DIVORCING?

WHAT YOU NEED TO KNOW ABOUT **YOUR HOUSE & REAL ESTATE.**

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NOTE: **This presentation is highly technical.** Please contact the Samalin Group to understand how these concepts relate to your situation.

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Capital Stack in Real Estate

- What is a capital stack?
  - The capital stack illustrates the risk and return hierarchy between an asset, an asset class, or a group of assets and the client. In this case, the divorcing client is exposed to and could be liable for multiple instruments within the capital stack. Higher positions within the stack require different returns than those lower in the stack, and have a different level of risk. There are also different obligations inherent within each level of the capital stack, which lead to different consequences and opportunities for the client.

- How does it affect your clients in divorce?
  - Given the different risks and return characteristics of the different levels within the capital stack, it's important to analyze the instrument and describe these positions in order to highlight the ramifications and the opportunities of the decision. By visualizing the capital stack, you, your clients and the other professionals on the team will be able to see the liquidity, safety of principle and risk/return inherent in the transaction.

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When you understand the capital stack, you'll understand:

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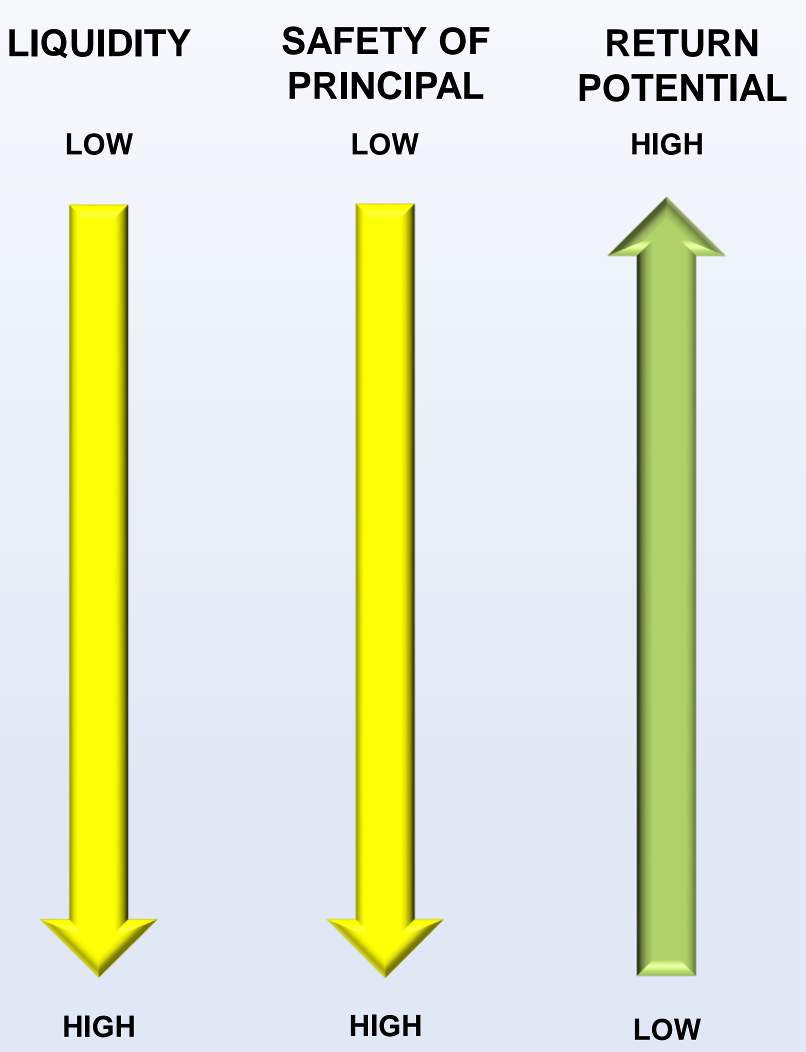
Examples of Hierarchy



Generally, the level of safety and liquidity is inversely proportional to the level of return potential

