holder, in writing, of the scope of the authorized activities.
2. A broker is responsible for the authorized acts of the license holders.
3. A broker must maintain current written policies and procedures to ensure each sponsored licensed holder is advised of the scope of authorized activities.
4. Real estate professionals are expected to know when they are not competent to perform a task, including the following:
   - a) Practicing outside their area of expertise

     Example: residential broker selling commercial property, or a city broker selling farm land
   - b) Real estate professionals can become competent in a new area of practice by receiving education and working with others who are knowledgeable in that area.

B. Unauthorized practice of law

1. A license holder must not
   - a) practice law,
   - b) offer, give, or attempt to give legal advice, either directly or indirectly,
   - c) give opinions concerning the status or validity of title to real estate, or
   - d) attempt to prevent or in any manner whatsoever discourage any principal to a real estate transaction from employing a lawyer.

C. Privacy and do not contact

1. Obligations of all real estate professionals
   - a) License holders are required to maintain the security of documents and the confidentiality of those they represent.
     - (1) This includes having security on all electronic contracts, files, and signatures.
     - (2) Care must also be taken so security is not breached in social media or emails.
2. The federal Privacy Act of 1974 gives citizens the right to view information the government holds about them.
3. National Do Not Call Registry
   - a) The registry is a national list of phone numbers that telemarketers cannot call.
     - (1) Real estate brokers and salespeople must check the list before cold calling.
   - b) Brokers may contact a consumer for three months after the consumer has made an inquiry.
   - c) Brokers may call consumers with whom they have an established business relationship for up to 18 months after the last purchase.

II. BROKERAGE AGREEMENTS BETWEEN THE BROKER AND PRINCIPAL (SELLER, BUYER, LANDLORD, AND TENANT)

A. Seller representation—types of listing agreements

1. Exclusive right-to-sell listing
    a) The brokerage firm gets paid even if the seller or someone else finds the buyer.
    b) It gives the brokerage maximum protection by eliminating procuring cause disagreements.
2. Exclusive agency listing
    a) Owners retain the right to sell the property themselves without liability to the brokerage or an obligation to pay a commission.
    b) If anyone other than the owner obtains the buyer, the brokerage firm gets paid.
3. Open/nonexclusive listing
    a) Owners may list with more than one brokerage or offer to pay anyone who brings an offer.
    b) The listing brokerage is paid only if the brokerage obtains the buyer and is the procuring cause of the sale.
    c) The listing may be terminated at any time before performance.
        - When does the broker get paid?

Type of listing	Owner obtains buyer	Co-op agency obtains buyer	Listing agency obtains buyer	Someone else obtains buyer
Exclusive right to sell	$	$	$	$
Exclusive agency		$	$	$
Open			$	

4. Net listing (conflict of interest)
    a) Any excess over the seller's desired net from the sale is paid to the broker as compensation.
    b) This practice may be prohibited by state law.
5. Multiple listing service (MLS)
    a) May be included in an exclusive listing with written consent from seller(s)
    b) Used as a marketing organization available to members through cooperation

B. Buyer representation

1. The exclusive right-to-represent contract
    a) Authorizes a brokerage to represent the buyer
    b) Requires the buyer to compensate the brokerage when purchasing property through any source
2. Termination is done in the same way as listing contracts (i.e., death, bankruptcy, etc.)

3. Buyer representation contracts must have a definite <u>termination date</u>.
4. License holders who show property based on the potential commission instead of buyer needs violate the fiduciary obligation of loyalty.

C. Property management agreement

1. Creates a <u>general agency</u> relationship between the owner and the firm
   a) An agreement is signed by the employing broker, who becomes a general agent of the landlord.
   b) It may not be signed by a sales agent or broker associate without permission of the employing/managing broker.
2. Accounting for funds
   a) Any money received on behalf of a landlord must always be deposited into a broker's <u>trust account</u>.
   b) A sales agent may <u>not</u> operate a trust account.
   c) A license holder is prohibited from <u>commingling</u> trust account funds with the broker's own funds.
   d) Other than proper disbursement, money held in a trust account is evidence of commingling.
   e) A broker must provide an accounting to the client at least <u>monthly</u>.
   f) A brokerage must develop annual budget and prepare financial reports.
3. Property maintenance
   a) Generates <u>income</u> and <u>maintains</u> the physical condition
   b) Markets space to attract tenants
      (1) Careful selection of the highest-qualified tenants
      (2) Manager renting industrial property would be concerned about environmental issues
   c) The property management agreement explains what a broker is <u>authorized</u> to do and what is expected.
   d) The broker must avoid negligence that may result in injury.
4. Leasing property
   a) Rekeying the home
   b) Tenant walk through
   c) Addressing problems occurring during the leasing period
   d) <u>Negotiates</u> leases, including investigating applicants' qualifications
5. Collecting rents and security deposits
   a) License holders are prohibited from commingling trust account funds with the broker's own funds.
   b) The agreements contain termination, services, fees, and compensation.

D. Termination of agreements

1. Death of the broker
2. Death of one of the principals
3. Bankruptcy of the brokerage or principal

E. Services, fees, and compensation

1. Always paid directly to the broker/brokerage
2. Always negotiable, unless the broker sets the fees for the brokerage
3. Referrals are from one broker to another
4. Can be a percentage or flat fee

III. FAIR HOUSING

A. Equal opportunity in housing

1. Prohibits discrimination in the sale, rental, or financing of housing

B. Protected classifications (FReSH CoRN)

1. Family status (added in 1988)
   a) Protects pregnant women and families with children
   b) Does <u>not</u> apply to retirement communities in which 80% of the units are occupied by residents age 55 or older
   c) May not refuse to rent to children but may limit the number of persons in a unit

      Example: could refuse to rent a studio unit to a family of four
2. <u>Race</u> (only protected class in the 1866 Civil Rights Act)
3. Sex (added in 1974)
4. Handicap/disability (added in 1988)—any physical or mental impairment that substantially limits one or more major life activity
   a) It includes those suffering from HIV/AIDS.
   b) Alcoholics and drug addicts are protected if seeking treatment, but not if using illegal drugs.
      (1) The law specifically excludes those convicted of dealing drugs.
      (2) Landlords are not obligated to rent to a person with a history of violence.
      (3) Both current and recovered mental patients are protected.
      (4) Landlords must allow a disabled tenant to make changes at the tenant's expense.
      (5) The owner may require the tenant to return the property to its original condition upon termination of the lease.
      (6) Landlords must make reasonable accommodations for a disabled tenant, such as reserving a parking space, if it is available.

5. Color
6. Religion
7. National origin

C. Fair housing laws

1. Must have equal opportunity poster in a prominent position where it can be seen by consumers
2. Poster is obtained from HUD
3. Failure to display poster can shift burden of proof to brokerage firm in an alleged discrimination complaint

D. Illegal practices, enforcement, and penalties

1. Steering
    a) The channeling of potential buyers to or away from particular areas as a means of discrimination
2. Blockbusting
    a) Also called panic peddling
    b) Inducing people to sell their homes because of the entry into the neighborhood of members of protected classes
3. Redlining
    a) Refusing to offer or limiting loans in certain areas
    b) May not refuse to loan based on high crime rates in a neighborhood
    c) Less favorable treatment
    d) Discriminatory or restrictive advertising
4. Complaints
    a) HUD will first investigate all incidents.
        (1) Complaints can be filed with HUD within one year of the discriminatory act.
        (2) Aggrieved party can file a civil suit directly in federal court within two years.
    b) A broker could file a complaint and request the commission as damages if a seller refuses to accept an offer from a protected class.
    c) A broker's best protection is to keep good records.
    d) When advertising, it is best to describe the property, not who should or should not live there.
    e) In a complaint, HUD will consider the following:
        (1) Testing studies on the company completed by HUD
        (2) Properties shown to the buyer or tenant
        (3) If an equal opportunity poster is displayed in the office

f) HUD will not consider the broker or sales agent's <u>intentions</u> as a rightful reason, even if the discriminatory act was performed because the broker/sales agent thought it would be best for the buyer.

Example: showing only neighborhoods with children to a family

5. Penalties

a) Financial penalties

b) <u>License</u> may be suspended or revoked

E. Prohibited advertising

1. Advertising that <u>excludes</u> a protected class or gives the consumer the impression of excluding a protected class

Example: master bedroom = okay; exclusive neighborhood = discriminatory

F. Housing and Urban Development (HUD)

1. Administers the Fair Housing Act
2. Establishes rules and regulations for further interpretation in the practices affected by the law

G. Americans with Disabilities Act (ADA)

1. Purpose

a) The ADA ensures equal <u>access</u> to public accommodations for disabled persons.

b) Public accommodations are places accessible to the public (including broker's office and retail stores).

IV. RISK MANAGEMENT

- Points for evaluation

— <u>Avoid</u>—by removing the source of risk

Example: swimming pool may pose an unacceptable risk

— <u>Control</u>—by preparing for an emergency before it happens

Examples: installing sprinklers, fire doors, and security systems

— <u>Transfer</u>—by shifting the risk onto another party

Example: taking out an insurance policy

— <u>Retain</u>—by deciding that the chances of the event occurring are too small to justify the expense of any response

— Remember ACTR (ACT to lessen Risk)

A. Supervision

1. Broker may not relinquish overall <u>responsibility</u> for supervision of license holders sponsored by broker

B. Compliance with federal regulations

1. Operation reporting objectives
    a) An internal summary
    b) Design and implement operation goals
    c) Evaluate
    d) Implement

C. Vicarious liability

1. Employing brokers are responsible for all professional acts and conduct performed by sales agents or associate brokers working under them.
2. Brokers or sales agents may not misrepresent property or conceal material facts.
3. If real estate professionals promise something such as, "I know the new light rail will run past here," and, in fact, it doesn't, they would be guilty of material misrepresentation.

D. Antitrust laws

1. Price-fixing occurs when competitors agree to charge the same rates.
    a) Illegal because it inhibits competition
2. The amount and method of compensation paid to the listing broker is negotiable.
    a) MLS compensation is set by the seller and listing brokerage firm.
    b) Other firms may be offered a set split of the commission in the MLS, with the seller's approval.
    c) Brokers must not be a party to discussions of commissions with those outside their office, such as one employing broker to another employing broker.
3. Employing brokers may have commission agreements with their sales agents or broker associates, but not with someone outside the firm.
    a) Employing brokers may not work with different brokerage firms in the area to standardize company splits.
4. Brokers who overhear conversations about commissions among outside brokers should shout and then get out of the area. (Say loudly, "I wouldn't talk about commissions outside of the office!" and then leave.)

E. Fraud and misrepresentation

1. If real estate professionals promise something such as, "I know the new light rail will run past here," and, in fact, it doesn't, they would be guilty of material misrepresentation.
2. Commission—saying something that deceives or misrepresents a material fact
3. Omission—not saying something that then deceives or misrepresents a material fact

F. Types of insurance

1. Errors and omissions (E&O)
   a) Covers brokerage firms, brokers, and sales agents for liability for errors and negligence in listing, selling, and property management activities
   b) Required in some states in order to hold an active real estate license
   c) Does not cover criminal acts, fraud, or <u>violations</u> of civil rights and antitrust laws
2. General liability
   a) Covers if a <u>third</u> party sustains bodily injuries or experiences property loss or damage on the brokerage premises

REVIEW QUESTIONS

1. An employing broker would be commingling trust funds if the employing broker deposited monies and rents received from a client's various properties in the same trust account.
   a. True
   b. False
2. The purpose of the Americans with Disabilities Act (ADA) is to ensure equal access to public accommodations for disabled people.
   a. True
   b. False
3. Under an exclusive agency listing, the broker is entitled to receive a commission, regardless of who sells the property.
   a. True
   b. False
4. The four risk management evaluation points are as follows: avoid, control, defer, and ignore.
   a. True
   b. False
5. E&O insurance that is held by the brokerage firm will cover all errors and acts of negligence by all salespeople.
   a. True
   b. False
6. Duress, fraud, minors, and misrepresentation make contracts voidable.
   a. True
   b. False
7. Professional liability insurance for real estate professionals is known as a surety bond.
   a. True
   b. False
8. If a seller misrepresents a material fact about the property, from the buyer's point of view, the contract is unenforceable.
   a. True
   b. False
9. A property management company has installed fire doors and ceiling sprinklers. This is an example of control.
   a. True
   b. False
10. Earnest money is deposited into the operations account.
   a. True
   b. False

6

UNIT

Property Disclosures and Environmental Issues

LEARNING OBJECTIVE *When you have completed this unit, you will be able to*

- **identify** and **explain** the various environmental hazards and their disclosures.

