TALES FROM THE TRENCHES
BY BARRY C. MCGUIRE

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THE BASICS

As real estate investors our perfect world would be something like this:

- ☺ Find a completely renovated property that exactly fits the system, make an offer,
- ☺ do and be satisfied with your diligence (due diligence), remove conditions,
- ☺ close on time,
- ☺ place your perfect tenant
- ☺ and enjoy your solid positive cash flow.

That would be a perfect world but real estate investing, and life, isn't really like that. There are lots of bumps and twists, questions and situations that come up every day in your normal lives and with every real estate transaction.

What I have discovered over 35 years of being a lawyer and handling approximately 25,000 transactions is that every deal has its wrinkles and crinkles, its ups and downs; situations where you say, "should I or shouldn't I?" There are many situations that keep coming up time and time again, situations that raise basic questions to which you need the answers. Having answers will help you move forward with your business of real estate. These answers will be valuable tools in your real estate toolbox, enabling you to quickly deal with those ever-present puzzles and questions that come up constantly in the world of real estate investing.

This chapter in Tales From The Trenches is called 'The Basics'. We are going to look at those situations that keep coming up, get into the details and give you those tools to solve real estate problems. Let's get started!

IS IT BLACK, WHITE OR GREY?

It would be lovely if every situation had an obvious answer. But, that's not reality. Situations often come up where there seem to be a number of answers. We often talk about the 'Grey Area'. We say, "Stay out of the Grey Area".

- Our reference points are **'Black'** which means bad, bad, bad, absolutely forbidden, just don't do it.
- The next reference point is **'White'** which means legitimate, no questions at all, perfectly okay.
- Lastly, we have, **'Grey'**. Grey means we aren't sure, could be offside and, usually, is heading in the direction of Black.

In future presentations of 'Tales From The Trenches - The Basics' we will be looking at joint ventures, contracts and negotiating along with other interesting topics. For now let's look at some of those scenarios that surround money and mortgages and decide whether the scenario is Black, White or Grey.

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FIRST SCENARIO:

Lucky Logan is one of my clients and was fortunate enough to win $75,000 on the lottery. He is a very private individual and was quite happy that there were also a $1,000,000 winner and a $500,000 winner in his local area. His win was relatively anonymous, which suited him just fine.

He put the money in his bank account and thought it would be sufficient to buy at least two more investment properties. He said to me, "Lenders often want to know where you got the cash portion of your purchase money. I'm not going to tell them because it's none of their business." Lucky's plan is to not tell the lender where he got his down payment money – **Is It Black, White or Grey?**

If the lender doesn't ask where Lucky got the money, then this is a <u>White</u> scenario. There is no obligation to flap your gums and tell everybody your private business. If the lender wants proof that Lucky has the money, they may ask to see a copy of his bank statement. At that point, depending on how long the money has been in the account, the lender may ask where the money came from.

To keep this scenario White, if the lender asks where the money came from, Lucky has to give a truthful answer. If Lucky says he won the money in a poker game he has moved himself, at the very minimum, into the Grey area. I say Grey rather than Black because, if the lender discovered it was lottery winnings rather than poker winnings, there is a good chance they would not care. The better practice is to make sure you always give truthful answers to your lender. That way you will always have a White scenario.

SECOND SCENARIO:

Here's a scenario that comes up way more often than you would think. My client calls me and says, "My mom and dad are helping me with the down payment. The lender wanted, and I have provided, a gift letter from mom and dad saying that they are giving me the down payment. My dad wants some security and is going to call you and ask if you will prepare a promissory note. He wants it registered against the property Can you help him?"

I can tell my client doesn't see any issues here, doesn't even know there is a problem. He just wants to know about the promissory note. Let's forget about the promissory note for a moment. **Is the gift letter situation Black, White or Grey?**

First off, what is a gift letter and why did the lender want one? Lenders always want you to put up some of your own money; the percentage varies depending on the kind of deal you are doing. They don't want you to borrow all the money it takes to buy a property.

Sometimes, parents help out their children by giving them part of the required funds. If you say your parents are giving you some money, that's when the lender wants a letter confirming the money is a gift. If the money is really a loan, **this is an obviously <u>Black</u> scenario for my client.**

Here's the funny part, or maybe it's not so funny. When I get the call that talks about the gift letter and how mom and dad are going to secure the money, there is always a shocked silence when I say that:

- If the money is a gift, then, by definition, it doesn't need to be paid back.
- I won't help dad with a promissory note or any other security.
- You (meaning my client) have to talk to your mom and dad and confirm to me that the money is a gift and therefore does not need to be repaid. Remember I am, in almost all circumstances, the bank's lawyer too. If I know that the bank is expecting 'gift' and my client is saying 'loan' then, unless I deal with the issue I am in the Black area too and participating with my client in yet another example of MORTGAGE FRAUD. Folks, I am not going to do that.

