The Basics of Analyzing Rental Income

August 2023
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Topics of Discussion

• Required Documentation
• Analyzing Leases/Fair Market Rents
• Analyzing Schedule E Rental Income
• How Rental Income and Losses are Treated
Where to Begin

- Determining rental income or losses from a rental property (or properties) is a common challenge.

- Knowing what documentation is required and using a rental analysis worksheet will help make the process easy to follow.

- Rental income can come from a borrower’s primary residence (2-4 units), personally held investment properties or from properties held in partnerships or S-corporations.*

*Income analysis of properties owned through a partnership or s-corporation will not be covered in any detail.
Reporting Rental Income and Expenses

Most real estate investors report the net income or loss from their rental properties using **Schedule E** on Form 1040. Generally speaking, borrowers use the Schedule E if:

- They own rental property in their own name, with a spouse, or through a single-member LLC

**Partnerships and S corporations use Form 8825** to report income and deductible expenses from rental real estate activities, including net income (loss) from rental real estate activities that flow through from partnerships, estates, or trusts.
Knowledge Check

Assuming DU is being used, which of the following types of rental income can be used for qualifying?

a. Rent from a second home
b. Rent from short-term rental property
c. Rent from a boarder/roommate
d. Rent from a live-in aide
e. All of the above

The answers are b. and d., and maybe c.

- Short-term rental income is eligible but the income must be reflected on the borrower’s tax returns. Fannie Mae’s guidelines only allow boarder income if the boarder is a live-in aide or personal assistant.
- Fannie Mae’s HomeReady® option does allow boarder income.
Required Documentation for Rental Income Analysis
Let’s Discuss

Paul is reviewing the leases provided by the seller of a property his borrower is purchasing. He notices that the appraisal shows market rents in the area are much higher.

*What would you do?*

Find out why the leases are lower.

Are friends or relatives currently renting at a lower amount?

Does the borrower need the higher rents to qualify?
Documentation

Documentation and rental income analysis requirements may differ based upon certain characteristics:

- What kind of transaction is it? Purchase? Refinance?
- Is the property currently rented?
- Is the rental income coming from the subject property or other properties owned by the borrower?
- Is or will the property be owner-occupied?
- If already owned, how long has the borrower owned the property?
Documentation Based on Rental Status

**Subject properties:**
If a purchase, is the subject property currently rented out?

<table>
<thead>
<tr>
<th>YES</th>
<th>NO</th>
</tr>
</thead>
<tbody>
<tr>
<td>If it’s a 1-unit property, make sure the appraisal includes a</td>
<td>Use the <strong>Comparable Rent Schedule</strong> (Form 1007/1000) for a 1-unit</td>
</tr>
<tr>
<td><strong>Comparable Rent Schedule</strong> (Form 1007/1000).</td>
<td>property.</td>
</tr>
<tr>
<td>If the property consists of 2-4 units, a **Small Residential</td>
<td>Use a <strong>Small Residential Income Property Appraisal Report</strong> (Form 1025/72) for 2-4 unit properties to determine the fair market rental amount.</td>
</tr>
<tr>
<td><strong>Income Property Appraisal Report</strong> (Form 1025/72) should be</td>
<td></td>
</tr>
<tr>
<td>requested.</td>
<td></td>
</tr>
<tr>
<td>Obtain copies of <strong>any current leases</strong> to compare with the</td>
<td></td>
</tr>
<tr>
<td>appraisal data.</td>
<td></td>
</tr>
</tbody>
</table>
## Subject properties:
If a refinance, is there a history of receiving rents on the property?

<table>
<thead>
<tr>
<th>YES</th>
<th>NO</th>
</tr>
</thead>
</table>
| • An appraisal with a **Comparable Rent Schedule or a Small Residential Income Property Appraisal** and;  
   • The borrower's most recent year* of signed federal tax returns including **Schedule 1** and **Schedule E** or  
   • If the property was acquired after the last tax filing year, a copy of the **current lease(s)** and/or rental data from the appraisal should be analyzed. |  
| • An appraisal with a **Comparable Rent Schedule (1-unit)** or a **Small Residential Income Property Appraisal (2-4 units)**. |
Documentation for Non-Subject Properties

Non-subject properties:

• Borrower’s who own investment properties must provide their most recent federal tax return so Schedule E may be analyzed.
  ✓ Rental income is typically analyzed using the most recent tax return and unlike other forms of variable income should not be averaged over two years.