I. PROPERTY CONDITIONS AND ENVIRONMENTAL ISSUES

A. Hazardous substances

1. Lead-based paint disclosure requirements
   a) The seller must give a copy of the EPA pamphlet to buyers of homes that were built before January 1, 1978.
   b) Buyers have a 10-day opportunity to have the home tested and may waive their right to have an inspection.
   c) The seller is not required to do a lead inspection or removal.
   d) Lead is not typically found in wall insulation but might be in soil, pipes, and paint.
   e) Real estate professionals are responsible for making sure all parties are in compliance.
2. Asbestos
   a) Asbestos is a mineral used in building that can cause respiratory disease.
   b) It is harmful only if the fibers are exposed because the microscopic fibers could be inhaled.
   c) Its deteriorated state is called friable.
      (1) If a building is being demolished or renovated, abatement (removal) should be done by a licensed professional beforehand.
      (2) Encapsulation (sealing in place) is often a better choice than removal because there is no danger of exposing the fibers.
3. Radon
   a) A naturally occurring odorless, radioactive gas
   b) Enters through cracks in the basement and can cause lung cancer
   c) Typically mitigated by adding a ventilation system to move the gas outside
   d) Relatively inexpensive to detect and mitigate
4. Mold
   a) Toxic mold is created by excess moisture and humidity.
   b) Not all mold is hazardous; in fact, mold is naturally occurring in the air.
   c) All mold requires moisture to grow.
   d) If found in walls or other areas of housing, it may be considered toxic and would require remediation.
   e) Remediation (removal) should be done per EPA and state regulations.
   f) There is no federal disclosure law; however, some states have disclosure requirements.
   g) All sellers must disclose if there is a mold issue.
   h) Brokers and sales agent should be aware of indications of mold, including musty smells, water damage, high humidity, and water leaks.

5. Groundwater contamination and underground storage tanks
   a) Forms the water table under the earth's surface
   b) Safe Drinking Water Act (SDWA) regulates public drinking water
   c) Any water source other than municipal supply should be tested, as well as septic systems
6. Underground storage tanks (USTs)
   a) May contain petroleum products, industrial chemicals, and other substances and are subject to federal and state laws
7. Waste disposal sites and brownfields
   a) Waste disposal sites can be owned by municipalities, commercial enterprises, or found in rural areas.
   b) Sites are lined to prevent seepage, capped with soil, and vented to release gasses created by decomposing waste.
   c) Brownfields legislation encourages development of abandoned properties by shielding innocent developers from liability for the presence of prior toxic wastes.
   d) License holders should also be aware of the impact of underground storage tanks, groundwater pollution, brownfields, and waste disposal sites.
8. Flood plain and flood insurance
   a) A flood plain is an area of land adjacent to a stream or river that may experience flooding during periods of high discharge.
   b) The National Flood Insurance Reform Act of 1994 imposes mandatory obligations on loan servicers to set aside (escrow) funds for flood insurance for properties in a flood-prone area.

B. Clean air and water acts

1. Clean Air Act
   a) Building and residential hazardous air pollutants
      (1) Formaldehyde
      (2) Urea-formaldehyde foam insulation (UFFI)
         (a) Causes respiratory problems
         (b) Eye and skin irritations
         (c) Possible cancer
   b) In 1985, HUD placed regulations for use in wood products.
   c) License holders should check state formaldehyde disclosure requirements.
   d) Appraisers should note the presence of formaldehyde.

C. Environmental Protection Agency (EPA)

1. Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA)
2. Superfund Amendment and Reauthorization Act (SARA)
3. Environmental site assessments and impact statements
4. Wetlands protection
    a) The review process for the Clean Water Act, Section 404 permit
        (1) After <u>notice</u> and opportunity for a <u>public hearing</u>, the Army Corps of Engineers district engineer may issue or deny the permit.
        (2) The district engineer must comply with the EPA's Section 404(b) guidelines and must consider the public interest when evaluating a proposed permit.
        (3) Four questions related to the guidelines are considered an application:
            (a) Is the proposed discharge the least damaging practical alternative?
            (b) Does the proposed discharge <u>comply</u> with other environmental standards or regulations?
            (c) Will the proposed discharge significantly degrade wetlands?
            (d) Have all the appropriate and practical steps been taken to <u>minimize</u> potential harm to the wetlands?

II. DISCLOSURE OBLIGATIONS AND LIABILITY

A. Disclosure obligations and liability

1. Strict liability
    a) The <u>landowner</u> has no defense to the responsibility for cleanup.
2. Joint and several liability
    a) Each of several landowners is responsible for the entire cleanup.
3. <u>Retroactive liability</u>
    a) Present owner and previous owners are considered responsible for cleanup.
4. Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA) defines when innocent landowner immunity applies.

REVIEW QUESTIONS

1. Radon, mold, and asbestos may require mitigation, cleanup, or abatement.
   a. True
   b. False

2. Asbestos encapsulation is often a safer and better solution than abatement or removal.
   a. True
   b. False

3. Real estate professionals need to be aware of issues about wetlands, floodplains, and protected species.
   a. True
   b. False

4. The EPA regulates most environmental issues, including lead-based paint.
   a. True
   b. False

5. A seller of a property that was built in 1988 will need to give the buyer a lead-based-paint disclosure.
   a. True
   b. False

6. Radon and carbon monoxide are colorless and odorless gases that can cause harm or death.
   a. True
   b. False

7. CERCLA is a fund used to clean up large hazardous waste areas.
   a. True
   b. False

8. Federal flood insurance is available for all properties.
   a. True
   b. False

9. A seller has knowledge of an environmental impact report that is being done on a nearby industrial park. Because the report is not complete, the seller does *NOT* have to disclose the report.
   a. True
   b. False

10. Real estate professionals do *NOT* have to disclose material facts if the seller is selling "as is."
   a. True
   b. False

UNIT 7

Financing and Settlement

LEARNING OBJECTIVE *When you have completed this unit, you will be able to*

- **describe** the various facets of financing and the procedures for closing a transaction.

I. FINANCING CONCEPTS AND COMPONENTS

A. Methods of financing

1. Mortgage financing—conventional and nonconventional loans

a) Term/straight/interest-only loan (balloon loan) (See Figure 7.1)

(1) Only interest is paid until maturity at the end of the term.

(2) The loan has a small monthly payment, but a large balloon.

(3) The full amount of principal (balloon) is due at the end.

b) Partially amortized (balloon loan)

(1) The loan is repaid through equal payments of principal and interest.

(2) The payments are larger than a term loan, but smaller than a fully amortized loan.

(3) The loan has a balloon payment at the end of the term that will be smaller than the original loan amount.

Example: A $20,000 loan is amortized over 30 years and due in full in 10 years.

c) Fully amortized (no balloon)

(1) The loan is repaid in equal payments of principal and interest with the balance paid in full on the last payment.

(2) Payments are made at regular intervals and are larger than those for a term or partially amortized loan.

(3) Interest is paid in arrears.

FIGURE 7.1: Loan Payment Chart

Loan Type	Payment Amount	Balloon
Term/straight/interest only	$ Small: interest only	Large: full principal
Partially amortized	$ Medium: principal and interest	Smaller: balance of principal
Fully amortized	$ Large	None

d) Adjustable-rate mortgage (ARM)

(1) The rate may go up or down based on changes in the index and as agreed to in the loan documents.

(2) It may include interest and/or payment caps.

(3) The interest rate = index + margin (e.g., 5% index + 2% margin = 7% interest).

e) Budget (PITI)

(1) The borrower pays P&I plus 1/12 taxes and 1/12 insurance into the lender's impound escrow account. (Interest and taxes are deductible.)

(2) The lender will always collect for the month of closing.

f) Reverse mortgage

(1) The mortgagee makes payments to the mortgagor over a specific term.

(2) It is used to obtain money from the equity in the home when a senior does not want to sell but needs cash.

(3) It is due upon the sale of the property, death of the mortgagor(s), or at the end of the term.

g) Blanket loan

(1) It includes more than one property in a single loan transaction.

(2) It may have a partial release clause.

h) Line of credit

(1) It allows the borrower to obtain further advances on the loan at a later date.

(2) The future advance is limited to the difference between the original loan amount and the current amount owed.

i) Subprime loans

(1) The borrower is of higher risk, so the loan is more likely to default.

(2) A higher-than-prime rate is charged because the borrower and/or the property used as security is a higher risk than a prime borrower (e.g., prime rate might be 6% and subprime 8%).

(3) Subprime loans were often coupled with down payment assistance (a second mortgage) in which borrowers made no down payment and borrowed 100%.

(a) This made these loans more likely to default.

j) Conforming versus nonconforming loans

(1) Conforming loan

(a) Meets the underwriting guidelines of Fannie Mae or Freddie Mac

(b) Buys loans from the lenders

(c) Falls within their maximum size limits, and "conforms" to pre-established criteria

(2) Jumbo loan/nonconforming loan

(a) Exceeds the conforming loan limits established by Fannie Mae and Freddie Mac

(b) Represents a higher risk for the lender

(c) Jumbo borrowers typically must have excellent credit, larger down payments

(d) Interest rates generally higher with jumbo products

k) Conventional loans versus nonconventional loans

(1) Conventional loans typically refer to a loan that is not secured by a government-sponsored entity.

(2) A nonconventional loan is backed by the government, insured, or guaranteed.

(a) FHA

(b) VA

2. Seller financing—Land contract/contract for deed/contract of sale/a bond for title/installment contract

a) The seller (vendor) who retains legal title holds the deed.

b) The buyer (vendee) has equitable title.

c) The buyer takes possession when the contract is signed.

d) The seller transfers title via a deed when the buyer makes the final payment.

e) Buyer is responsible for property taxes and insurance.

3. Promissory note

a) Promise to repay and terms; evidence of the debt (not recorded)

b) Features may include the following:

(1) Prepayment clause—privilege to prepay

(2) Acceleration clause—speeds up the note when the borrower is in default

c) Secured by a mortgage or deed of trust, which are the collateral and are recorded—creates the lien

B. Lien theory vs. title theory and deed of trust

1. Lien theory

a) Legal title and equitable title of property resides with the borrower

2. Title theory

a) Lender has legal title to the property and the borrower has equitable title

3. Deed of trust

a) A three-party instrument

(1) The borrower is known as the trustor.

(2) The lender is known as the beneficiary.

(3) The property is conveyed in trust to a trustee to be held as security for a loan.

4. Mortgage
    a) A two-party instrument
        (1) The borrower is the mortgagor.
        (2) The lender is the mortgagee.

C. Sources of financing (primary and secondary mortgage markets, and seller financing)

1. Primary mortgage market—mortgage bankers and mortgage brokers
    a) Mortgage brokers act as intermediaries between borrowers and lenders but don't usually service loans.
    b) Mortgage bankers originate and service loans with their company's money.
2. Secondary mortgage market
    a) The secondary mortgage market buys mortgages from primary lenders—which are banks, not retirement or insurance funds—to supplement the mortgage and lending process.
    b) Borrowers may need to send monthly payments to a new address if their mortgage is sold.
    c) Organizations that sell mortgage-backed securities to investors include:
        (1) FNMA—buys all types of mortgages (Federal National Mortgage Association, or Fannie Mae)
        (2) GNMA—an agency of HUD; backs FHA/VA mortgages (Government National Mortgage Association, or Ginnie Mae)
        (3) FHLMC—buys from savings and loan associations and commercial banks (Federal Home Loan Mortgage Corporation, or Freddie Mac)
3. Seller financing
    a) Seller carry-back purchase money
        (1) This is owner financing in which title transfers to the buyer at closing.
        (2) The seller takes back a loan as a partial payment; the seller has the lien.
    b) Risks
        (1) Real estate professionals should make sure the seller and the buyer understand the risks that may be involved with seller financing.

D. Types of loans and loan programs

1. Fixed vs. adjustable-rate
    a) Fixed-rate loans have the same interest rate for the entire repayment term.
    b) Adjustable-rate loans (ARMs) have an interest rate that will change, or "adjust," periodically.
2. Conventional loans
    a) These are loans not insured or guaranteed by the federal government.

3. Government-insured home loans
   - a) Federal Housing Administration (FHA) mortgage insurance program
     - (1) Managed by the Department of Housing and Urban Development (HUD)
     - (2) Government insures the lender against losses that might result from borrower default
     - (3) Borrower must put down at least 3.5% of the purchase price
   - b) U.S. Department of Veterans Affairs (VA)
     - (1) Offers a loan program to veterans; will reimburse the lender for any losses that may result from borrower default
     - (2) 100% financing for the purchase of a home
     - (3) Nonveterans may assume VA loans from veterans, active National Guard members, or retired military reserve members
   - c) United States Department of Agriculture (USDA)
     - (1) Loan program for rural borrowers who meet certain income requirements
     - (2) Managed by the Rural Housing Service (RHS)
     - (3) Income must be no higher than 115% of the adjusted area median income
   - d) Reverse mortgage
     - (1) Homeowner age 62 or older
     - (2) Receives monthly amount from lender
     - (3) Property's equity decreases as the loan amount increases
     - (4) Can be paid in a lump sum or monthly
     - (5) Fixed interest rate charged
     - (6) Full payment is due upon
       - (a) the death of the property owner,
       - (b) the fulfillment of the loan's term,
       - (c) the owner's relocation,
       - (d) the sale of the property, or
       - (e) default.

