

Modern Real Estate Practice in Illinois, 6th Edition
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Chapter 23: Closing the Real Estate Transaction

Learning Objectives

After reading this chapter, students should be able to:

- Identify the issues of particular interest to the buyer and the seller as a real estate transaction closes.
- Describe the steps involved in preparing a closing statement.
- Explain the general rules for prorating.
- Distinguish the procedures involved in face-to-face closings from those in escrow closings.
- Define the following key terms: accrued item; closing; closing statement; controlled business arrangement; credit; debit; escrow; prepaid items; prorations; Real Estate Settlement Procedures Act; and Uniform Settlement Statement.

Why Learn About Closing The Real Estate Transaction?

Everything a licensee does in the course of a real estate transaction, from soliciting clients to presenting offers and coordinating inspections, leads to one final event—closing. Closing is the consummation of the real estate transaction. It is the time when the title to the real estate is transferred in exchange for payment of the purchase price. Closing marks the end of any real estate transaction; it is the goal toward which all the agent's efforts are driven. It's also a complicated time. Up until closing preparations begin, the agent's relationship has been primarily with his or her client. During the closing period, new players come on the scene: appraisers, inspectors, loan officers, insurance agents, and lawyers. Negotiations continue, sometimes right up until the property is finally transferred, and the risk of a deal falling through is high. For those reasons alone, it is vital that you understand how closings work to ensure that they do.

Suggested Items to Bring to Class

1. Blank copies of the HUD 1 form (Uniform Settlement Statement)
2. Copies of the HUD booklet *Settlement Costs and You*.
3. Copies of any additional buyer and seller closing statements used in Illinois.
4. Copies of broker closing statements and attorney's seller/buyer closing statement.

Lecture Outline

I. PreClosing Procedures

Closing marks the end of any real estate sales transaction. At closing, the executory contract becomes fully executed.

A. Buyer's Issues

In addition to ensuring that the seller delivers good title, the buyer has other concerns.

1. Final property inspection

The buyer makes sure that the property is in the promised condition.

2. Survey

The survey should set out, in full, any existing easements and encroachments. Most lenders require a spotted survey not over six months old.

B. Seller's Issues

The seller's main interest is in producing adequate documentation so that the closing can go forward and he or she can be paid.

C. Title Procedures

Both the buyer and the buyer's lender will want assurance that the seller's title complies with the requirements of the sales contract.

- The seller is usually required to produce a current abstract of title or title commitment from the title insurance company.
- When an abstract of title is used, the purchaser's attorney examines it and issues an opinion of title.

1. There are usually two searches of the public records.

- The first shows the status of the seller's title on the date of the first search.
- The second search is made after the closing. This search is referred to as either a bring down or later date survey.

2. The seller may be required to execute an affidavit of title stating that he or she has done nothing that has caused any changes in title since the title commitment was issued.

II. Conducting the Closing

IN ILLINOIS . . . *the closing statement is customarily prepared by the buyer's lender, the lender's agent (usually a title company), or the seller's lawyer.. Although real estate licensees are prohibited by the Illinois Supreme*

Court's decision in Chicago Bar Association, et al. v. Quinlan and Tyson, Inc., from completing formal closing statements, estimated statements are often needed when preparing a CMA, filling out an offer for a buyer, or when presenting an offer to a seller. For this reason, licensees must understand the preparation of a closing statement, which includes the expenses and prorations of costs to close the transaction. In addition, the Illinois licensing examination for broker candidates includes specific questions regarding closing statement calculations.

A. Face-to-Face Closing

The promises made in the sales contract are fulfilled, the buyer's loan is finalized, and the mortgage lender disburses the loan funds during a single meeting of all the parties and their attorneys.

1. Closing agent or closing officer

One person, usually a title company employee, conducts the proceedings at a closing and calculates the division of income and expenses between the parties. The employee is acting as an escrow agent for the buyer's lender during the time of the closing.

2. The exchange

When the parties are satisfied, the exchange of money for the deed is made.

B. Closing in Escrow

A method of handling real estate transactions in which a disinterested third party is authorized to act as escrow agent for both the buyer and the seller and to coordinate the closing activities

1. Escrow procedure

Buyer and seller execute escrow instructions to the escrow agent immediately after the sales contract is signed. The broker turns over the earnest money to the escrow agent, who deposits it in a special trust, or escrow, account.

- When all conditions of the escrow agreement have been met and all liens are paid the agent disburses the purchase price to the seller and records the deed and mortgage or deed of trust. The Doctrine of Relation Back protects the validity of documents placed in an escrow, even if the signer of the document dies before the escrow is completed.

C. IRS Reporting Requirements

The closing agent or another representative of the seller must report every real estate transaction to the IRS on a Form 1099-S.

D. Broker's Role at Closing

It varies depending on local practice, but usually the role is a public relations role to accompany the client to the event that terminates the transaction.