• If a property was purchased recently and not reflected on the borrower’s last tax return, leases should be obtained.
Analyzing Leases and Fair Market Rents
Leases and Fair Market Rents
Using Leases and/or Market Rents

For transactions where there is no history of receiving rent on a property, leases and/or market rents* must be used

- Always use **75%** of the gross rents (to calculate, multiply the gross monthly rent by .75).

- The remaining **25%** of the gross rent is considered as vacancy losses and maintenance expenses.

For subject properties, market rents are reported on Form 1007/1000 or the appraisal, 1025/72. This data should be compared to the leases.
Leases and Fair Market Rents

All of the Fannie Mae rental worksheets have sections for calculating rental income using leases and/or market rents

- **Fannie Mae Form 1037** used for owner-occupied, 2-4 unit properties.
- **Fannie Mae Form 1038** used when the subject property is an investment property (MPF Xtra only) or a non-subject investment property.
- **Fannie Mae Form 1038A** is the same as Form 1038, but accommodates up to ten properties.

*Freddie Mac and many of the MI companies have similar worksheets that are also acceptable.*
Calculating Leases or Market Rents

Using Fannie Mae’s **Form 1037** to analyze leases or market rents from an owner-occupied property (purchase transaction)

<table>
<thead>
<tr>
<th>Step 2B. Lease Agreement OR Fannie Mae Form 1025</th>
<th>For each property complete ONLY 2A or 2B</th>
</tr>
</thead>
<tbody>
<tr>
<td>This method is used when the transaction is a purchase, the property was acquired subsequent to the most recent tax filing.</td>
<td></td>
</tr>
</tbody>
</table>

| B1 | Enter the gross monthly rent (from the lease agreement) or market rent (from Form 1025) for the applicable rental unit | Enter | 1500 |
| B2 | Multiply gross monthly rent or market rent by 75% (.75). The remaining 25% accounts for vacancy loss, maintenance, and management expenses. | Multiply | x.75 | x.75 | x.75 |
| | Equals monthly rental income per unit | Total | 1125 |
| B3 | Combine the monthly rental income of all non-owner-occupied rental units (up to a maximum of 3 rental units since rental income is not eligible on the unit occupied by the borrower). | Add | 0 |

**Step 2B. Result:** Monthly qualifying rental income: 1125
Form 1037 does not subtract the borrower’s PITIA from the net rent(s).

- **Form 1037** is for *owner-occupied* properties that generate rental income.
- Rental income from **Form 1037** may be added to the borrower’s qualifying income.
- Use the full PITIA to calculate DTI ratios using the borrower’s income plus the additional rental income.
- Most calculations on **Form 1037** will result in rental income, not a loss.
Calculating Leases or Market Rents

Fannie Mae Form 1038 section for leases or market rents for non-owner occupied subject properties*

*May sometimes be used for non-subject properties not listed on Schedule E (i.e. the property was recently purchased or a conversion of a departure residence into a rental property).

<table>
<thead>
<tr>
<th>Step 2B. Lease Agreement OR Fannie Mae Form 1007 or Form 1025</th>
<th>Enter</th>
<th>Multiply</th>
<th>Total</th>
<th>Subtract</th>
<th>Result</th>
</tr>
</thead>
<tbody>
<tr>
<td>Enter the gross monthly rent (from the lease agreement) or market rent (reported on Form 1007 or Form 1025). For multi-unit properties, combine gross rent from all rental units.</td>
<td>1000</td>
<td>x.75</td>
<td>750</td>
<td>870</td>
<td>(120)</td>
</tr>
</tbody>
</table>

*For each property complete ONLY 2A or 2B.*
Form 1038

Form 1038 is used for non-owner occupied properties

- Since the PITIA is part of the expenses for a non-owner occupied property, it should be subtracted along with other expenses.

- Some calculations may result in a loss.

- Losses are held against the borrower as a monthly liability.

