REAL ESTATE AND DIVORCE

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Introduction

"You can do anything with real estate except eat it and move it."

-William Zeckendorf

Disclaimer

Disclaimer- the information contained herein is for illustration purposes only. There are limitations to a presentation for a national audience given State-specific laws inherent in the subject matter. There are substantial differences between equitable distribution and community property states. Be sure to consult your local tax and legal professionals when engaging in your work. This presentation is not meant to provide tax advice, only tax information in the divorce financial planning context. Throughout the presentation, you'll see a  and a  symbol. You'll seek further clarification from a tax and legal professional for the topic being noted. This presentation isn't meant as a substitute for your local legal, mental health and accounting professionals in the divorce process and/or your client's existing team, if any.

Overview

1. Reasons for Owning Real Estate
2. Capital Stack in Real Estate
3. Financing and Refinancing Basics
4. Property Transfers
5. Valuation Metrics
6. Marital Residence
7. Rental Property
8. Vacation Homes

Section 1:
Reasons for Owning Real Estate

Reasons for Owning Real Estate

It is likely that there are as many reasons for owning real estate as there are owners of real estate.

	Residence	Single & Multi-Family Investment	Commercial
Basic Need	✓	✓	
Tax Benefits	✓	✓	✓
Inflation Hedge	✓	✓	✓
Cash Flow Potential		✓	✓
Appreciation Potential	✓	✓	✓
Portfolio Diversification		✓	✓
Compulsory Savings	✓	✓	✓
Investment Leverage		✓	✓

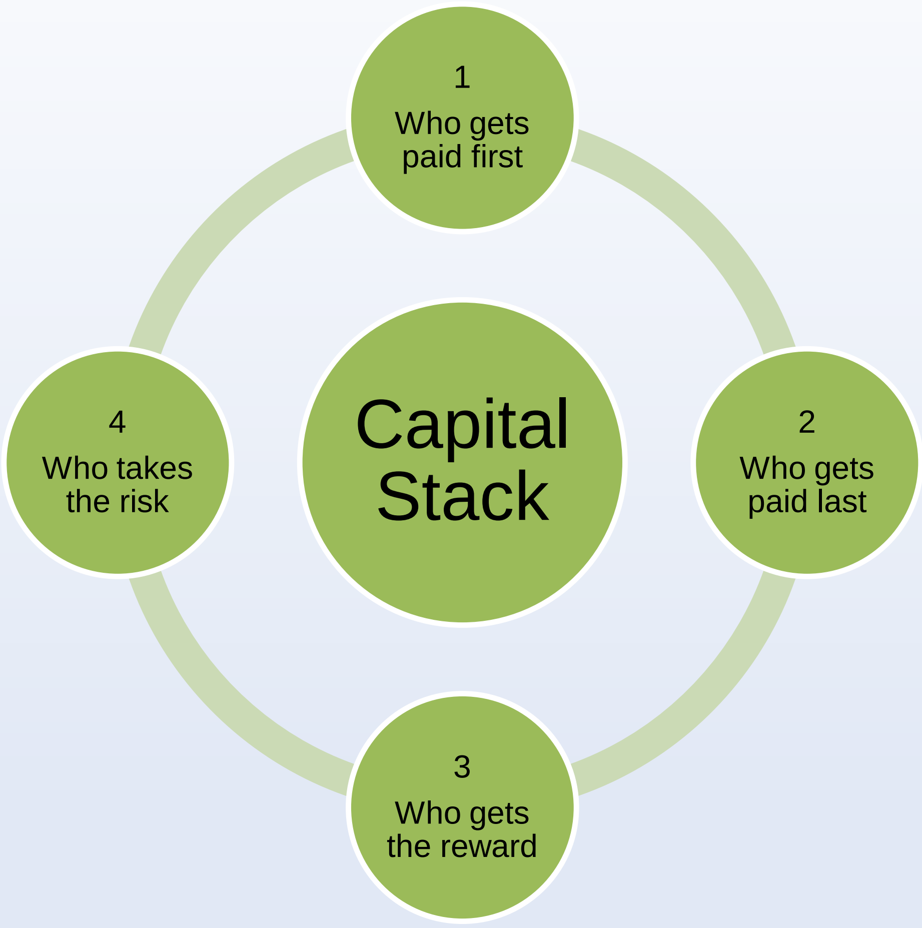
Section 2:
Capital Stack in Real Estate

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.