E. Lender's Interest in Closing

- The lender wants to protect its security interest in the property.
- The lender wants its mortgage lien to have priority over other liens.
- The lender wants an insurance escrow or impound account created so that insurance will be available in case the property is damaged or destroyed.
- The lender wants a tax escrow or impound account created at closing so it can control the payment of real estate taxes

III. RESPA Requirements

The Real Estate Settlement Procedures Act (RESPA) ensures that consumers are provided with important, accurate, and timely information about the actual costs of settling or closing a transaction. It also eliminates kickbacks and other referral fees that tend to inflate the costs of settlement unnecessarily.

A. Applicability

- RESPA applies when a purchase is financed by a federally related mortgage loan.
 - *Federally related:* loans made by banks, savings and loan associations, or other lenders whose deposits are insured by federal agencies. Loans that will be sold on the secondary market are also covered.
- RESPA applies to first-lien residential mortgage loans made to finance the purchases of one- to four-family homes and second or subordinate liens for home equity loans.

B. Exemptions

- A transaction financed solely by a purchase-money mortgage taken back by the seller
- An installment contract (contract for deed)
- A buyer's assumption of a seller's existing loan

C. Controlled Business Arrangements

Brokers are often involved in collateral business activities: title companies, survey companies, home inspection companies, and even financial institutions. If consumers are clearly informed of the relationship among the service providers and are instructed that other providers are available, brokers may offer these services. Fees may not be exchanged

among the affiliated companies simply for referring business to one another.

D. Disclosure Requirements

Lenders and settlement agents have certain disclosure obligations.

- Lenders must provide a copy of a special informational HUD booklet at the time a loan application is received or within three days afterward.
- No later than three business days after receiving a loan application, the lender must provide the borrower with a *good-faith estimate* of settlement costs.
- RESPA requires that a *Uniform Settlement Statement* (HUD Form 1) be completed at closing to itemize all charges to be paid by a borrower and seller.
 - A draft of the settlement statement must be made available to the buyer within one day of closing.
 - Lenders must retain these statements for two years after the dates of closing.

1. Kickbacks and referral fees

RESPA prohibits the payment of kickbacks, or unearned fees, in any real estate settlement service.

IV. Preparation of Closing Statements

- A *debit* is a charge against the party.
- A *credit* is an amount entered in a person's favor.
 - 1. Calculating buyer cash at closing**
 - The buyer's debits are totaled with the major item being purchase price.
 - Any expenses and prorated amounts for seller-prepaid items are added to the purchase price.
 - Then the buyer's credits including earnest money deposit and loan proceeds are totaled.
 - Finally, the total of the buyer's credits is subtracted from the total debits.
 - 2. Calculating amount to be received by seller**
 - The seller's credits are totaled, the major item being purchase price.

- The total of the seller's debits including existing mortgage payoff is subtracted from the total credits.

3. Broker's commission is determined by previous agreement and will be charged to the parties at closing. In many instances, the seller has agreed to allow the broker to retain the earnest money deposit as commission.

4. Attorney's fees

- If either of the party's attorneys will be paid from the closing proceeds, that party will be charged with the expense in the closing statement.

5. Recording expenses

- The seller usually pays for recording charges necessary to furnish the purchaser with a marketable title including recording of a release of the existing mortgage.
- The purchaser pays for recording charges that arise from the actual transfer of title. Usually, such items include recording the deed that conveys title to the purchaser and a mortgage or deed of trust executed by the purchaser.

6. Transfer tax

IN ILLINOIS . . . *the seller, in accordance with most sales contracts and state law, usually pays state and county transfer taxes. Local ordinances usually establish which party is responsible for paying municipal transfer taxes.*

7. Title expenses

IN ILLINOIS . . . *two title policies are usually issued for a closing, one insuring the buyer and the other insuring the lender. The first of these will be in the amount of the purchase; the second will be in the amount of the mortgage loan. Customarily the seller pays for the buyer's owner's title insurance policy and the buyer pays for his or her own lender's policy.*

8. Loan fees

The lender ordinarily charges a loan origination fee and may also charge discount points. These loan-related costs are charged to the buyer at closing.

- If the buyer assumes the seller's existing financing, the buyer may pay an assumption fee.

9. Tax reserves and insurance reserves (escrow or impound accounts)

Most mortgage lenders require that borrowers provide reserve funds or escrow accounts to pay future real estate taxes and insurance premiums.

- The borrower is responsible for maintaining adequate fire or hazard insurance.

10. Appraisal fees

Ordinarily the lender requires an appraisal. The cost will be charged to the buyer, but often the buyer has prepaid it as part of a nonrefundable application fee. It will show up an expense paid outside of closing.