- Income may be added to the borrower’s monthly income (subject to restrictions).
Analyzing Rental Income/Loss from Schedule E
Schedule E Analysis

Each of the Fannie Mae rental income worksheets include sections for Schedule E analysis. Use those sections for:

- Refinances of owner-occupied properties with rental units (2-4 unit properties).
- Refinances of non-owner occupied subject properties (MPF Xtra only).
- Any transaction where the borrower owns additional investment properties.
Schedule E Analysis

When analyzing rental income listed on Schedule E, Fannie Mae’s guidelines refer to this calculation method:

**Start with:** The total annual rental income for the property

**Subtract:** The total annual expenses for the property

**Add Back:** Depreciation
- Mortgage Interest
- Real Estate Taxes
- Insurance
- Homeowner’s Association Fees (if applicable)
- Non-recurring Expenses (if documented accordingly)

**Subtract:** The current monthly PITIA for the property
Schedule E Analysis

1. Lists the property address_addresses.
2. Describes the property type.
3. Notes how many days during the tax year the property was rented.
Partial History of Receiving Rents

What if the property was acquired during the most recent tax year or if the property was out of service for an extended period of time?

• If acquired during the last tax year, confirm the purchase date using the closing disclosure or other documentation.

• If acquired during the last tax year or if the property was out of service for a period of time, refer to Schedule E and use the *Fair Rental Days* to confirm income and expenses.

• Divide the total amount of fair rental days by 30 to determine how many months the property was in service.

• If Schedule E reflects costs for renovation or rehabilitation, additional documentation may be required to ensure that the expenses support the amount of time the property was out of service.
### Schedule E Analysis

#### Income:
- Rents received: 3, $13,200
- Royalties received: 4

#### Expenses:
- Advertising: 5
- Auto and travel (see instructions): 6
- Cleaning and maintenance: 7
- Commissions: 8
- Insurance: 9
- Legal and other professional fees: 10
- Management fees: 11
- Mortgage interest paid to banks, etc. (see instructions): 12
- Other interest: 13
- Repairs: 14
- Supplies: 15
- Taxes: 16
- Utilities: 17
- Depreciation expense or depletion: 18
- Other (list): 19
- Total expenses: 20, $12,140
- Net income or (loss): 21, $1,060
## Using a Worksheet to Analyze Schedule E

This is the section of Fannie Mae Form 1038 which helps to analyze Schedule E data.

<table>
<thead>
<tr>
<th>Step 2A. Schedule E - Part I</th>
<th>For each property complete ONLY 2A or 2B</th>
</tr>
</thead>
<tbody>
<tr>
<td>A1 Enter total rents received.</td>
<td>Enter</td>
</tr>
<tr>
<td>A2 Enter total expenses.</td>
<td>Subtract</td>
</tr>
<tr>
<td>A3 Enter insurance expense.</td>
<td>Add</td>
</tr>
<tr>
<td>A4 Enter mortgage interest paid.</td>
<td>Add</td>
</tr>
<tr>
<td>A5 Enter tax expense.</td>
<td>Add</td>
</tr>
<tr>
<td>A6 Enter homeowners’ association dues.</td>
<td>Add</td>
</tr>
<tr>
<td>A7 Enter depreciation expense or depletion.</td>
<td>Add</td>
</tr>
<tr>
<td>A8 Enter any one-time extraordinary expense (e.g., casualty loss). There must be evidence of the nature of the one-time extraordinary expense.</td>
<td>Add</td>
</tr>
<tr>
<td>Equals adjusted rental income.</td>
<td>Total</td>
</tr>
<tr>
<td>A9 Enter the number of months the property was in service (Step 1 Result).</td>
<td>Divide</td>
</tr>
<tr>
<td>Equals adjusted monthly rental income</td>
<td>Total</td>
</tr>
<tr>
<td>A10 Enter proposed PITIA (for subject property) or existing PITIA (for non-subject property).</td>
<td>Subtract</td>
</tr>
</tbody>
</table>

**Step 2A. Result: Monthly qualifying rental income (or loss):**

Result: 0
Justin wants to refinance his primary residence. He also owns a single family home that he rents out.