THIRD SCENARIO:

You already own your personal residence and are looking to buy your first investment property. Your friend/realtor/lawyer/mortgage broker says, "Get one of those 5% mortgages. Using the 5% down payment strategy means you can use your limited funds to buy at least three properties. It's okay as long as you move into the property for one day/1-week/1-month."

Is It Black, White or Grey?

Inexperienced investors often think this scenario is White for at least a couple of reasons. Firstly, there is inexperience. Because they are inexperienced, they frequently don't know because it has not been properly explained that these ultra-high ratio, small-downpayment mortgages are strictly for owner-occupiers. Secondly, there is bad advice. Sometimes inexperienced investors have an idea, or sort of understand, that these types of mortgages are for owner-occupiers. They aren't really sure but they sense they could be in the Grey area.

What to do? Let's raise the issue with members of our team. Let's ask the question, "Can I get a 5% down loan to buy an investment property?" When the answer is yes, when their trusted friend / lawyer / realtor / mortgage broker tells them it's okay as long as they occupy the property for some period of time, they heave a sigh of relief. In their minds they have moved from that uncertain Grey area back to White.

The real answer is that this situation is not White or even Grey, it is definitely <u>Black</u>. If you are getting a high ratio owner-occupier mortgage, you must really and truly mean to move in to the property and be an owner-occupier. Moving in for a day/week/month or even six months or a year does not make you an owner-occupier. It's always about intention and if, in the end, your underlying intention is cheap investor financing, you are in the Black area. Just to be clear, knowingly buying investment properties with owner-occupier financing is MORTGAGE FRAUD!

FOURTH AND FIFTH SCENARIOS:

A member called me and said that he had an unconditional real estate purchase contract to buy his new home. He and his family were really looking forward to moving in and enjoying the new schools and neighbourhood. Their financing was 5% down and the usual high-ratio, CMHC owner-occupier mortgage. One week before closing, their realtor called and said, "I know you love your new home but your dream home just came on the market". He and his wife couldn't resist; they went to have a look and fell in love. They had to have this home.

Since their first deal was unconditional, they were now buying two homes. They figured they could rent out the first one and turn it into an investment property. Our member thought that, because he 100% intended to move into the first home, he was okay keeping that 5% down owner-occupier mortgage and getting another 5% down owner-occupier mortgage for the new dream home.

Is their situation, Black, White or Grey?

In a similar scenario our member had only been in his brand-new home with his brand-new 5% down, owner-occupier mortgage for one month. Then, he got the email from his boss. "You're being transferred to head office" (300 miles away). He could sell the home and not lose any money because of his company's generous monetary transfer policies. Or, he thought, "what if I keep this place and rent it out? I can buy a new home and get another 5% down, owner-occupier mortgage."

Is his situation, Black, White or Grey?

The answer to both scenarios is Grey. In both cases, our members purchased homes with 5% down, owner-occupier mortgages, one intending to and the other actually moving into the new home. Now that circumstances have changed, neither member knows if they are off side with their lender and CMHC. So, it's Grey.

Saying nothing exposes both members to potential problems if a CMHC auditor bangs on the door of what was supposed to be an owner-occupier property and meets a renter. Audits are rare but they do occur. The answer for both our members is to sit down with their broker/lender and explain the new circumstances. The broker/lender should review the circumstances and follow internal policy which might mean consulting with CMHC. In the end, the answer might be that each member has to pay down their 5% mortgage to meet current CMHC requirements for investor property. Or, policy might say that our member who was transferred one month after moving in, doesn't have to do anything. Or there might be other answers. That's the thing about policy, we never know quite what it is and it's always changing.

Both of these scenarios were Grey whether our members knew it or not. There was an issue, a new element where it could be a problem but no one knew the answer. By meeting with their broker/lender, disclosing the new circumstances, getting advice and acting on the advice, our members move this Grey scenario to a White scenario. Remember, whatever advice you get from your broker lender, confirm with a letter or e-mail.

"When it comes to creative financing, every good investor knows that the success of your deal can hinge on the quality of your documents. Are YOU at risk?"

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