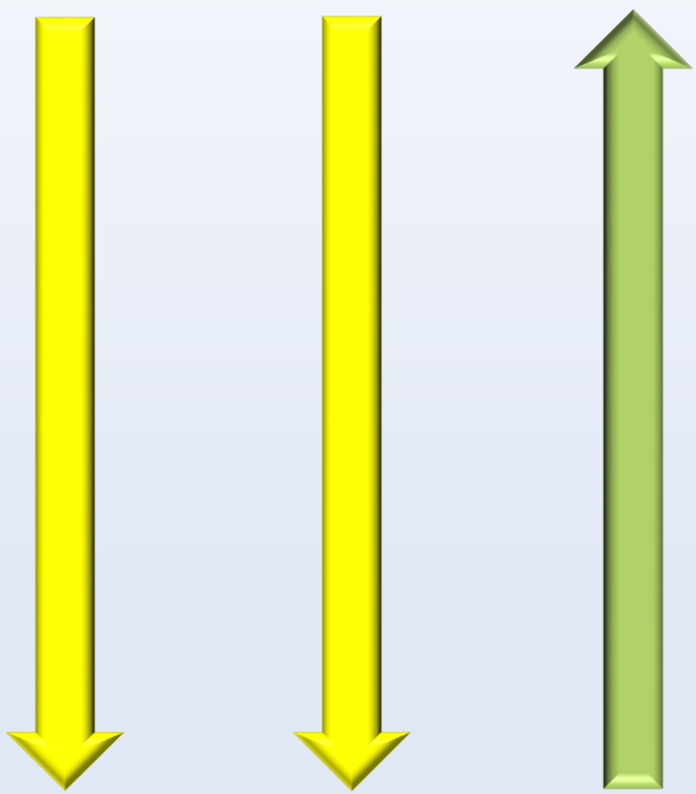
When you understand the capital stack, you'll understand:



Examples of Hierarchy

LIQUIDITY | **SAFETY OF PRINCIPAL** | **RETURN POTENTIAL**

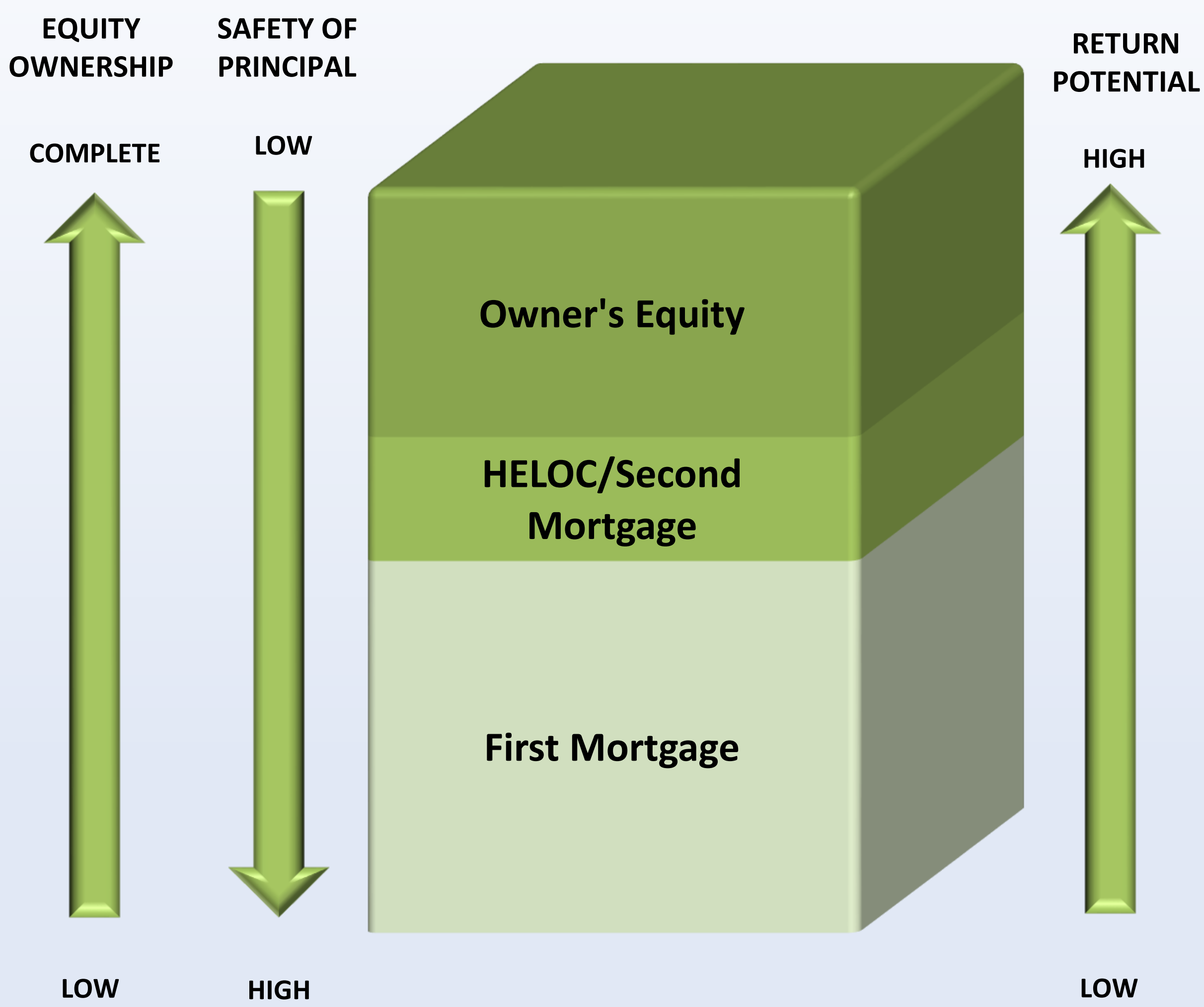
LOW | LOW | HIGH



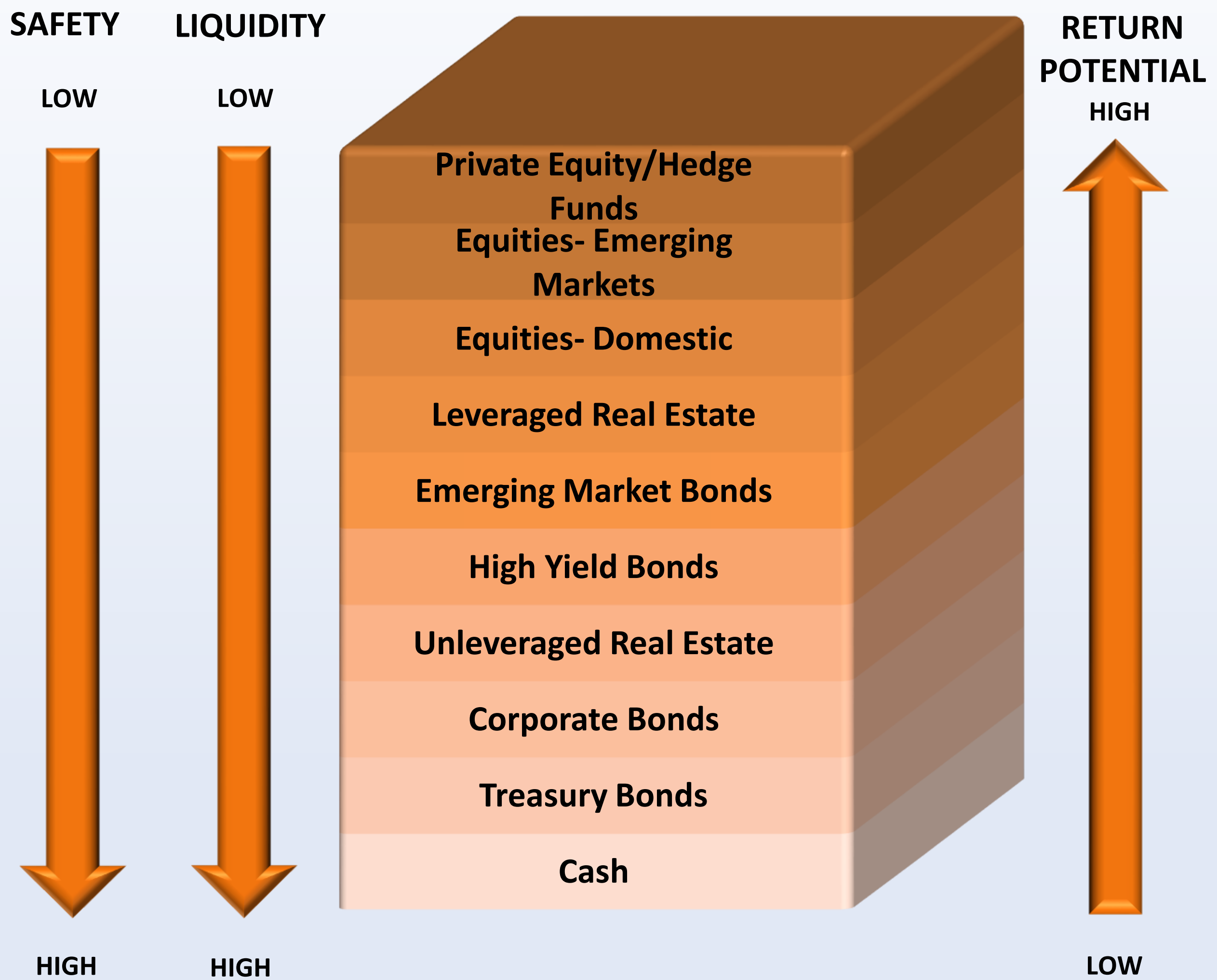
HIGH | HIGH | LOW

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