E. Mortgage clauses

1. Includes the following covenants, which are causes of foreclosure and default:
   - a) Nonpayment of principal and interest
   - b) Nonpayment of taxes

c) Inadequate or no insurance

d) Waste

2. Prepayment penalty clause

a) Determines if the loan can be paid off early and its terms

b) May have a penalty, which is an additional charge for the early payment

3. Due-on-sale clause/alienation clause

a) Requires payment in full if the collateral property is sold

b) Would be used if the borrower sold the property without telling the lender and paid off the loan

4. Acceleration clause

a) Allows the lender to demand immediate payment of the entire balance owed if the mortgage is in default

5. Subordination clause

a) This allows a change in the order/priority of mortgages.

b) Usury is the charging of an interest rate in excess of what is permitted by state law.

c) State laws determine the maximum interest rate and the type of loans affected by usury law.

II. LENDER REQUIREMENTS

A. FHA and VA requirements

1. Funds come from qualified lenders approved by HUD.

a) Both programs require the property to be owner-occupied.

(1) Veterans may buy a property with up to four units, but they must live in one of the units.

2. The rules regarding assumption depend on the date of the original loan.

3. No prepayment penalty is allowed, no matter when or how the loan was originated.

4. Borrowers must have an appraisal done to be approved for the first loan.

5. Both programs offer higher loan-to-value ratios than conventional mortgages.

B. Buyer qualification and loan-to-value ratio (LTV)

1. LTV is the maximum percentage of value the lender will loan.

2. It is used to determine the loan amount and if the borrower will have to pay PMI.

3. It is based on the price or appraisal, whichever is less.

C. Hazard and flood insurance

1. Types of insurance for property owners

a) Tenants insurance—covers tenant's personal property

b) Fire and hazard—covers fire and other hazards, such as windstorm, hail, and smoke damage

c) Flood insurance—always a separate policy from home, rental, or building insurance policies

(1) Property must be in a community participating in the National Flood Insurance Program (NFIP).

d) Liability—covers the risks an owner assumes whenever the public enters the building

e) Casualty—covers theft, burglary, vandalism, and machinery damage, as well as health and accident insurance

f) Surety bonds—covers an owner against financial losses resulting from an employee's criminal acts or negligence while performing assigned duties

g) Owners association—covers the common elements in condominiums and cooperatives

D. Private mortgage insurance (PMI) and mortgage insurance premium (MIP)

1. Private Mortgage Insurance (PMI)

a) Depending on the loan-to-value ratio, the lender may require private mortgage insurance (PMI).

b) Loans over 80% LTV require PMI.

c) PMI does not pay off the full loan amount.

d) The advantage to the borrower is a smaller down payment.

2. Mortgage insurance premium (MIP)

a) A part of all FHA loans

b) Up-front fee along with monthly installments

c) Can be financed into the loan

d) Only monthly premium for condominium, no up-front

III. FEDERAL FINANCING REGULATIONS AND REGULATORY BODIES

A. Truth-in-Lending and Regulation Z

1. Applies to all consumer lending, not just real estate
2. Requires lenders to disclose the total cost of obtaining credit
3. Includes a three-day right of rescission for refinance and home equity loans
4. Right of rescission does not include purchase of primary homes, vacation homes, or construction loans

B. The TILA-RESPA Integrated Disclosures (TRID)

1. Known as the "Know Before You Owe" rule
2. Replaced disclosure form with Loan Estimate and Closing Disclosure
3. New forms required for all real estate transactions

4. Excluding home equity lines of credit, reverse mortgages, mobile homes, or if the dwelling is not attached to land
5. Consumer Financial Protection Bureau (CFPB)
   a) A U.S. government agency that makes sure banks, lenders, and other financial companies treat the consumer fairly
   b) Prepared the forms to make it easier for consumers to understand cost and closing procedures
6. Loan estimate (LE)
   a) Replaced the Truth in Lending statement (TIL) and the good-faith estimate (GFE)
   b) Highlights interest rate, monthly payment, and total closing costs
   c) Must be delivered or placed in the mail no later than the <u>third</u> business day after consumer's application
7. Closing disclosure (CD)
   a) Replaced the HUD-1 Settlement Statement and the final TIL
   b) Explains the potential change in the costs of taxes, insurance, interest rate, and payments
   c) Itemizes all charges paid by borrower and seller, or another party
   d) Must be provided to the borrower at least <u>three</u> business days prior to closing

C. Real Estate Settlement Procedures Act (RESPA)

1. Intended to inform consumers purchasing real estate of the total cost of settlement fees
2. <u>Referrals and rebates</u>
   a) RESPA prohibits any person or entity from providing or accepting a fee, kickback, or other valuable consideration for the referral of "business incident to or part of a real estate settlement service."
      (1) Settlement services include any service provided in connection with a real estate settlement, including, but not limited to:
         (a) Mortgage origination
         (b) Title insurance
         (c) Closing/settlement
         (d) Services provided by real estate agents and brokers
         (e) Appraisals
         (f) Surveys
         (g) Some warranties
         (h) Credit reporting
         (i) Home and pest inspection

b) Referrals

(1) Prohibits a person from giving or accepting anything of value for settlement service businesses related to a federally related mortgage loan

c) Rebates

(1) Prohibits a person from giving or accepting any part of a charge for services that are not performed

(2) Also known as kickbacks, fee-splitting, and unearned fees

d) Exempt from the RESPA requirements are:

(1) Cash sales

(2) Sales where the seller takes back the mortgage

(3) Rental property transactions (more than four units)

(4) Temporary financing (e.g., construction financing in most cases, but not construction to permanent loans)

(5) Vacant land

(6) Properties of 25 acres or more (even if there is a residence on it)

(7) Some mortgage assumptions and conversions (generally where the lender has no rights to approve the assumption)

(8) Commercial and agricultural property

D. Equal Credit Opportunity Act (ECOA)

1. Enforced by the Federal Trade Commission (FTC)

2. Prohibits discrimination in granting or arranging credit on the basis of:

Age	Familial status	Color
Receipt of assistance	Race	Opportunity
Marital status	Equal	Religion
	Sex	National origin
	Handicap	
	AIDS/HIV; Rehabilitation	

E. Mortgage fraud and predatory lending

1. Mortgage fraud

a) Inflating an appraisal to obtain a loan for more than a property is worth

b) Claiming income or assets the borrower does not have

c) Straw buyer—posing as a borrower on behalf of another who's actually making the purchase

d) Taking advantage of the elderly, minorities, or those who speak English as a second language or not at all

e) Pretending to provide financial assistance to an economically stressed homeowner in order to skim off equity from the home

2. Predatory lending

a) This is an umbrella term for unfair or illegal lending practices.

b) Predatory lending often occurs in the subprime market.

c) Many states now have predatory lending laws that require lenders and originators to be licensed.

IV. SETTLEMENT AND CLOSING THE TRANSACTION

A. Escrow/closing procedures

1. The terms of escrow or closing are created by the purchase contract and finalized at closing.

B. Closing statement—debits and credits

(See Figure 7.2)

1. Credit to seller is anything that increases the amount of money the seller takes from the closing (e.g., sales price).

2. Debit to seller is anything that decreases the amount of money the seller takes from the closing (e.g., brokerage fee, mortgage payoff, or contract for deed).

3. Credit to buyer is anything that decreases the amount of money the buyer must bring to the closing (e.g., earnest money, new loan, or contract for deed).

Remember: Loans are always a buyer credit.

4. Debit to buyer is anything that increases the amount of money the buyer must bring to the closing (e.g., sales price, recording the warranty deed, loan origination, or discount points if paid by buyer).

a) Proration is based on a 365-day year or 360-day year (30-day months)—the exam will state which one to use.

b) Mortgage interest is paid in arrears.

c) Taxes can be paid in advance or in arrears.

d) Rent is prorated (paid in advance).

e) Security deposits transfer to the new owner and are not prorated.

FIGURE 7.2: How Paid Items Are Recorded on the Settlement Worksheet and Closing Statement

Selected Items	Details to Remember	Settlement Worksheet	Closing Statement
Sales price		**Debit buyer, credit seller**	**Appears on both buyer's and seller's**
Earnest money		Credit buyer, debit closer*	Appears on buyer's only
Assumed loan amount	**Principal remaining on loan assumed by buyer**	**Always credit buyer, debit seller**	**Appears on both buyer's and seller's**
Accrued interest on assumed loan	**Prorated seller owes buyer for month of closing**	**Debit seller, credit buyer**	**Appears on both buyer's and seller's**
Seller carry loan amount	Reduces seller's cash at closing	Credit buyer, debit seller	Appears on both buyer's and seller's
Broker's commission	Negotiable Usually seller pays	If seller pays, debit seller, credit broker	If seller pays, appears on seller's only
Owner's (buyer's) title insurance	**Negotiable based on tradition**	**Debit seller, credit closer***	**Appears on seller's only**
Mortgagee's (lender's) title insurance	Buyer pays lender's policy	Debit buyer, credit closer*	Appears on buyer's only
Notary fee for warranty deed	**Who signs document pays notary; seller signs deed**	**Debit seller, credit closer***	**Appears on seller's only**
Recording of warranty deed	**Recording deed benefits buyer/grantee**	**Debit buyer, credit closer***	**Appears on buyer's only**
Notary fee for deed of trust	Buyer signs promissory note and deed of trust at closing	Debit buyer, credit closer*	Appears on buyer's only
Tenant security deposits	Not prorated; belong to tenants	Debit seller, credit buyer	Appears on both buyer's and seller's
Rents	**Prorated; paid in advance**	**Always debit seller, credit buyer**	**Appears on both buyer's and seller's**
New loan amount	**Figures from the new lender**	**Credit buyer, single entry**	**Appears on buyer's only**
Net loan proceeds	**New loan closing**	**Debit closer* only**	**Does not appear on either**
Taxes for the preceding year if unpaid	Credit depends on circumstances	Always debit seller, may credit buyer or closer* or new lender	Debit seller
Special taxes (special assessments)	May be paid off or assumed	If assumed, no entry; if paid, debit seller	Appears on seller's only

Remember: All loans are always a buyer credit.

*The closer could be the broker or the escrow or closing company.

REVIEW QUESTIONS

1. A purchase money mortgage is a loan involving a borrower, a construction lender, and any permanent lender.
   a. True
   b. False
2. A blanket loan is likely to contain a partial release clause.
   a. True
   b. False
3. A senior borrower who wants to access her equity without selling her house or making payments should get a home equity line of credit (HELOC).
   a. True
   b. False
4. A lender for a loan over 75% LTV would require PMI.
   a. True
   b. False
5. The parents of a veteran may obtain a VA loan using their child's benefit.
   a. True
   b. False
6. A borrower who pays a fixed monthly payment of principal and interest over the term of the loan, and then makes a large principal payment at the end, *MOST* likely had a fully amortized loan.
   a. True
   b. False
7. *MOST* loan origination fees are tax deductible.
   a. True
   b. False
8. Written evidence of a promise to repay borrowed money is known as an acknowledgment.
   a. True
   b. False
9. A disadvantage to being highly leveraged is that the borrower is more likely to go into foreclosure.
   a. True
   b. False
10. A clause in an existing note and mortgage states that a new buyer may not assume the mortgage without the lender's written permission. This clause is known as a prepayment clause.
    a. True
    b. False

8

UNIT

Real Estate Math Calculations

■ **LEARNING OBJECTIVE** *When you have completed this unit, you will be able to*

- **illustrate** the math calculations needed as a real estate professional.

OVERVIEW

The national real estate licensing examination contains math calculations related to real estate transactions and decisions. Generally, these calculations are straightforward. With a little work, you can be prepared to answer these exam questions correctly. The following review provides methods for performing calculations and ways to remember how to manipulate the numbers.

Real estate students have widely different backgrounds and experience in handling these calculations. If you have not done numeric calculations in quite some time, this unit will provide simple explanations and methods to guide you to the proper solutions for the problems you are likely to face. If you are experienced in math, you will still need to understand how the world of real estate deals with many of these calculations.

SIMPLE BASICS

Using a calculator

You will have a simple calculator available during your examination, and you will not be allowed to bring in your own. The testing services provide calculators that include the ability to add, subtract, multiply, and divide. These calculators perform calculations in the standard way. For example, if you are adding the numbers 12, 15, and 37, you simply key in the problem as you would visualize it: 12 + 15 + 37.

- Key in the number 12 on the keypad (you should see the digits on the display).
- Press the + key.
- Key in the number 15 (only the new number will show in the display).
- Press the + again (the sum of the first two numbers will appear).
- Key in the number 37.
- Press the = key. Using the = key finishes the calculation and displays the solution (64).

There is usually a clear button that is often marked as CLR or C. Touching this button erases any numbers or actions that are in the calculator's memory. It is a good idea to press this key at the start of all calculations.

Decimals and fractions

Decimals and fractions express parts of whole numbers, because not all calculations come out evenly. For example, ½ is a fraction that expresses 1 part out of 2. It is really a division problem stated as 1 divided by 2. Calculators and computers are not set up to easily deal with fractions, so fractions are converted to decimal fractions by actually performing the calculation. On the calculator, 1 ÷ 2 = .5 or 0.5 (these are the same thing).

For example, if you are calculating what part of June that 19 days represents, this would be 19 days (the part) divided by 30 days (the whole month). You could state it as 19/30, but that is probably not an available exam answer and would be difficult to use on a calculator. Instead, complete the division indicated by the bar or slash mark: 19 ÷ 30 = 0.6333.