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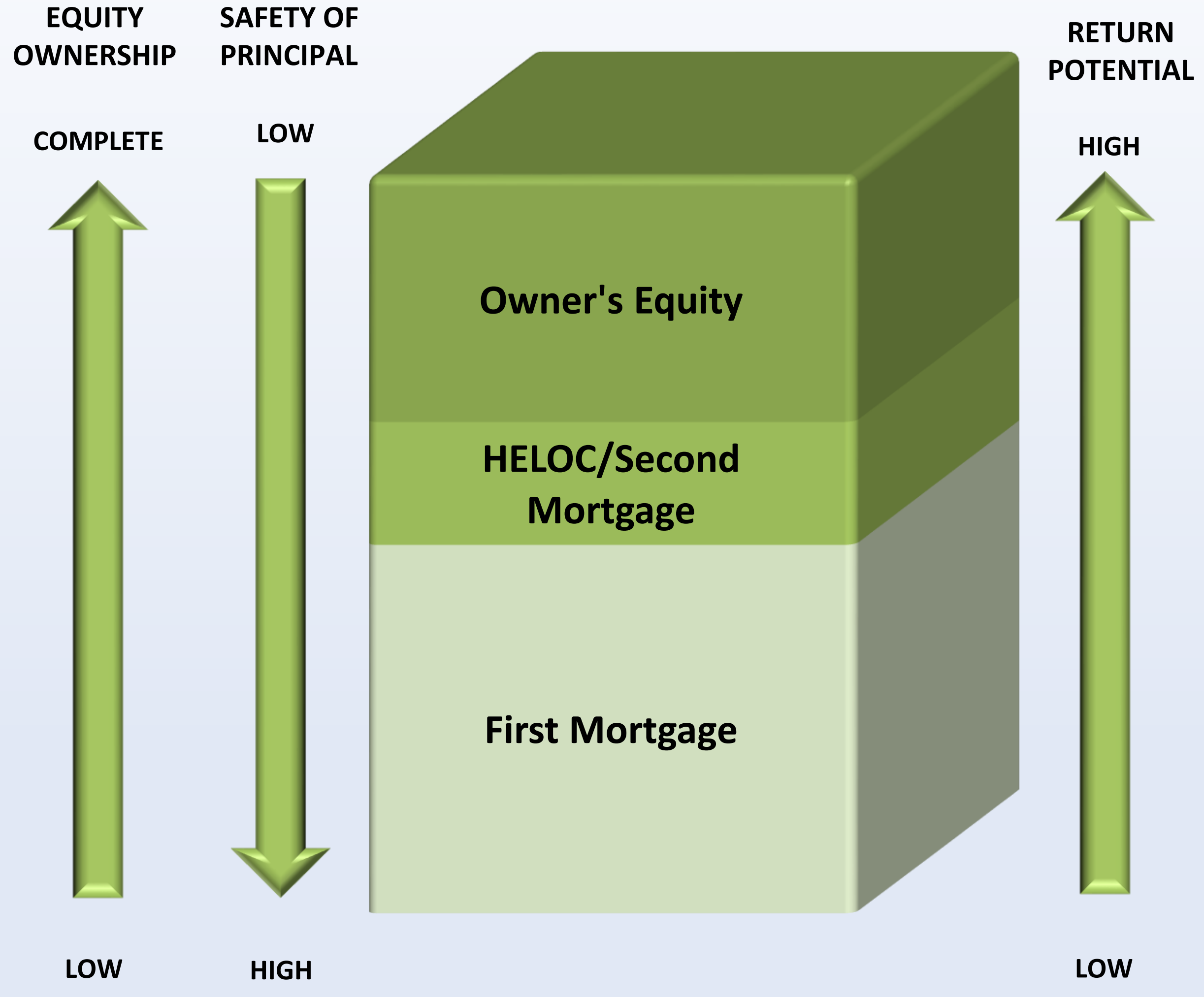
Examples of Capital Hierarchy: Real Estate Capital Stack for a Single Family Transaction



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Why Is It Important? Capital Stack Summary

The risk or opportunity of any financial settlement cannot be understood apart from the knowledge of an investment's place in the capital stack. The capital stack position controls how a client's collateral is accessed, what level of return can be expected, what tax benefits are available, and ultimately, the level of downside and upside to which a client is exposing their finances.

Typically, if you cannot easily discern an investment's position in the capital stack, you do not understand what you are trading away or accepting in a divorce settlement.[2]

[2]*Sources: JRW Investments, LLC, SICounsel, LLC*

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Financing and Refinancing Basics: The Bank's View

After the Great Recession, banks were reminded that it's easy to lend, and difficult to collect.