You are analyzing Schedule E from his 2021 federal tax return.

His current monthly payment on the rental property breaks down as follows:

- **Principal and Interest:** $517.00
- **Real Estate Taxes:** $260.00
- **Insurance:** $92.00

**Total PITIA:** $869.00
Schedule E Analysis

Fill in the property address and the number of months the property was in service during the last tax year.
**Schedule E Analysis Using a Worksheet**

<table>
<thead>
<tr>
<th>Income:</th>
<th>Properties:</th>
<th>A</th>
<th>B</th>
<th>C</th>
</tr>
</thead>
<tbody>
<tr>
<td>Rents received</td>
<td>3</td>
<td>14,400</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Royalties received</td>
<td>4</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Expenses:**

<table>
<thead>
<tr>
<th>Item</th>
<th>A</th>
<th>B</th>
<th>C</th>
</tr>
</thead>
<tbody>
<tr>
<td>Advertising</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Auto and travel (see instructions)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cleaning and maintenance</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Commissions</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Insurance</td>
<td></td>
<td>1,100</td>
<td></td>
</tr>
<tr>
<td>Legal and other professional fees</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Management fees</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Mortgage interest paid to banks, etc. (see instructions)</td>
<td></td>
<td>3,950</td>
<td></td>
</tr>
<tr>
<td>Other interest</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Repairs</td>
<td></td>
<td>2,230</td>
<td></td>
</tr>
<tr>
<td>Supplies</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Taxes</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Utilities</td>
<td></td>
<td>1,680</td>
<td></td>
</tr>
<tr>
<td>Depreciation expense or depletion</td>
<td></td>
<td>2,120</td>
<td></td>
</tr>
<tr>
<td>Other (list)</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Total expenses. Add lines 5 through 19:**

| Line 20                                                |           | 15,745    |           |

**Step 2A. Schedule E - Part I**

- **Enter total rents received.**
  - Enter: 14,400

- **Subtract total expenses.**
  - Subtract: 15,745

- **Add insurance expense.**
  - Add: 1,100

- **Add mortgage interest paid.**
  - Add: 3,950

- **Add tax expense.**
  - Add: 3,120

- **Add homeowners’ association dues.**
  - Add: 712

- **Add any one-time extraordinary expense (e.g., casualty loss).**
  - Add: 869

- **Equals adjusted rental income.**
  - Total: 8,545

- **Enter the number of months the property was in service (Step 1 Result).**
  - Divide: 12

- **Equals adjusted monthly rental income.**
  - Total: 712

- **Subtract proposed PITIA (for subject property) or existing PITIA (for non-subject property).**
  - Result: (157)
How Income and Losses are Treated
How Rental Losses are Treated

If your calculation on Form 1038 results in a loss, that loss should be held against him as a monthly liability.

We just used Schedule E and Form 1038 to determine Justin’s income/loss on his rental property. We arrived at a loss so...

$157 must be added to his monthly liabilities.
How Rental Income is Treated

If your calculation on Form 1037 or 1038 results in a gain, that amount *may* be considered as additional income for the borrower.

Let’s look at the guidelines for adding income…
How Rental Income is Treated

Guidelines for adding rental income to a borrower’s qualifying income

1. The borrower does not own a primary residence (or have a housing payment)

2. The borrower has a primary residence (or a housing payment) but does not have at least one year of property management experience.

3. The borrower has a primary residence (or housing payment) and has over one year of property management experience.

a. Rental income added to the borrower’s income cannot exceed the total PITIA for the property.

b. No rental income can be added to the borrower’s monthly income.

c. There is no limit to the amount of rental income that can be added to the borrower’s monthly income.
Summary

• Always use a worksheet to calculate rental income/losses.

• Even when not using rental income to qualify, calculations must be completed.

• Calculation methods differ between owner-occupied properties with rental income and non-owner occupied investment properties.

• If using leases for a subject property, compare the rents with the appraisal data.

• Keep in mind that there are additional reserve requirements for borrowers with multiple investment properties and sometimes limits to the amount of properties a borrower can own.
MPF Program Contacts and Resources

MPF Service Center
Email - MPF-Help@FHLBC.com
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mpftraining@fhlbc.com

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