Depending on the calculator, this could look like 0.63333333… (and so on, to the end of the display). This would occur on a floating decimal calculator. It could also look like 0.63 if the calculator is set to display only two decimal places. The calculator available for the exam will most likely have the floating decimal display.

If you are solving a multiple-step problem that will use the first result in another step, leave the first calculated result on the display (don't touch CLR or C). If you instead write down the 0.63 display, clear the calculator, then key in just 0.63; you will only be using part of the actual calculated decimal fraction. Most of the time, you would not detect any difference in the final calculated result compared to the test answer choices—but if you are involved in a $1 million property sale, for example, it could lead to a significant error for things like loan payments or tax prorations. These errors are called *rounding errors* because when you cut off the extra digits from the first calculation, you are rounding the number.

If you are using a floating decimal calculator, you can round a displayed result to match the exam answer choices—usually no more than four places to the right of the decimal point. For rounding, look 1 digit beyond the number of places in the exam answer (in the previous example, the fifth digit beyond the decimal) and if the next digit is 5 or greater, increase the last digit in the rounded answer by 1. If the next digit is 4 or less, just cut off the digits beyond the fourth digit without adjusting the last digit.

For example, if you are dividing $34 into 13 parts, you will get 34 ÷ 13 = 2.6153846153… (and so on). If the answer is to be in dollars and cents, you need to round to just two decimal places. Because the third digit is 5, you would round to $2.62 to match the correct exam choice.

If you are using a calculator that allows you to set the number of decimal places displayed, be sure to set it to display at least as many decimal places as the answers require. In the previous calculation, if you had the display set to zero decimals, you would see a display of 3, which would likely be confusing—especially if an incorrect answer choice was $3 to test your understanding of rounding errors.

Percentages

Percentages are another way to use decimals. Normal decimals represent parts of the whole number 1 (or 1.000000). In the first example, ½ = 0.5 or 0.50 (the same thing). Percentages relate the same part to the whole number 100. If the decimal fraction is 0.50, multiply that decimal by 100 and add a sign (%) to get the percentage: 0.50 × 100 = 50%.

You can always change a decimal into a percentage by multiplying by 100. To convert a percentage to a decimal, divide by 100: 50% ÷ 100 = 0.50 as a pure decimal fraction.

Note that you can make either conversion by simply moving the decimal point two places. To convert a percentage to a decimal, move the decimal point two places to the left: 50% = 0.50. To convert a decimal to a percentage, move the decimal point two places to the right: 0.25 = 25%.

Some calculators have a % key to do this conversion. Be careful; they do not all work in the same way. Unless you are sure how the % key works on a particular calculator, just do the simple conversion yourself.

I. PROPERTY AREA CALCULATIONS

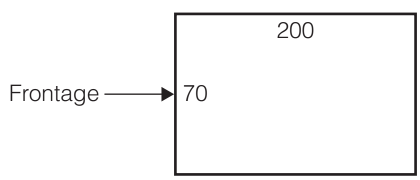
- The area of a lot and the floor area of a structure are both common calculations in real estate. In practice, many of these can be quite complex, and are the appropriate specialty of a land surveyor or possibly an appraiser.

A. Area of a lot

1. For test purposes, most lots will be rectangles or squares. The lot is usually measured in feet, which may be signified by the ' symbol (e.g., 25 feet may appear as 25').
2. *Frontage* is a term used to describe the dimension of a lot that lies along a street (or sometimes along a lake or river) because this exposure may be very valuable for commercial exposure or access to recreational amenities. Traditionally, frontage is the first number used in describing the lot. A 65-by-110 foot lot has a frontage of 65 feet and is 110 feet deep—meaning the distance between the front lot line and the rear lot line.
3. The area of a rectangle is calculated as follows: area = width × length. If the lot dimensions are in feet, the result will be the area in square feet. A square foot is simply one foot wide and one foot long.
4. Practice questions:

   a) What is the area of a lot that is 70 by 200 feet?

      (1) Solution:



area of a rectangle = length times width (A = L × W)

A = <u>70</u> ft. × 200 ft. = <u>14,000</u> sq. ft. The frontage (street front) is <u>70</u>.

   b) What would the previously listed lot sell for at $3 per square foot plus a $5 premium per front foot?

      (1) Solution:

Area: A = 70' × 200' = 14,000 sq. ft.

Selling price: 14,000 sq. ft. × $3 per sq. ft. = $42,000.

Plus 70 front feet × $5 = $350 premium in addition to the price per foot.

So, $42,000 + $350 = $42,350 selling price.

5. For most uses, the square footage or floor area of a building is measured using the exterior dimensions of the foundation. This sounds simple, but foundations may have many sides or even curved walls. In addition, some designs have upper levels that extend beyond the foundation. Different market areas have different traditions about which areas are included or excluded in square-footage calculations, such as garages or basement areas. You will learn about these differences in the local practices of your community. For testing purposes, square-footage problems are usually simple rectangles. To calculate the square footage or area of a two-story house, include the square footage of both levels.

6. Practice questions:

   a) What is the square footage of a single-level house with exterior dimensions of 75 × 32 feet?

      (1) Solution: A = 75' × 32' = 2,400 sq. ft.

   b) What would be the square footage of the same house if it had two stories?

      (1) Solution: A = 75' × 32' × 2 (stories) = 4,800 sq. ft.

   c) A residential lot is 65' × 110' and zoning limits the home's footprint (which means the building cannot exceed these dimensions, but can have more height) to 40% of the lot. What is the square footage of the largest two-story house that can be built on the lot?

      (1) Solution: A = 65' × 110' = 7,150 square feet for the total lot. The allowed footprint = 7,150 × 0.4 = 2,860 square feet for the footprint; for two stories, 2,860 × 2 = 5,720 square feet.

B. Square footage

1. Appraisers often compare the price per square foot among properties they are evaluating, and in some markets, buyers are concerned with the price per square foot.

   a) price per square foot = selling price ÷ area in square feet

2. Practice questions:

   a) What is the price per square foot of a house measuring 35 feet by 40 feet that recently sold for $220,000?

      (1) Solution: A = 35 ft. × 40 ft. = <u>1,400</u> sq. ft.

      $220,000 ÷ <u>1,400</u> = <u>$157.14</u> per square foot

   b) If an industrial lot is 250 by 375 feet and sold for $1.15 per square foot, what was its sales price?

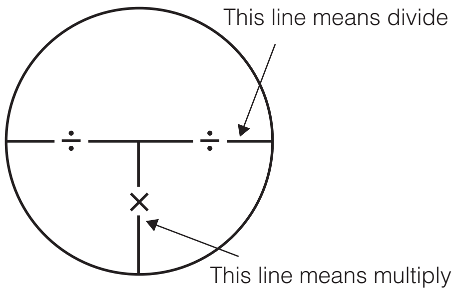
      This is best done as a chain calculation where instead of finding the area, writing it down, and then multiplying by the price per square foot, you key it into your calculator as 250' × 375' × $1.15 = price. The chain calculation avoids possible rounding errors as mentioned previously.

      (1) Solution: price = 250 ft. × 375 ft. × $1.15 = <u>$107,812.50</u>.

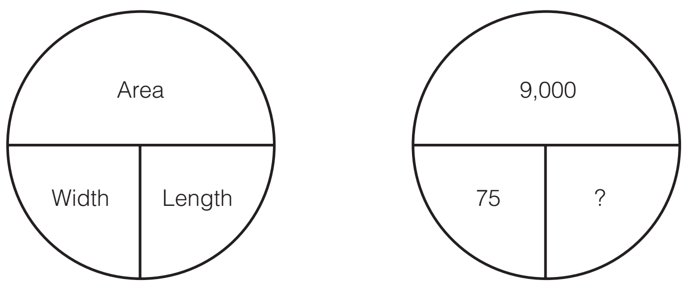
3. Circle T formula

   a) Circle formulas are a simple tool for remembering what to do. You are not required to use them, but they can be very helpful.

FIGURE 8.1: Circle Formula



4. Practice question:
   a) A = L × W; 9,000 = 75 × length
      (1) Solution: 9,000 ÷ 75 = 120 feet deep



C. Acreage total

1. Practice question:
   a) How many acres are there in a parcel of land that measures 450 ft. × 484 ft.?
      (1) Solution: 484 ft. × 450 ft. = 217,800 sq. ft. ÷ 43,560 = 5 acres of land

      Remember: 43,560 square feet equals 1 acre; 640 acres in a section of a township

II. PROPERTY VALUATION

A. Competitive market analysis (CMA)

1. A real estate professional's job is to perform a CMA. Real estate professionals may charge a fee, but they must make sure the CMA is not mistaken for an appraisal.
2. The CMA/BPO/BOV assists both the seller and the buyer in determining price, but it may not be used to finance property.
3. Always make adjustments to comparable properties that are currently on the market.
   a) These are known as the seller's competition.
4. Make adjustments on the sold comparable properties, usually those that have sold in the past six months.
   a) However, each market area exhibits its own market time.

B. Net operating income (NOI)

1. potential gross income – vacancy and credit loss = effective gross income (EGI)
2. EGI (effective gross income) – operating expenses = net operating income (NOI)
3. Example:
   a) The calculation of future income is based on a property's net operating income
      (1) Solution:

      Step 1:

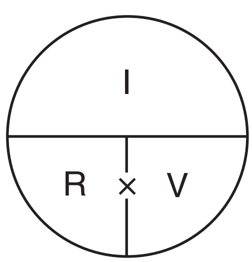
Potential annual gross income	$66,000
– Bad debt (2%)	– $1,320
– Vacancy (3%)	– $1,980
Effective gross income	$62,700

      Step 2:

Effective gross income	$62,700
– Operating expenses	– $29,400
= NOI	$33,300

C. Capitalization rate

FIGURE 8.2: Circle Formula for Capitalization

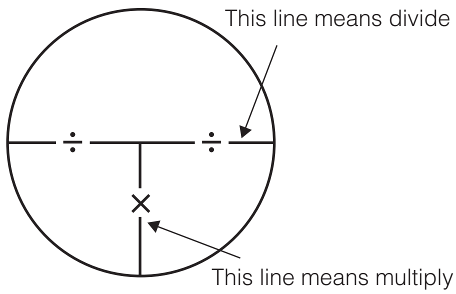


Income = Rate × Value
I = Net operating income
R = Capitalization rate (investor rate of return, also affected by market forces)
V = Value (what can be paid for a property to get the expected return)

Three relationships: I = R × V; R = I ÷ V; V = I ÷ R

1. Practice question:
   a) A small office building has gross rental income of $60,000 per year. The owner pays an average of $18,000 per year in expenses. If an investor is seeking a capitalization rate of 7%, what would this property be worth?
      a. $857,143
      b. $420,000
      c. $7,000,000
      d. $600,000

(1) Solution:



income (NOI) = \$60,000 – \$18,000 = <u>\$42,000</u> annual net operating income

V = I ÷ R = \$42,000 ÷ 0.07 = <u>\$600,000</u>. The answer is d.

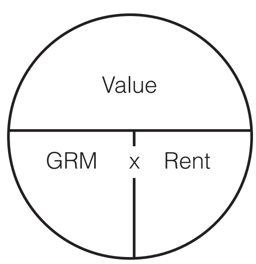
D. Gross rent multiplier (GRM)

1. Practice question:

a) If the multiplier in the neighborhood is 150 and a property has annual income of \$12,000, what is its value?

a. \$150,000
b. \$175,000
c. \$102,000
d. \$196,000

(1) Solution:



150 (monthly multiplier) × (12,000 ÷ 12 = \$1,000 / month in rent) = \$150,000. The answer is a.

E. Gross income multiplier (GIM)

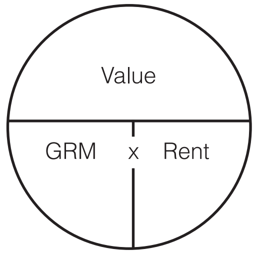
1. For a property with five or more units and commercial properties with income from a variety of sources:

sales price ÷ annual gross income = gross income multiplier (GIM)

2. Practice question:

a) If a commercial property recently sold for \$155,000 and its annual rental income was \$15,000, what would the GIM for the property be?

(1) Solution:



$155,000 ÷ $15,000 = <u>10.33</u> GIM

F. Equity in property

1. market value today – total debt today = equity
2. Lending practices permit homebuyers to borrow considerable amounts of money for their purchase. As homeowners pay down the remaining balance on their home loan, they increase the part of the value of their home that is not pledged as security for a mortgage. This part is truly theirs.
   a) Equity is the current market value of the home minus all debts that use the home as security for a loan.
3. A property owned free and clear of all mortgages or home equity loans has 100% equity.
   a) For example, a home recently purchased using a 100% LTV loan guaranteed by the Veterans Administration has no equity.
4. Practice question:
   a) A buyer purchased a property for $90,000 with 10% down. The current loan balance is $74,000. The property recently appraised for $116,000. What is the owner's equity?
      a. $16,000
      b. $42,000
      c. $116,000
      d. $83,000

      (1) Solution: equity = current value – loans outstanding = $116,000 – $74,000 = <u>$42,000</u>. The answer is b.