11. Survey fees

IN ILLINOIS . . . *most real estate contracts require the seller to furnish a current survey to the buyer. As a result, the expense of preparing a survey is usually borne by the seller.*

12. Additional fees

- **FHA:** a lump sum for payment of the mortgage insurance premium (MIP) if it is not financed as part of the loan, and it will be charged to the buyer.
- **VA:** funding fee paid directly to the VA at closing will be charged to the buyer.
- **Conventional:** if the loan carries private mortgage insurance, the buyer prepays one year's insurance premium at closing.

A. Accounting for Expenses

Expenses paid out of the closing proceeds are charged to the person who is responsible for the debt. Occasionally, an expense item may be shared between the parties.

V. Prorations

Prorations are necessary to ensure that expenses are divided fairly between the seller and the buyer.

- **Accrued items** are expenses that are owed by the seller but will be paid by the buyer after closing. The seller pays for these items by giving the buyer credit for them at closing. The seller will be charged for his or her share in the form of a debit.
- **Prepaid items** are expenses that have been prepaid by the seller but are not fully used up. They are therefore credited to the seller and result in a debit or charge to the buyer.

A. The Arithmetic of Prorating

The computation of a proration involves identifying a yearly charge for the item to be prorated, then dividing by 12 to determine a monthly charge for the item. Usually it is also necessary to identify a daily charge for the item by dividing the monthly charge by the number of days in the month. These daily portions are then multiplied by the number of months or days in the prorated time period to determine the accrued or unearned amount that will be figured in the settlement.

1. Statutory method

The yearly charge is divided by a 360-day year, or 12 months of 30 days each.

2. Actual number of days method

The yearly charge is divided by 365 (366 in a leap year) to determine the daily charge. Then the actual number of days in the proration period is determined, and this number is multiplied by the daily charge.

IN ILLINOIS . . . *a third method, the **statutory month variation**, is also acceptable for inexpensive residential properties. Attorneys for the parties usually demand an actual number of days method. If the statutory month variation is used, the yearly charge is divided by 12 to determine a monthly amount. The monthly charge is then divided by the actual number of days in the month in which the closing occurs. This final number is the daily charge for that month.*

B. Accrued Items

When the real estate tax is levied for the calendar year and is payable during that year or in the following year, the accrued portion is for the period from January 1 to the date of closing.

C. Prepaid Items

Because real estate tax may be paid in the early part of the year, a tax proration calculated for a closing taking place later in the year must reflect the fact that the seller has already paid the tax.

D. General Rules for Prorating

The rules or customs governing the computation of prorations for the closing of a real estate sale vary widely from state to state.

- in most states, the seller owns the property on the day of closing, and prorations or apportionments are usually made to and including the day of closing. All expenses are charged against the seller, but all revenue is credited to the seller for the closing date.
- Mortgage interest, general real estate taxes, water taxes, insurance premiums, and similar expenses are usually computed by using 360 days in a year and 30 days in a month.

- Accrued or prepaid general real estate taxes are usually prorated at the closing.
- Special assessments for municipal improvements: the seller normally pays the current installment, and the buyer assumes all future installments.
- Rents are usually adjusted on the basis of the actual number of days in the month of closing.
- The seller generally transfers security deposits to the buyer.

1. Real estate taxes

IN ILLINOIS . . . *taxes are paid in the year after they become a lien. If there is an unpaid installment that has been billed, this actual amount is credited to the buyer and debited to the seller. The buyer must also be credited with the current year's taxes, and the seller debited accordingly; a proration from January 1 up to and including the date of closing.*

2. Mortgage loan interest

IN ILLINOIS . . . *the terms of some assumed mortgage loans provide that interest is charged at the beginning of the month (in advance); without this provision, interest is always charged at the end of the month (in arrears). When the interest on the existing mortgage to be assumed by the buyer is charged at the beginning of the month, the unearned portion (that is, the part that is prepaid from the date of closing to the end of the month) must be credited to the seller and debited to the buyer. When the mortgage interest is charged at the end of the month, the earned portion of the mortgage interest through the date of closing is an accrued expense, debited to the seller and credited to the buyer.*

3. Prepaid condo assessment

The buyer will be charged for the share of the assessment from the day after closing until the end of the month. The seller will receive a credit for this amount.

VI. Sample Closing Statement

A. Basic Information of Offer and Sale

1. Computing the prorations and charges

B. - HUD-1 (The Uniform Settlement Statement)

Discussion Questions

1. What is the customary procedure for closing real estate transactions in your part of Illinois? Does the custom vary from one area to another?

2. How has RESPA proven helpful to both buyers and sellers of real estate? Or has it proven helpful at all?
3. Why should a salesperson be knowledgeable about the payment of seller and buyer expenses at a closing?

Classroom Exercises

1. Go through the sample closing statement in the text or select other problems from the questions in this manual. Attempt to tailor these problems to the customary type of prorating used in your area.
2. Have students identify whether closing statement items should be identified as debits or credits and against whom they should be charged?