There are two primary questions the bank is going to ask your client:

1. Can you afford to pay the mortgage?
    - A slew of lending abuses were partially to blame for the Great Recession of 2008. As a result, new lending rules were put in place to constrict the gaming of the banking system.

2. Can you satisfy the due diligence requirements?
    - Lenders must generally use reasonably reliable third-party records to verify the information they use to evaluate the factors.[3]

[3]http://www.qualifiedmortgage.org/docs/federal-register.pdf

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Primary components of a loan decision

- Income qualifications
  - *Does maintenance qualify as income?*
- Loan to value (LTV)
- Titling
- Valuation
- Amount of the loan
- Property type

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Components of a Loan Decision:

Income qualifications

*Do maintenance payments qualify as income? Yes, but with an **

- FHA has two sets of rules: <30% of income from maintenance and child support, and >30% of income from maintenance and child support
    - <30% of total income
        - The party paying alimony or child support must be obligated in writing to pay.
        - The payer must have paid for at least half a year before the loan application is filled out.
        - The payer must be obligated to continue paying for a minimum of three years after closing the sale.
        - There must be evidence of "stable receipt" of the full amount of alimony or child support for the most current six months prior to applying for the FHA home loan.
    - >30% of total income
        - Roughly the same terms as <30%, but term of receipt is 12 months.
- Confirm with your individual bank as requirements may vary from one institution to another

- http://www.fha.com/fha_article?id=141

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IRC Sec. 1041 allows the transfer of assets without recognizing tax

Under IRC §1041 no gain or loss is recognized on a transfer of property from a spouse to a spouse or from or to a former spouse if the transfer is incident to a divorce. IRC §1041 applies to any transfer of property between spouses regardless of whether the transfer is a gift or is a sale or exchange between spouses acting at arms' length.[16]

[16]Temp. Treas. Reg. A-2 of §1.1041-1T

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Tax Consequences and Timing of Transfers

Tax Consequences of Transfer of Property From a Spouse or Former Spouse

- The tax basis of the transferred property in the hands of the transferee is the adjusted basis[17] of the transferor immediately before the transfer.[18]

Timing of transfers

- Any property transferred between former spouses within one year of the date a divorce or separation becomes final is presumed to be incident to the divorce

- A property transfer made under a divorce or separation instrument and which occurs within six years after the date the marriage ends is considered related to the end of the marriage.[19]

[17] I.R.C. §1016.
[18] Temp. Treas. Reg. Q & A 11 of §1.1041-1T.
[19] Temp. Reg. 1.1041-1T(b), Q-7

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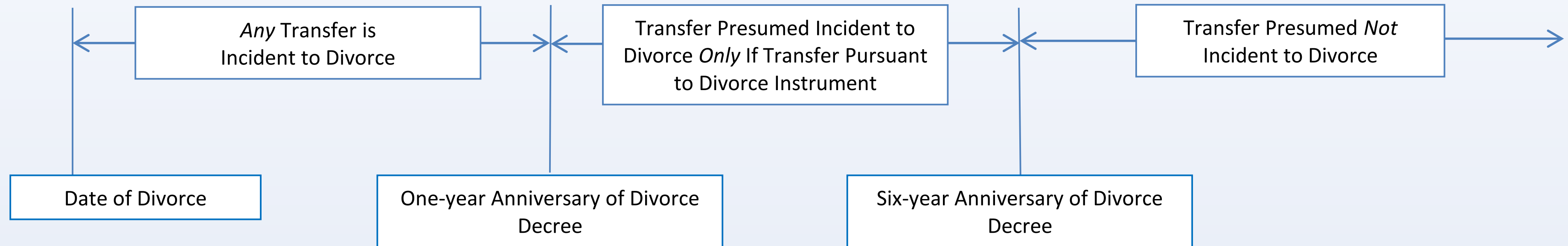
Illustration of Transfer of Property Time Line



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Why Is It Important? It's critical to the Marital Residence