G. Establishing a listing price

1. Practice question:
   a) A real estate sales associate is preparing a CMA for a potential listing. The listing property has 1,800 square feet, two bedrooms, one bath, and a fireplace. The home across the street sold for $181,000 and has 1,800 square feet, two bedrooms, two baths, and no fireplace. A home on the next street over sold for $175,000 and has 1,800 square feet, two bedrooms, one bath, and no fireplace. If an extra bath is worth $5,000 and a fireplace adds $3,000, what would be the estimated listing price for the subject property?

(1) Solution:

	Subject	Across Street	Next Street
Sold price		$181,000	$175,000
Area	1800	1800	1800
Bedrooms	2	2	2
Baths	1	2	1
Fireplace	1	0	0
Total adjustment		+$3000 – $5000	+$3000
Adjusted price		$179,000	$178,000

Once subtractions and additions have been made to the comparable properties, look for the highest adjusted price. This would be an acceptable way to suggest a list price to a seller.

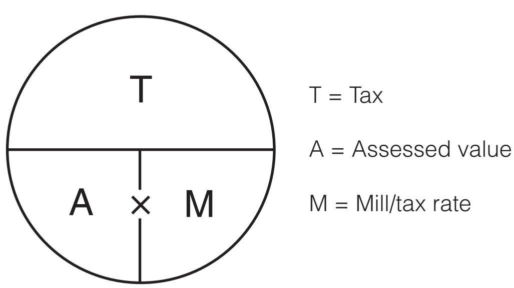
estimated list price / sales price = $179,000

Note: Do not average the two.

H. Assessed value and property taxes

1. Property taxes are charged (levied) based on an assessment rate. The assessor (usually a county official) uses mass appraisal methods to place a value on each privately owned property in the jurisdiction, which is usually the county, township, or similar political division. The county commissioners or other similar body determines the total budget for the jurisdiction based on the services and needs of the county. The assessor then has the job of distributing the tax burden to each of the privately owned properties. Most taxing areas have several classes of property, such as residential, commercial, agricultural, et cetera. These classes may have different taxing rates.
2. The assessor multiplies the actual value (as appraised by the assessor) by the tax rate for the class of property to determine the real property tax that the property owner will owe.
   a) annual tax = assessed value × tax rate

FIGURE 8.3: Circle Formula for Taxes



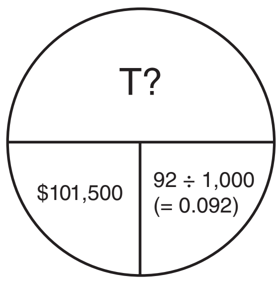
3. The assessed value is smaller than the actual value.
4. The sum of all the annual tax amounts must equal the total budget.
5. The tax rate is expressed as a fraction of the assessed value. It may be a percentage (an amount of tax per $100 of assessed value) or a mill, which is an amount of tax per $1,000 of assessed value. This tax based on $1,000 of assessed value is called a *mill rate*. If the tax rate is given as a whole number, such as 85 mills, convert it to a decimal fraction by dividing by 1,000 (85 ÷ 1,000 = 0.085). If the tax rate is dollars per $100 of assessed value, divide by 100.

6. Tax calculations based on the actual (appraised) value are often three-step calculations. The first step is to determine the assessed value needed for the circle formula.

7. Practice question:

   a) If the assessor has determined that a property has an actual value of $350,000 and this class of property has an assessment rate of 29%, and the tax rate is 92 mills, what is the annual tax?

      (1) Solution:



assessed value = actual value × assessment rate

Step 1: 350,000 × 0.29 = $101,500

Step 2: 92 ÷ 1,000 = 0.0092

Step 3: $101,500 × 0.0092 = $933.80

III. COMMISSION/COMPENSATION

A. Getting paid

1. Brokerage fees are generally paid based on a percentage of the selling price of a property.

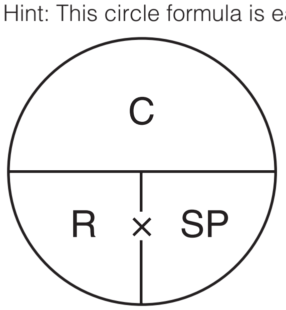
   Note: Commission rates are used for example purposes here and are not intended to imply any standard rate. Commission rates are always negotiable, and can vary considerably with different types of property and geographic areas.

2. Practice questions:

   a) Croft agreed to pay a 6% commission on the home she listed with broker Wright. The home sold for $80,000. How much was the commission?

      (1) Solution:

Hint: This circle formula is easy to remember: What you want to earn is CRiSP new dollars



C = Commission (in dollars)

R = Rate

SP = Selling price

To find the *commission* when the *rate* and *selling price* are known, cover up the C so R and SP are both below the line and separated by the ×. The formula is: C = R × SP

rate × selling price = commission dollars

0.06 × $80,000 = $4,800

b) The commission received was $4,800 and the rate was 6%. What was the sales price?

(1) Solution: $4,800 ÷ 0.06 = $80,000

To solve for the rate, divide the commission by the sales price: $4,800 ÷ $80,000 = 0.06 or 6%.

B. Sales price

1. Practice question:

a) The commission received was $4,800 and the rate was 6%. What was the sales price?

(1) Solution: Commission divided by the rate: $4,800 ÷ 0.06 = $80,000.

To solve for the rate, divide the commission by the sales price: $4,800 ÷ $80,000 = 0.06 or 6%.

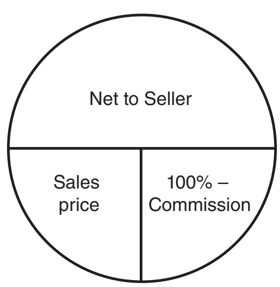
C. Net to the seller

1. To solve problems involving the net amount to the seller, a new circle formula and this calculation is needed: sales price × (100% – commission rate) = net to seller.

2. Practice question:

a) The seller will get 93% of the amount that the property sells for (100% of selling price minus the 7% commission) and the seller wants this net amount to be $80,000.

(1) Solution:



- Net to seller in this problem is $80,000
- Sales price is the unknown value
- sales price = net to seller ÷ 93% (this is 100% – commission)

To determine the sales price that will net the seller the amount wanted: $80,000 ÷ 0.93 = $86,021.51.

3. On the test, you may be able to gain a lot of information from the answer choices. In the previous problem, the listing price must be higher than the $80,000 the seller wishes to receive, so any answer choices smaller than $80,000 cannot be correct. Also, you could multiply each answer choice by 93% to see which one is closest to $80,000.

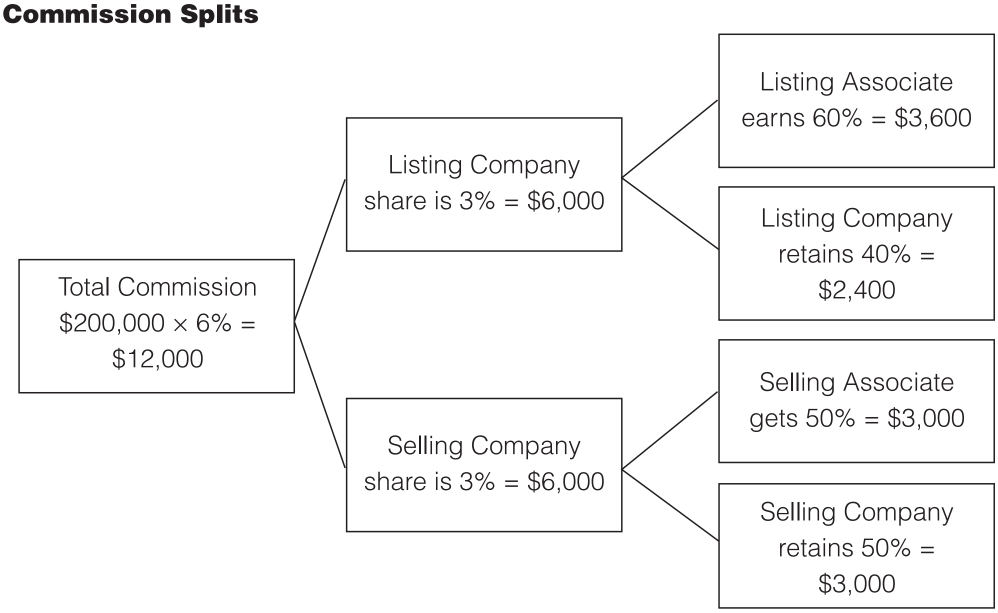
D. Commission splits

1. Commissions are always negotiable between the broker (brokerage company) and the buyer or seller. Typically, the managing broker delegates the power to negotiate this fee within limits to the sales agent or broker associate. The total commission is an agreed percentage of the selling price. The commission is then split between the brokerage and the salespeople or broker associates involved.

2. Companies will have a written agreement with each employed sales agent or broker associate for the way the fee will be split. For example, a company could keep 40% and give 60% to the sales agent who actually negotiated and serviced the listing. There may also be a split between the listing brokerage company and another brokerage firm that brought a buyer for the property. As an example, the listing brokerage might negotiate a 6% total commission to be paid by the seller. The listing company further agrees to split that fee with a cooperating brokerage that brings the buyer with 3% to each company. In that case, the commission is first divided between the companies, listing or selling/buyer side, and then split between each brokerage firm's sales agent or broker associate.

    a) Example: For a property with a selling price of $200,000 with a 6% commission, the gross commission is $12,000. The listing company keeps $6,000 and shares the other $6,000 with the buyer's brokerage. The listing company then splits its portion of the fee, giving 60% to the listing associate ($3,600) and retaining the rest ($2,400). If the listing company has a 50-50 split policy with its associates, both keep $3,000.

FIGURE 8.4: Commission Splits



3. Practice question

    a) A seller lists his home with an agent, Sally, and negotiates a commission of 5½%. The home is put on the market for $435,000. Another agent brings in an offer of $420,000, which is accepted. The two companies split the fee equally between them. Sally has an agreement to receive 60% of the company's commission on her listings. When the transaction closes, how much should Sally receive from her brokerage company?

        (1) Solution: $420,000 × 5½% = $23,100. Split equally, each company receives $11,550. Sally's brokerage pays her 60%, which is $6,930.

4. Practice question

   a) A home sells for $150,000 at a commission rate of 6%. The listing brokerage has agreed to pay 55% of the commission to the selling brokerage. How much does the listing brokerage retain?

      (1) Solution: Listing brokerage pays out 55% and keeps 45% (calculate 100% – 55% = 45%). Selling price × 6% × 45% = $4,050.

IV. LOAN FINANCING COSTS

A. Interest

1. Loan interest calculations involve the interest rate (usually stated as an annual percentage), the amount of the loan (the principal sum), and the dollars of interest. Some calculations are for annual interest, and must be done with an annual rate to yield an annual interest amount. Other calculations are for monthly interest, and must use a monthly rate to yield a monthly payment.

2. Real estate loans are generally paid 12 times a year on the same date each month.

   a) As a result, monthly payment calculations for the entire loan are based on 1/12 of the year and 1/12 of the annual interest rate.

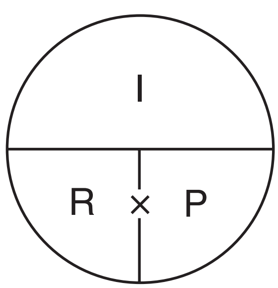
      (1) These calculations are not based on the number of days in a particular month.

      (2) The lender simply computes the payments for 360 total payments for a 30-year loan, and expects to receive 12 payments each year.

3. Most questions on the exam will require monthly interest, so it is important to remember to divide the annual number by 12.

4. For interest calculations, use the circle formula with the following:

FIGURE 8.5: Circle Formula for Interest



I = interest amount (annual number will need to be divided by 12 to get monthly amount)

R = rate of interest

P = principal sum (the amount borrowed)

B. Loan-to-value (LTV)

1. A ratio is a fraction relating the amount of a proposed loan to the value of the property. The ratio is usually stated as a percentage. For this purpose, lenders will use either the selling price of the property or the appraised value, whichever is less. Lenders offer their best terms to loans with a loan-to-value ratio of 80% or less. If the loan is 80% of the value, the down payment (20%) must make up the rest of the selling price.

2. Loan-to-value ratio + down payment percentage = 100%

3. Practice question:

   a) What is the required down payment to get a new conventional loan with an 80% LTV ratio on a property appraised at $376,000?

      (1) Solution: 100% – 80% = 20% down

      $376,000 value × 0.20 = $75,200

C. Amortization

1. Practice question:

   a) A couple who earns $4,840 per month after taxes wants to make a mortgage payment of no more than 25% of their monthly earnings. Using the amortization table, determine which interest rate and term will give the couple the payment closest to what they are seeking.

Interest	10 Years	15 Years	20 Years	30 Years
5.00%	$1,750.08	$1,304.81	$1,088.93	$885.76
5.25%	$1,770.31	$1,326.40	$1,111.84	$911.14
5.50%	$1,790.68	$1,348.19	$1,135.01	$936.85
5.75%	$1,811.19	$1,370.18	$1,158.44	$962.90
6.00%	$1,831.84	$1,392.36	$1,182.11	$989.26
6.25%	$1,852.62	$1,414.75	$1,206.03	$1,015.93
6.50%	$1,873.54	$1,437.33	$1,230.20	$1,042.91
6.75%	$1,894.60	$1,460.10	$1,254.60	$1,070.19
7.00%	$1,915.79	$1,483.07	$1,279.24	$1,097.75

      (1) Solution: The first step is to determine the amount of the payment.

