

## **Schedule E and Fannie Mae, Inc. vs. LLC**

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A change to the IRS Schedule E occurred in 2011, and with it, a change to the way taxes for real estate investors are reviewed for income. Added to the Schedule E on the top right is a column labeled Fair Rental Days. Fair Rental Days are the number of days that a property was occupied by tenants. The number that is entered in this box has income implications when the income taxes are underwritten to determine debt ratio. If the property was not vacant in the past year you would enter 365 into the Fair Rental Days column to represent the number of days occupied. If 365 is entered here, then the actual taxes, as filed, with all deductions will be used to establish income or loss. In many cases, real estate investors manage to show a loss against personal income when ALL deductions are claimed. However, if the property went vacant for a month and 335 fair rental days are claimed, then the income taxes are allowed to be disregarded and what is usually a far more generous way of deriving income can be utilized. In this case, we would take 75% of the monthly lease and subtract mortgage payments, taxes and insurance. This method usually results in a profit or at least a loss. Be sure to use the Fair Rental Days when your property is not generating revenue for you to maximize your rental income for mortgage qualifying.

Fannie Mae, which allows up to 10 total personally mortgaged properties (PMP), also made a change in Spring 2013 to its guidelines regarding how it counts the number of PMP each applicant has if the homes are held in the name of a limited liability company (LLC) or partnership. Prior to this change, commercial debt in the name of the LLC or Partnership for a 1-4 family residential home, even if personally guaranteed, was not deemed to be a PMP. Now mortgage debt for a 1-4 family home, when owned by an LLC or partnership, even if the mortgage is a commercial loan and not appearing on a personal credit, is considered a PMP. If the LLC or partnership has a commercial blanket mortgage with 12 residential 1-4 family homes held in the blanket mortgage that now counts as 12 PMP. Before the change to the guidelines, PMP did not count at all for LLCs.

Corporations, S and C types, however do not have this burden of commercial mortgaged property debt. S corporations are corporations that elect to pass corporate income, losses, deductions, and credit to their shareholders for federal tax purposes, while C corporations are taxed separately from their owners. My active real estate investors who originally formed their businesses as LLCs are being compelled to change their business structure to a corporation (Inc).

For those with existing LLC 1-4 family debt, there are added steps required before the mortgage debt will not be considered part of the 10 total allowable. The existing vesting of the home must be changed with the county to the Inc., as well as modifying the underlying note and mortgage with the existing creditor. Once all homes are vested in the name of the Inc and the debt is held in the name of the Inc, then the homes are not considered a personally mortgaged property.

In some areas, above and beyond the hassle and cost of the various corporate filings, there will be transfer taxes that have to be paid to execute the title change and that can amount to tens of thousands of dollars.

As this change is recent, many CPAs and attorneys are not aware of the new lending rules and may state that this is not required. Please check for yourself. Fannie Mae posts its guidelines for all to read at the link listed below.

<https://www.fanniemae.com/content/guide/se1073013.pdf>

Go to page 253 and read the section on *Multiple Financed Properties for the Same Borrower*.

There likely will be legal and tax consequences for changing business entity types and we encourage everyone to please seek the appropriate legal and tax advice. This information is offered as mortgage qualifying advice, not legal or tax advice. Having helped my own clients with this change I am glad to offer insights to the process.