- **Residential real estate values can be subjective**. The layout, materials, style, age, neighborhood all play into the subjective value of the home, either from one of the two spouses in a divorce or a prospective buyer if the home is for sale.
- **Housing as a meaningful percentage of net worth**. Depending on the net worth of the client, the marital residence can be a meaningful percentage of the client's net worth
- **You may not know who is going to keep the house** At the outset of the divorce process, particularly if there aren't any children of the marriage, one of the variables in the negotiation is who keeps the house and what asset is traded in exchange for it. Many times, the discussion is centered on the equalization of the unlike assets (the house and the JTWROS investment account, for example).
- **Transference of risks to the spouse who remains in the home.** A lack of accuracy at the outset can flow through the bloodstream of the case, and will likely manifest itself in divorce financial planning deliverables, such as a lifestyle analysis as well as the property statements whose accuracy could be dubious.

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What are the Takeaways?

- **Real estate is an illiquid asset** There are many methods of analysis that speak to inherent value, replacement cost, and market environment. However, valuation is just one facet of the tools to be used in the analysis of real estate. The ultimate arbiter of value is the closing of the transaction. All other methods are accurate guesses. You might have to rely on accurate guesses.
- **Trust but verify** The client(s) will provide an estimated value for their property. It may or may not be accurate. It may be based on what they want it to be, or what it *used to be*. Neither will be helpful in the divorce process. This estimate will likely be used throughout the case, including potential refinance discussions. Be sure to obtain a professional appraisal or a complete CMA before attempting negotiations, offsets, or a refinance exercise.
- **Start at the end** Before discussing a financing or refinancing project, be sure to look at the project through the bank's valuation and LTV requirements first and confirm that the client is able to meet those requirements.

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Paper Equity vs. Real Equity

Why such a big difference?

1. Contingent liabilities- (aka what can get in the way of future cash proceeds)
2. Renovations
3. Assessments
4. Obsolescence- functional, design
5. Sales charges, settlement fees
6. Taxes
7. Depreciation recapture for home office, etc.
8. Inadvertent inaccuracies of the real estate broker
9. Competing appraisals

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Marital Residence

What is the true cost of carrying the marital residence?

The cost of home ownership is not to be taken lightly generally nor should it be underestimated in the divorce process. There are costs that are more obvious than others that get accounted for, and there are those that get ignored, generally to the peril of the spouse who might have chosen to remain in the marital residence.

- Mortgage expenses can include: principal and interest, escrow deposits for taxes, mortgage insurance premium, etc.
- Escrows for long cycle maintenance projects: escrows for larger capital expenditures, such as roofing, boiler, HVAC, driveway, siding, remodeling of kitchen and bathrooms
- General upkeep items include landscaping, snow removal, pest control, painting, property maintenance contracts, plantings.

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Samalin's Rule #1:

If cash is king, liquidity is queen

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Titling Determines Tax

The titling of the property is generally the deciding factor in the allocation of any capital gains tax obligations upon the sale of the marital residence. The settlement agreement or the divorce decree may determine the allocation of the proceeds of the home, but the gains are divided in the proportion of the ownership of the property.

1. The fact that one spouse is awarded, for example, 80% of the proceeds from the sale of the marital home, doesn't mean that the ownership of the home itself, or the tax obligation arising from the capital gains, if any, from the sale of the home has been changed[22] from the ownership structure.

2. The marital interest and/or the presence of a separate property credit has no bearing on the tax liability, nor does it shield a taxpayer from his or her portion of a tax liability[23]

3. State law controls the nature of the legal interest of the taxpayer. Once ownership is decided under state law, Federal law is utilized to decide the tax consequences".[24]

4. The Yonadi and Friscone[25] cases have shown that a beneficial ownership interest to each spouse can be based on the percentage of proceeds he receives, regardless of the actual ownership at the sale date. For example, a spouse receiving 70% of the proceeds would realize 70% of the gain. The Suhr and Urbauer[26] cases have found that ownership interests *aren't* equal to the division of sales proceeds.

5. Practice tip- Determine who is on the deed, note and mortgage. You'll want to review with counsel and client alike the difference between ownership percentage, proceeds amounts, and tax liability. From there, one can estimate the potential tax liability in the year of sale, and can ultimately determine the net after proceeds from the property.