      $4,840 × 0.25 = $1,210

      Using the amortization chart, a loan at 6.25% for 20 years = a payment of $1,206.03

D. Discount points

1. Lenders may charge points to increase their yield (income) when making a loan. These points are calculated on the loan amount, not the total purchase price. Points could also be used to prepay some of the interest, so the lender will reduce the interest rate on the loan without reducing the lender's income from the loan. One point is 1% of the loan amount.

2. Practice question:

   a) A lender is charging 2.5 points on an 80% LTV loan for a home purchased for $235,000. How much is the lender charging in dollars?

(1) Solution:

Step 1: Find the loan amount.

purchase price × LTV = loan amount, so \$235,000 × 0.80 = <u>\$188,000</u>

Step 2: Calculate the dollar amount of the points.

loan amount × points stated as a decimal fraction = <u>\$188,000</u> × 2.5 = <u>\$4,700</u>

\$235,000 × 0.8 × 0.025 = dollar amount = <u>\$4,700</u>

E. Prepayment penalties

1. Lenders determine the maximum loan a buyer can afford using various percentages of the borrower's' monthly income before and after other debts, such as car loans and credit card debt. These percentages vary according to the type of loan and the amounts available for down payment. A test question might provide an income and a percentage to calculate the maximum loan payment. This payment refers only to the principal and interest at the current market interest rates.

2. The lender may use a calculation to determine your penalty, rather than simply using a stated penalty. If your lender uses what is called an *interest rate differential* to derive your prepayment penalty, you will need to find the difference in interest rates by subtracting the interest rate you are currently paying from the current interest rate for a similar loan.

   a) For example, if you have a 7% loan, but current prices for the same loan are 4%, the interest rate differential—and thus the prepayment fee—would be 3% (7% – 4%) of the outstanding principal.

      (1) In either case, find the penalty by simply multiplying the remaining principal by the stated percentage. So, for a loan with \$150,000 remaining and a 3% penalty, the penalty would be 0.03 × \$150,000 = \$4,500.

3. Many lenders charge a prepayment fee based on a percentage of interest paid within a certain time period, perhaps six months.

   a) For example, a common penalty is 80% of six months' interest. The interest refers specifically to the interest-only portion of the mortgage payment. For a mortgage with \$150,000 remaining and a 5% interest rate, start by finding the interest-only payments in six months.

      (1) First, divide the annual interest rate in half to get 2½%.

      Then, multiply this value by the outstanding balance to get interest paid in six months. This would be \$150,000 × 0.025 = \$3,750.

      Then, multiply this result by 80% to find the prepayment penalty. This would be 0.8 × \$3,750, or \$3,000.

4. Practice question:

   a) Jim and Jane are buying a house together, and they earn \$65,000 per year combined. A lender states that they can qualify for payments up to 28% of their monthly income. What monthly payment could they qualify for?

(1) Solution: Their combined income is \$65,000 divided by 12 = <u>\$5,416.67</u> per month.

0.28 × \$5,416.67 = <u>\$1,516.67</u> per month principal and interest (P&I) payment

0.28 × \$5,416.67 = \$1,516.67

F. Fees

1. Practice question:

a) If you have a 7% loan but current prices for the same loan are 4%, the interest rate differential, and thus the prepayment fee, would be 3% (7% – 4%) of the outstanding principal.

(1) Solution: To find the penalty, multiply the remaining principal by the stated percentage.

A loan with \$150,000 remaining and a 3% penalty: 0.03 × \$150,000 = <u>\$4,500</u>.

2. Points or origination fees:

a) An origination fee is paid to the bank or lender for its services in creating the loan.

b) A point is 1% of the loan and is often worked into the total cost of the loan.

(1) If the loan is \$100,000, then the 1% would equal <u>\$1,000</u>.

V. SETTLEMENT AND CLOSING COSTS

A. Purchase price and down payment

1. The buyer's credits include, but are not limited to, the following: earnest money (if used); the balance of the loan; and the seller's share of any prorated items the buyer will pay in the future, such as property tax.

2. The total of the buyer's credits are then subtracted from the total of the buyer's debits to arrive at the actual amount of cash the buyer must bring to closing.

3. The closing entity will know the amount the buyer will need to bring to closing.

4. Practice question:

Sally and John are wanting to purchase their Aunt Rosita's property. She is selling her property for \$200,000. John and Sally are approved for a 30-year conventional loan at 3.389%. They will not be charged PMI. Sally and John have saved \$50,000. John and Sally are being charged \$1,200 of prorated taxes and insurance, \$1,600 in origination fees, half of the escrow fee that totals \$1,000, \$700 in title fees, and \$2,000 toward broker commission.

a) What is the amount of money needed at closing?

a. \$50,000
b. \$40,000
c. \$46,000
d. \$6,000

(1) Solution:

The first step is to add all the fees.

- \$1,200 of prorated taxes and insurance

- $1,600 in origination fees (1% of the loan amt.)
- $500 (half of the escrow fee that totals $1000)
- $700 in title fees
- $2,000 towards broker commission = <u>$6,000</u>

The second step is to add the fees plus the down payment.

- $6,000 + <u>$40,000</u> = <u>$46,000</u>
- sales price × 20% = down payment
- $200,000 × 0.20 = <u>$40,000</u>

The answer is c.

b) What is the amount of down payment?
   a. $6,000
   b. $46,000
   c. $50,000
   d. $40,000

(1) Solution: down payment = $200,000 × 0.20 = $40,000

(2) The answer is d.

B. Monthly mortgage calculations—principal, interest, taxes, and insurance (PITI)

1. Most real estate loans first have payments that include amounts set aside to pay property taxes and hazard insurance. They are referred to as principal, interest, taxes, and insurance payments (PITI payments). The lender will collect the taxes and insurance payments in an impound or escrow account and will make the payments directly to the tax authority or insurance carrier at the appropriate time. Calculate these payments using the principal plus interest from a loan payment table or loan factor chart plus 1/12 of the annual taxes and 1/12 of the annual hazard insurance.

2. Practice question:

   a) Mary and Fred are getting a new first loan to purchase a $250,000 house. They will put 20% down and with a loan factor of 6.3207 per $1,000. The property taxes will be $2,100 per year, and the insurance will be $915 per year. Using this information, calculate their monthly payment.

   (1) Solution:

   $250,000 × 80% = $200,000

   6.3207 × 200 = <u>$1,264.14</u> = P + I

   Taxes: $2,100 ÷ 12 = $175.00 T

   Insurance: $915 ÷ 12 = <u>$76.25</u> I

   PITI = <u>$1,515.39</u>

C. Net to the seller

1. To solve problems involving the net amount to the seller, a new circle formula and this calculation is needed: sales price × (100% – commission rate) = net to seller.

2. Practice question:

   a) The seller will get 93% of the amount that the property sells for (100% of selling price minus the 7% commission) and the seller wants the net amount to be $80,000.

      (1) Solution:

Net to seller in this problem is $80,000.

Sales price is the unknown value.

sales price = net to seller ÷ 93% (this is 100% – commission)

To determine the sales price that will net the seller the amount wanted:

$80,000 ÷ 0.93 = <u>$86,021.51</u>.

Projected Closing Date	Month/Day/Year
Sales Price	$$$
Loan Payoff (s)	$$
Taxes (prorated)	$
Title and or Escrow (1/12)	$
Cost and Credits	$$
Total Net Proceeds	$$$$$

D. Cost to the buyer

1. Sum of all loans and prepaid items

   a) Purchase price

   b) Down payment

   c) Loan amount

2. Loan

   a) Interest rate

   b) Term

   c) Lender points

   d) Lender origination fees

   e) Lender fees

3. Prepaids
    a) Interest
    b) Taxes (prorated)
    c) Hazard insurance (prorated)

E. Prorated items

1. At settlement or closing, certain expenses must be equitably divided between the seller and buyer. For example, if the seller paid a bill in advance for water and sewer service, it is fair to calculate the cost of the buyer's part of the billing period and reimburse the seller at closing for that amount.
    a) When taking the exam, the problem should be prorated as stated in the test question.
    b) On the national license exam, the party who is responsible for the closing day will normally be identified.
    c) The party who is identified as having the day of closing will owe or need to be paid for that full day.
        (1) It may help to draw a timeline for the entire water and sewer bill period.
2. Taxes
3. Insurance
4. Rent
5. Utilities

FIGURE 8.6: Proration Diagrams

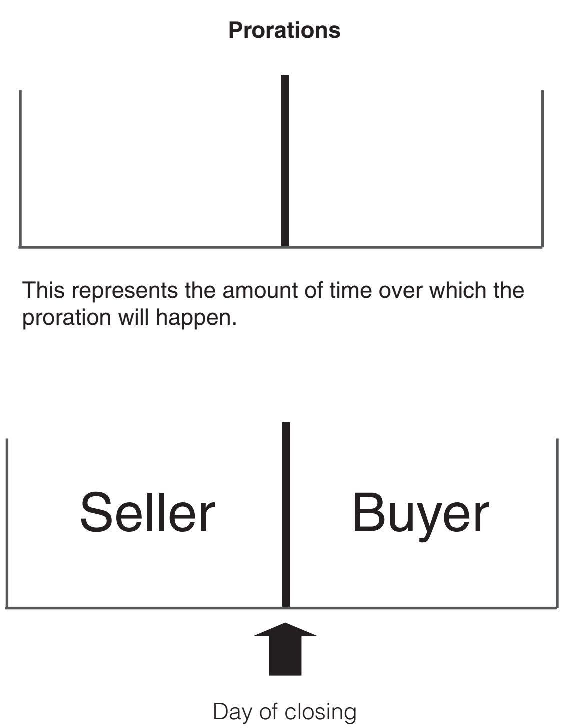
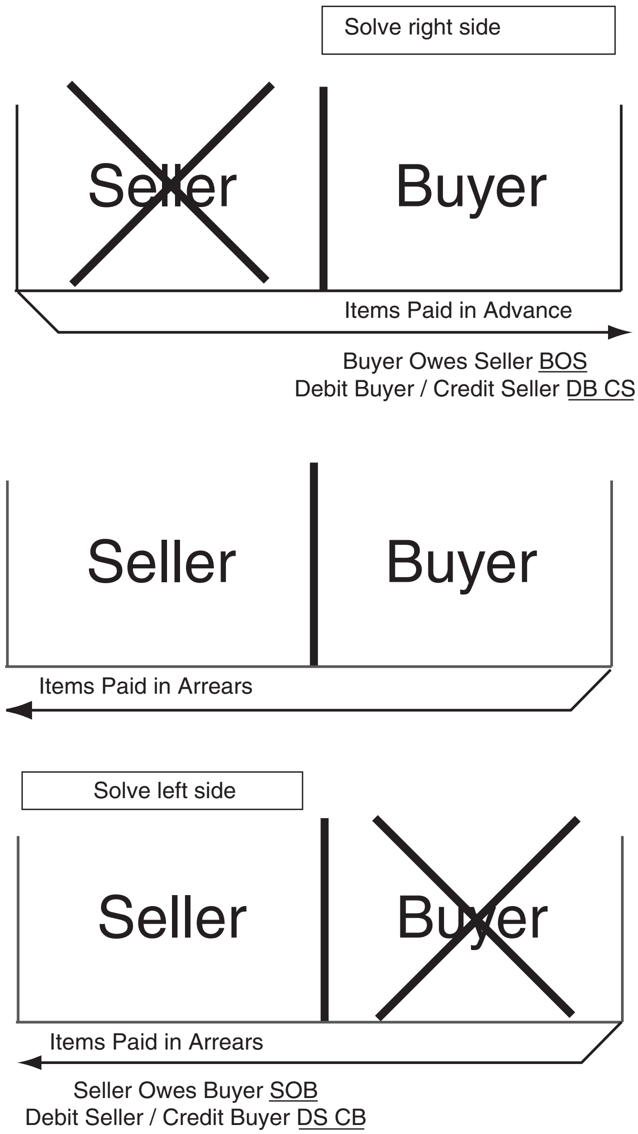
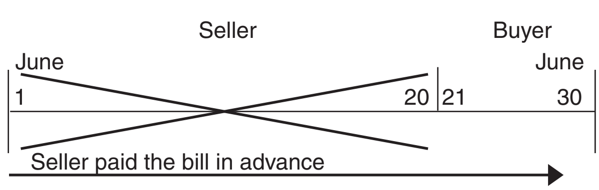


FIGURE 8.6: Proration Diagrams (continued)



6. Practice questions:

   a) A seller paid a $60 water bill for June in advance. If the closing is on June 20, how will the bill be divided between the seller and the buyer and how will it be charged on the settlement statements if the seller has the day of closing and the bill is prorated using a 360-day year?