[221]Suhr v. Commissioner, T.C. Memo 2001-28
[23]Treas. Reg. §1.121-1(c)(1)
[24]Wells v. Commissioner, T.C. Memo 1995-537
[25]PPC Thompson Reuters
[26]PPC Thompson Reuters

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Titling also determines maintenance payment deductibility

Property ownership may also determine the deductibility of payments made between former spouses. Assuming payments qualify for maintenance and the separation agreement or divorce decree codifies same, payments of cash which are made on behalf of a payee spouse will be taxable/deductible maintenance. Mortgage and tax payments may be made to third parties such as mortgage companies and taxing authorities qualify as maintenance under IRC Sec. 71.

Payor spouse holds 100% of title

- The payor may not deduct the payments as maintenance, but the payor may deduct the interest portion of the payment if payment is pursuant to a divorce or separation agreement.

Both spouses jointly hold title

- Assuming both spouses are liable for the note and mortgage on a qualified home, the payor can deduct 50% of the payment as maintenance, and can continue to deduct the other 50% of the payment as interest. Payee can deduct interest on the half for which payee receives maintenance.

100% of title held by payee spouse

- Provided that occupancy is held by payee spouse, and not by the payor, payor can deduct 100% of the payments as maintenance. Payee may deduct mortgage interest and taxes as itemized deductions.

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Sale of the Marital Residence- Exclusions from Capital Gains

Taxpayers may exclude up to $250,000 ($500,000 if married filing jointly) of realized gain from the sale or exchange of their principal residence. This gain is computed by subtracting the costs of sale and adjusted cost basis of the residence from the sales price.

1. **The taxpayer needs to meet three tests for the full exclusion**
2. **Reduced exclusion**
3. **Election to not take exclusion**
4. **IRC Sec. 121 Exclusion and Net Investment Income Tax**

5. **Before gain can be determined, basis should be computed**

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Other Considerations for the Marital Residence

1. If maintenance is the primary source of the funds for the lifestyle, what is the creditworthiness of the payor? Payee needs to act like a credit agency to determine the likelihood of the continuation of the agreed-upon maintenance payments.

2. Age of client, ages of children

3. Tax brackets of the clients pre- and post-divorce. Analyze the approximate tax rates of the payor and payee post-divorce. Look at the value of the deductibility of the interest and consider rental scenarios.

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Overview

Rental property is an area often overlooked and potentially under-analyzed by the divorce financial practitioner. The complexity of the asset itself, the tax implications of both the operations and those taxes due upon sale, not to mention the opportunity for the spouses in the divorce to game available income and loss estimates require the practitioner to be conversant with this asset class. Schedule E, the Supplemental Income and Loss form, is an area that is very helpful in finding the cash in taxable cash flow, and forecasting tax liabilities into the future should capital events such as a property disposition occur.

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Financing

Multi-family and other non-owner occupied

- Lenders require 20 percent to 50 percent down payment[37]
- Lenders may require a personal guarantee (PGs) to further secure the note and mortgage
- Credit Score above 620 and above 740 for best interest rate, though some lenders will lend to the asset, not necessarily the credit.

[37] http://www.freeandclear.com/programs/owner-occupied.html#.VBhd9xYXP5Q

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Overview

Exclusions from Capital Gains

Vacation homes are not eligible for the $250,000/$500,000 capital gains exclusion under IRC Sec. 121 due to the principal residence requirements. However, vacation homes that are converted to a taxpayer's spouse or former spouse as a principal residence may qualify for exclusion.

In the past, if a spouse or a former spouse moved into the house and fulfilled the three requirements (use as their principal residence for two of the last five years ending on the last day of the sale or exchange, ownership of two of the last five years ending on the last day of the sale or exchange, and didn't use the gain exclusion in the last two years), then they would be able to take the full exclusion. However, the Housing Assistance Tax Act of 2008 was passed by Congress, which limited the ability for the taxpayer to enjoy those benefits. Now, nonqualified use prior to 2009 is disregarded, with the following formula:

(((Total number of years owned after December 31, 2008 – number of years used as a principal residence)/total number of years owned after December 31, 2008) x capital gain equals the amount of nonexcludable (taxable) gain). The balance of the gain is excludable from capital gains tax.

Periods of nonqualified use prior to 2008 are ignored for the purposes of this Act. Be sure to interface with the client's accountant to assure that the client's facts and circumstances are taken into account.

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