   (1) Solution: The buyer always owes in advance because the seller paid the bill on the first of June for the entire month. The buyer owes the portion of the month from the 21st through the 30th or 10 days to the seller.

To find the days the buyer owes, subtract the total days from the seller's last day:

30 – 20 = 10 days

The formula is always the same: total amount ÷ total days × days owed.

$60 ÷ 30 (<u>$2</u> per day) × 10 = $20. Buyer owes seller: debit buyer and credit seller.

b) A seller has paid quarterly homeowners association dues of $101.20. If the closing is on August 17 with the seller having the day of closing and using a 360-day year, which would be the correct entry on the settlement statement?
   a. $48.35 debit buyer
   b. $101.20 credit seller
   c. $52.85 debit buyer
   d. $48.35 debit seller

   (1) Solution: The timeline is July 1 through September 30. With 30 days in each month, the total days are 90. For a bill paid in advance, the buyer will always owe the seller (BOS), so calculate the buyer's part. The buyer's first day is August 18. The buyer's days = 30 – 17 in August = 13 + 30 for September = 43 days. The seller already paid, so buyer owes seller (debit buyer). 101.2 ÷ 90 = $1.12 per day × 43 days = $48.35. The answer is a.

c) Taxes on a home will be paid in arrears on January 1 of next year. The taxes for the preceding year were $1,200. With a sale closing on April 15 and the buyer having the day of closing, using a 365-day year, how will taxes be handled at closing?
   a. $858.08 debit buyer, $858.08 debit seller
   b. $861.37 credit seller, $861.37 debit buyer
   c. $338.63 credit seller, $338.63 credit buyer
   d. $341.92 debit seller, $341.92 credit buyer

   (1) Solution: For bills paid in arrears, the seller will always owe the buyer (SOB) because the buyer will pay the entire tax bill next year.

   The buyer is owed the seller's portion for the time the seller occupied the property.

   The seller's time is January 1 through April 15 (31 + 28 + 31 + 14 = 104 days).

   $1,200 ÷ 365 = $3.29 per day (leave answer in calculator to avoid rounding) × 104 days = $341.92.

   The seller owes this amount to the buyer, who will pay the entire bill later. The seller may pay the tax directly at funding, thereby giving the buyer a credit.

   Debit the seller $341.92.

   $341.92 debit seller, $341.92 credit buyer

   The answer is d.

F. Debits and credits

FIGURE 8.7: Debits and Credits Chart

Item	Credit to Buyer	Debit to Buyer	Credit to Seller	Debit to Seller	Prorated
Principal amount of new mortgage	✓				
Payoff of existing mortgage				✓	
Unpaid principal balance if assumed mortgage	✓			✓	
Accrued interest on existing assumed mortgage	✓			✓	✓
Tenant's security deposit	✓			✓	
Purchase money mortgage	✓			✓	
Unpaid water and other utility bills	✓			✓	✓
Buyer's earnest money	✓				
Selling price of property		✓	✓		
Fuel oil on hand (valued at current market price)		✓	✓		✓
Prepaid insurance and tax reserve for mortgage assumed by buyer		✓	✓		✓
Refund to seller of prepaid water charges and similar utility expenses		✓	✓		✓
Prepaid general real estate taxes		✓	✓		✓

Note: This chart is based on generally applicable practices. Closing practices may be different in your state or county.

1. Practice question:

   a) A seller paid a $60 water bill for June in advance. If the closing is on June 20, how will the bill be divided between the seller and the buyer and how will it be charged on the settlement statements if the seller has the day of closing and the bill is prorated using a 360-day year?

      (1) Solution: The buyer always owes in advance because the seller paid the bill on the first of June for the entire month.

      The buyer owes the portion of the month from the 21st through the 30th or 10 days to the seller.

      To find the days the buyer owes, subtract the total days from the seller's last day: 30 – 20 = 10 days

      The formula is always the same: total amount ÷ total days × days owed.

      $60 ÷ 30 ($2 per day) × 10 = $20

      $20 debit buyer, $20 credit seller

G. Transfer tax and recording fee

1. How to calculate recording fees (to be used as an example):

   a) Base recording fee: each document title is $14 for the first page and $3 for each additional page.

b) If the document is a combined document (i.e., substitution of trustee and reconveyance), the fee is $28 for the first page ($14 for each title) (Government Code § 27361). Some documents have additional fees as set forth with the following.

(1) Survey monument fee (County Ordinance): $10 fee applied to any grant deed for property in the unincorporated area of the county and for which the legal description contains any of the following:

(a) Township and range

(b) County parcel map (CO-)

(c) Record of license survey

(d) Tract map recorded before August 24, 1929 (Book 5, page 10)

(e) Portion of lots on tract maps

(2) Real estate fraud prosecution fee (Government Code § 27388 and Local Resolution): $7 for any document on the Real Estate Fraud Prosecution Fee list unless the document is presented concurrently with a deed on which documentary transfer tax is collected

(3) Documentary transfer tax (Revenue and Taxation Code § 11902 et seq. and Local Ordinance): tax at the rate of .55 per $500 of value being transferred, unless exempt

(a) For exemptions, see Revenue and Taxation § 11921 et seq.

Note: The amount of the tax paid must be divisible by .55.

(4) Lien notice fee (Government Code § 27297.5): $12 per judgment debtor for whom an address is provided on any lien (e.g., abstract of judgment, mechanics lien) unless a proof of service of the lien is included with the document

VI. INVESTMENT

A. Return on investment (and capitalization rate)

1. The income approach to value is used for many income-producing properties because the investor is interested in the income from the rents. Converting future net income to an estimate of value is called *capitalization*, and is a primary tool for commercial property appraisers. A capitalization rate represents the yield or return on investment that an investor demands:

a) Capitalization is the process of converting estimated future income into a value

b) Net operating income

(1) The calculation of future income is based on a property's annual NOI.

Potential annual gross income	$66,000
Bad debt (2%)	– $1,320
Vacancy (3%)	– $1,980
Effective gross income	= $62,700
Operating expenses	– $29,400
NOI	= $33,300

c) cash flow = I (net operating income) – debt service

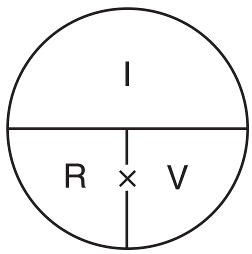
d) Capitalization math

2. Practice question:

   a) A small office building has gross rental income of $60,000 per year. The owner pays an average of $18,000 per year in expenses. If an investor is seeking a capitalization rate of 7%, what would this property be worth?

      a. $857,143
      b. $420,000
      c. $7,000,000
      d. $600,000

      (1) Solution:



Income = Rate × Value
I = Net operating income
R = Capitalization rate (investor rate of return, also affected by market forces)
V = Value (what can be paid for a property to get the expected return)

Three relationships: I = R × V; R = I ÷ V; V = I ÷ R

income (NOI) = $60,000 – $18,000 = $42,000 annual net operating income

V = I ÷ R = $42,000 ÷ 0.07 = $600,000.

The answer is d.

3. Investors want to know the return on the money they invested.

   a) The capitalization rate is based on what the investor wants to make, while the rate of return is what the investor made.

   b) The formula is NOI ÷ total invested = rate of return.

4. Practice questions:

   a) If the NOI is $20,000 and the rate of return is 10%, what is the investment amount?

      (1) Solution: $20,000 ÷ 0.10 (10%) = $200,000

   b) If the investment cost $200,000 and has an NOI of $20,000, what is the rate of return?

      (1) Solution: $20,000 ÷ $200,000 = 0.10 or 10%

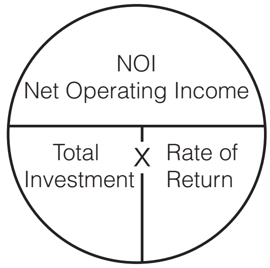
   c) If the rate of return on an investment of $200,000 is 10%, what is the NOI?

      (1) Solution: $200,000 × 0.10 = $20,000

   d) An investor bought a property for $350,000 and it recently appraised for $400,000. If the annual NOI is $34,000, what is the investor's rate of return?

      a. 8.5%
      b. 9.7%
      c. 10.29%
      d. 11.76%

(1) Solution:



$34,000 ÷ $350,000 = <u>0.0971 or 9.7%</u>

The answer is b.

e) A property has a total gross income of $50,000 with a net operating income of $27,000. An investor bought the property with a 9% cap rate, which has also been the rate of return for the last two years. How much did the investor originally invest in the property?

a. $2,430
b. $300,000
c. $450,000
d. $555,555

(1) Solution: $27,000 ÷ 0.09 = $300,000

The answer is b.

f) If an investor paid $560,000 for a property with an 8% rate of return, what is the NOI?

a. $35,000
b. $44,800
c. $56,000
d. $80,000

(1) Solution: $560,000 × 0.08 = $44,800

The answer is b.

g) The total gross income is $50,000 with a net operating income of $27,000. The investor bought the property with a 9% cap rate, which has also been the rate of return for the last two years. What was the amount invested in the property?

(1) Solution: $27,000 ÷ 0.09 = $300,000

h) An investor paid $760,000 for a property with an 8% rate of return. What is the NOI?

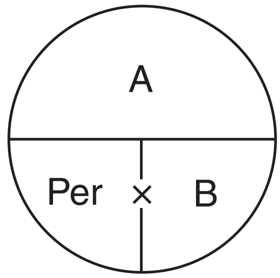
(1) Solution: $760,000 × 0.08 = $60,800

B. Appreciation

1. Practice question:

a) A home is located in an area that has increased in value by 10% over the past three years. If the home was bought three years ago for $185,000, what would be its estimated current value based on this information?

(1) Solution:



Always start with 100% and then add the appreciation percent.

A = After

B = Before

Per = %

A (after) is needed

Per (for appreciation): 100% + increase % = 100% + 10% = 1.10

B (before): $185,000

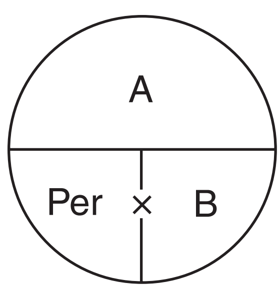
A = Per × B = 1.10 × $185,000 = $203,500

C. Depreciation

1. Practice question:

   a) A home is located in an area that has decreased in value by 10% over the past three years. If the home was bought three years ago for $185,000, what would be its estimated current value based on this information?

      (1) Solution:



Always start with 100% and then add the depreciation percent.

A = After

B = Before

Per = %

A (after) is needed

Per (for depreciation): 100% – loss = 100% – 10% = 90%

B (before): $185,000

A = Per × B = 0.09 × $185,000 = $166,500

D. Tax implications on investment

1. One income tax advantage of investment properties is that they may be depreciated during their lifetime to represent the wearing out of the asset. A nonresidential commercial property may be depreciated over 39 years. The amount of the depreciation is calculated using a method called straight-line depreciation in which the total value of the structure (not including land) is depreciated in 39 equal amounts over 39 years. This depreciation is purely an income tax calculation and is not directly related to the physical deterioration, functional obsolescence, or external obsolescence of the property.

2. Practice question:

   An investor owns a commercial building valued at $390,000. Using straight-line depreciation over 39 years, calculate the following:

   a) How much does the building depreciate each year?

      (1) Solution: $390,000 ÷ 39 years = $10,000 per year

   b) After nine years, how much would the investor have taken in depreciation?

      (1) Solution: $10,000 × 9 = $90,000

VII. PROPERTY MANAGEMENT CALCULATIONS

A. Property management and budget calculations

1. Cash flow report

   a) A monthly statement that details the financial status of the property

      (1) Sources of income

      (2) Expenses

      (3) Operating income

      (4) Net cash flow

2. Budget comparison statement

   a) Compares actual results with the original budget

      (1) Given in percentages or numerical variance of actual versus projected income and expenses

   b) Helpful in identifying trends to help future budget planning

FIGURE 8.8: Budget Calculations

Operating Expenses							
Building Engineer	$	73,615.00					
Direct Labor & Cleaning	$	146,979.07					
G & A and Other	$	10,410.00					
Maintenance & Repair	$	122,548.37					
Contract Services	$	116,517.71					
Utilities	$	382,135.48					
FAcilities/Safety	$	7,000.00					
Parking Maintenance	$	–					
Insurance	$	21,874.00					
Administrative	$	–					
Property Management Fee	$	73,424.18					
Total Escalatable Costs	$	954,503.80	$	954,503.80			
Tenants' Percentage				11.90%			
Total Tenant Share			$	113,585.95			
Less – Tenant's Base Amount (2011)			$	(91,293.92)			
Less – Prepayments Billed			$	(24,000.00)			
Total Due/(Credit)					$	(1,707.97)	
Real Estate Taxes							
Total Escalatable Costs			$	193,193.08			
Tenant's Percentage				11.90%			
			$	22,989.98			
Less – Tenant's Base Amount (2011)			$	(20,718.92)			
Less – Prepayments Billed			$	–			
Total Due/(Credit)					$	2,271.06	
Total Due/(Credit) Per This Invoice					$	563.09	

B. Tenancy and rental calculations

1. Weekly rent payments
   a) Divide the weekly rent by seven (e.g., \$180 per week ÷ 7 = \$25.71 per day).
2. Monthly rent payments
   a) Multiply the monthly rent by 12 and divide by 365 (e.g., \$800 per month × 12 ÷ 365 = \$26.30 per day).
3. Round the amount to two decimal points (i.e., \$\$.cc).

4. If your final figure has more than two decimal points, round up or down.
5. If the third number after the decimal point is 0 to 4, round down.
6. If the third number after the decimal point is 5 to 9, round up.

REVIEW QUESTIONS

1. An appraiser discovered that comparable houses were selling at the rate of $31 per square foot of living area, plus $9,700 for the lot value. If the subject property measures 24 feet by 52 feet and is two stories high, the appraiser's estimation of value would be $87,076.
   a. True
   b. False
2. An apartment building has an annual gross income of $70,000 and operating expenses of $40,000. If the capitalization rate is 10.5%, the market value would be $315,000.
   a. True
   b. False
3. A property produces $9,700 income per year. Management fees are $650 per year, and monthly heating costs are $102. If the property is valued at $78,260, the owner's capitalization rate would be 10%.
   a. True
   b. False
4. A rectangular lot that is 175 feet by 300 feet is sold at $1.75 per square foot. The brokerage fee of 10% would equal $5,250.
   a. True
   b. False
5. The market value of a property is $147,400. If properties are assessed at 60% of market value and the tax rate is $51.47 per $1,000, the property tax bill would be $4,552.
   a. True
   b. False
6. A restaurant has a gross annual income of $400,000 and an operating expense ratio of 80%. If the capitalization rate is 12.5%, the value would be $640,000.
   a. True
   b. False
7. The GRM is determined by the value times the rent.
   a. True
   b. False
8. The rate of return is determined by dividing the total investment by the NOI.
   a. True
   b. False
9. An appraiser is estimating the value of a building that has a net income of $5,000 per quarter and a capitalization rate of 8%. The value of this property is $250,000.
   a. True
   b. False
10. Converting future net income to an estimate of value is called *amortization*.
    a. True
    b. False

Answer Key

Unit 1

1. **a** The statement is true. An obsolescence typically means there is a negative effect on a property that may or may not be curable. The economic obsolescence results in a negative value effect to a property due to something outside the property lines (e.g., a shopping center on the other side of the subdivision retaining wall without a buffer zone). Economic obsolescence is rarely curable.
2. **a** The statement is true. The three measures of a fixture are (1) it is attached, (2) it is through adaptation that it is to remain with real property, or (3) through an agreement of the parties, the item is treated as a fixture and remains with the real property.
3. **b** The statement is false. An encroachment can be found on a survey or an improvement location certificate (ILC).
4. **a** The statement is true. These are called trade fixtures. Personal and real items are used for a trade—a business. The trade fixtures are the property of the tenant unless the tenant does not remove them no later than termination of the lease; they then become real property, and belong to the owner of the real estate.
5. **a** The statement is true. It is typical for the microwave to adapted and sometimes is attached; therefore, it must stay with the real property. If the seller wanted it, it needed to have been excluded in the written contract.
6. **b** The statement is false. Easements appurtenant are easements that are "apparent" that an easement was created for the use or access to another's property. An easement in gross references the right of ingress and egress for utility easements or mineral extractions.
7. **b** The statement is false. Easements are for ingress (the right to enter another's property) and egress (the right to exit another's property).
8. **a** The statement is true. The storage building is on the easement that may need to be available to the utility company. Therefore, it is an encroachment of the easement.
9. **b** The statement is false. The easement does not give rights of interest, only rights of use.
10. **a** The statement is true. This is given through the petition of the court. It is over a statutory time period that another accesses land (open, continuous, exclusive, adversely, and notorious).

Unit 2

1. **b** The statement is false. Constructive notice is given when documents are recorded in the county where the property is located. This gives the world notice of the title. An example of actual notice would be when an individual researches a title and now has knowledge of the title.
2. **a** The statement is true. For as long as interest is held, there is no termination of interest due to conditions.
3. **a** The statement is true. The life tenant is named in the life estate deed and has interest in the property until the death of the named life tenant.
4. **b** The statement is false. Riparian rights refer to river and streams, whereas the doctrine of prior appropriation states that the first beneficial user of water will have senior rights.
5. **b** The statement is false. General warranty deed, as a deed of trust, is used to create liens—not pass title.
6. **b** The statement is false. The spouse will own the property in severalty. The will is irrelevant because title was taken in joint tenancy. This would be a true statement if the couple owned the property as tenants in common.
7. **b** The statement is false. The right to sell, will, transfer, or otherwise dispose, or encumber real property are known as the right of disposition. The right to control the property within the framework of the law means that the owner(s) will abide by federal, state, and local municipalities, as well as deed restrictions (should they apply).

8. **b** The statement is false. The title policy or an abstract of title (summary of title) with an opinion of the title is used to prove marketable title. Title is the legal proof that one has a right to something. Deeds are the actually legal documents that transfer title.
9. **b** The statement is false. Pur autre vie means that the life estate may be based on the life of someone other than the holder of the life estate.
10. **b** The statement is false. A quiet title suit may need to be filed to clear the title. A quitclaim deed is used; it is a way to give your interest to somebody else. A quiet title action is a formal lawsuit to remove somebody else's interest from your property.

Unit 3

1. **b** The statement is false. Property taxes are based on assessed value.
2. **b** The statement is false. It is the function of the appraiser to estimate market value.
3. **b** The statement is false. The four elements of value are demand, utility, scarcity, and transferability (DUST).
4. **a** The statement is true. An example would be the replacement of a refrigerator; the function and use is for the same purpose.
5. **b** The statement is false. An example of functional obsolescence is a negative effect due to outdated plumbing. It is usually curable.
6. **a** The statement is true. The appraiser makes adjustments. This is an appraisal principle to the comparable properties by substituting what they lack or have that the subject property has or does not have.
7. **b** The statement is false. Rotting wood is an example of physical deterioration and depreciation.
8. **b** The statement is false. A BPO must clearly note that it is not an appraisal.
9. **b** The statement is false. Regression is negative, whereas progression is a positive aspect.
10. **b** The statement is false. Capitalization is used to determine the value of income-producing properties.

Unit 4

1. **a** The statement is true. The term "impossibility of performance" means just that. Due to a law, it is impossible to carry through with the contractual agreement.
2. **b** The statement is false. Only the minor has the legal right to make a contractual promise void. So, the minor has "voidable power."
3. **a** The statement is true. However, once the lease expires, all improvements become the land owner's.
4. **b** The statement is false. It is the written promise to do or not do specific things that makes the contract express. Most contractual promises are in writing.
5. **b** The statement is false. It is the statute of frauds that requires all sales contracts for real property be in writing.
6. **a** The statement is true. Under the statute of frauds, all contractual agreements to purchase or sell real property must be in writing to be valid.
7. **a** The statement is true. Offers are not enforceable; therefore, when a counteroffer occurs, it voids the first offer and makes a new offer.
8. **a** The statement is true. An open listing terminates upon the procuring of a ready, willing, and able buyer. All brokerages, other than the one with the buyer, must discontinue marketing the property.
9. **b** The statement is false. The broker violated the agency fiduciary duties by not looking for the seller's best interest (loyalty) as well as disclosing confidential information; therefore, the broker was practicing unethically and illegally.
10. **b** The statement is false. The seller can still negotiate other offers. The property is not off the market unless the seller asks for it to be temporarily off the market (TOM); if the property closes and funds; or if the termination takes place according to the listing.

Unit 5

1. **b** The statement is false. Commingling would be if all trust funds are deposited in the same trust account.
2. **a** The statement is true. The ADA covers the1988 amended Civil Rights Act of 1866 to include the handicapped. A person who is medically handicapped must have access to public building.
3. **b** The statement is false. This type of listing puts the seller and the broker in competition. If the seller finds a buyer, there is no commission paid to the listing brokerage. However, all brokerages must go through the listing office, not directly to the seller. If another brokerage has a buyer, the seller pays as promised in the listing.

4. **b** The statement is false. For risk management to be effective, the four evaluation points are taken into account. They are as follows: avoid, control, transfer, retain (ACTR).
5. **b** The statement is false. This will not cover criminal acts, fraud, and violations of civil rights and antitrust laws.
6. **a** The statement is true. All of these are cause for a contract to become void if the person claiming the reason acts on her power to void the agreement. The person does not have to void the agreement. The right to void in these cases is known as voidable power.
7. **b** The statement is false. The most common (and in some states, mandatory) insurance for a real estate entity is errors and omissions insurance.
8. **a** The statement is true. The buyer would have the right to file a DTPA case within two years from the date of discovery. Or, the buyer can accept the property with the now-known material fact. Sellers are strongly suggested they disclose all known material facts.
9. **a** The statement is true. Control is when the management company takes action by having the fire doors and ceiling sprinklers installed.
10. **b** The statement is false. A trust account that is specifically used for earnest monies is also known as an escrow account. Usually, the closing office holds the escrow funds.

Unit 6

1. **a** The statement is true. These are all hazardous materials that must be removed or cleaned in each individual process.
2. **a** The statement is true. Abatement is the removal. If asbestos was removed, the chances are much greater for small particles to become airborne. This is one way that mesothelioma (cancer) is contracted—the particles get into the respiratory system.
3. **a** The statement is true. In the area of practicing real estate, it is part of the profession to be knowledgeable regarding environmental issues.
4. **a** The statement is true. The EPA is the umbrella agency that covers the regulations of hazardous materials.
5. **b** The statement is false. It would not be illegal for the seller to provide the disclosure. However, only properties built before January 1, 1978, are required to disclose.
6. **a** The statement is true. Radon is usually found around furnaces, and carbon monoxide is usually detected with a meter near the water heater. The danger in both is that they are odorless and colorless. A monitor is the best way for detection.
7. **a** The statement is true. They clean up both small and large hazardous waste areas.
8. **b** The statement is false. Properties must be in a floodplain and in a community that is part of the NFIP.
9. **b** The statement is false. Because the report may impact the value and the buyer's decision, this is a material fact that must be disclosed.
10. **b** The statement is false. Known material facts must be disclosed to all parties.

Unit 7

1. **b** The statement is false. A purchase money mortgage or loan is a type of seller financing, also called financing by the seller.
2. **a** The statement is true. The typical borrower is a developer, who owns several adjacent lots and wants a loan for the lots. As the developer sells each lot, the payment to the loan is the value of the lot plus a percentage of the remaining lots (in the partial release clause). Once the note is paid, there are usually a few lots left to sell; this is all profit for the developer.
3. **b** The statement is false. A line of credit is at a minimum of $4,000 and a maximum of 80% of the equity the borrower has at the time. A reverse mortgage allows those age 62 or older to own their home, and they would receive monthly payments from a lending institution for a term. This helps to subsidize their income.
4. **b** The statement is false. In a conventional loan, the lender has more security of the loan being paid off with the more down payment a borrower makes, if the borrower puts down 20% and the loan is 80% (LTV).
5. **b** The statement is false. Only a spouse of an officer who dies in the line of duty or a veteran can originate a VA loan.
6. **b** The statement is false. "Fully amortized" is paying PITI every month until the note is paid in full. There is no balloon payment, such as in a partially amortized loan.
7. **a** The statement is true. There are few origination fees that would not be tax deductible. For test purposes, loan origination fees are tax deductible. It would be best to have the consumer check with a CPA or tax attorney.

8. **b** The statement is false. To acknowledge a document is to have it notarized. A promissory note is the instrument used to show there is a debt, an IOU.
9. **a** The statement is true. The subprime borrower is more of a risk to the lender, as he more prone to foreclosure than a prime borrower.
10. **b** The statement is false. This is known as a due-on-sale or alienation clause.

Unit 8

1. **a** The statement is true. 24 × 52 = 1,248; 1,248 × 2 = 2,496 sq. ft. living area; 2,496 × $31 = $77,376 house value; $77,376 + $9,700 = $87,076.
2. **b** The statement is false. $70,000 – $40,000 = $30,000 net; $30,000 ÷ 0.105 = $285,714.29.
3. **a** The statement is true. $102 × 12 = $1,224 annual heat; $1,224 + $650 = $1,874 operating expense; $9,700 – $1,874 = $7,826 net; $7,826 ÷ $78,260 = 0.1 (10%).
4. **b** The statement is false. 300 ft × 175 ft = 52,500 sq. ft.; 52,500 × $1.75 = $91,875; $91,875 × 0.1 = $9,187.50.
5. **a** The statement is true. $147,400 × 0.6 = $88,440; $88,440 ÷ 1,000 = 88.44; 88.44 × $51.47 = $4,552.
6. **a** The statement is true. $400,000 × 0.8 = 320,000; $400,000 – $320,000 = $80,000; (80%) = $80,000 NOI; $80,000 ÷ 0.125 = $640,000.
7. **b** The statement is false. Value ÷ rent = GRM.
8. **b** The statement is false. Rate of return = NOI ÷ total investment.
9. **a** The statement is true. (I) $5,000 × 4 = $20,000 ÷ (R) 0.08 = $250,000.
10. **b** The statement is false. Converting future net income to an estimate of value is called *capitalization*.

Notes