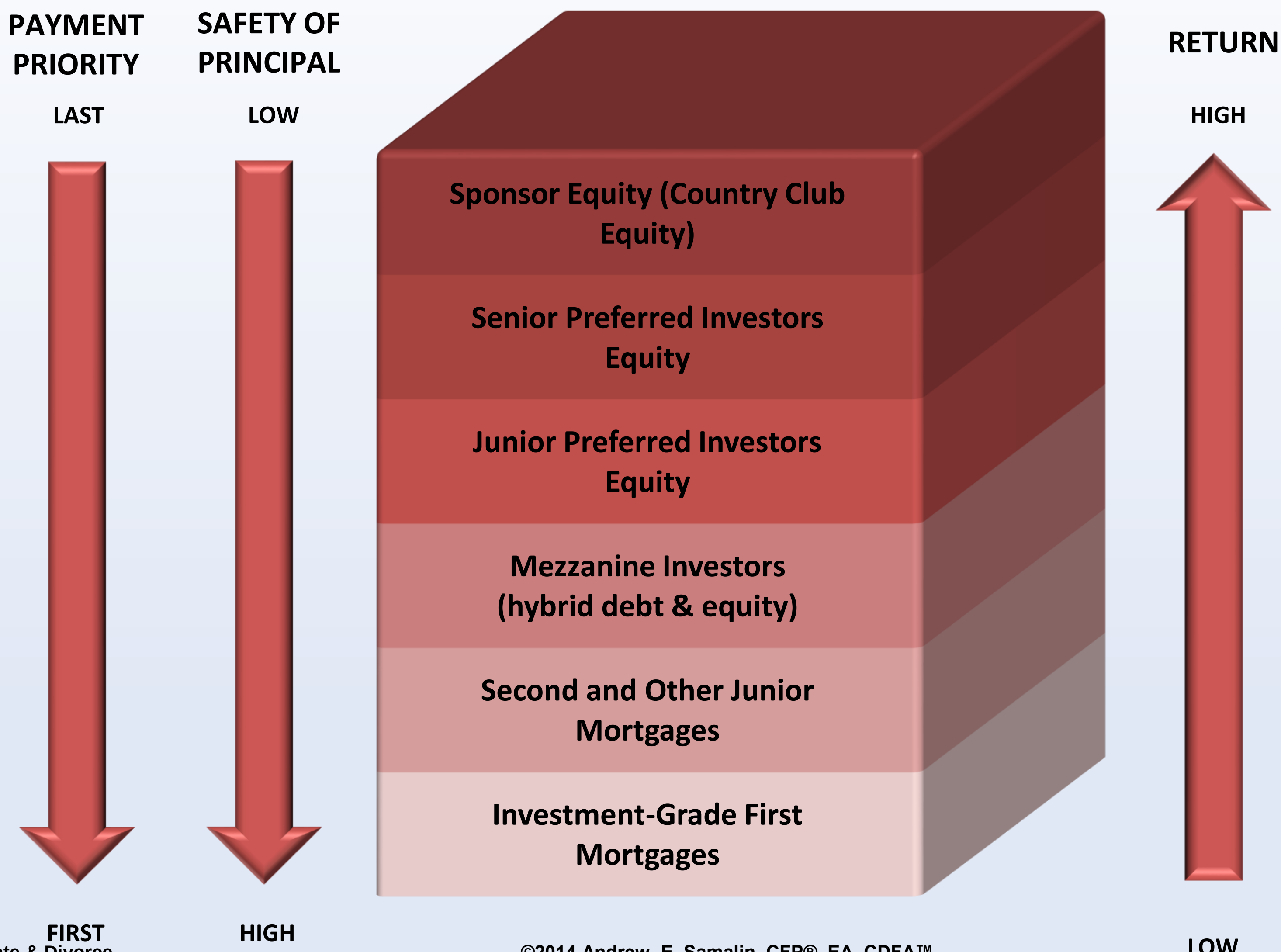
Examples of Capital Hierarchy: Real Estate Capital Stack for a Single Family Transaction



Examples of Hierarchy: Investor's Capital Stack



Equity vs. Debt: Real Estate Capital Stack for Commercial Property



Capital stack – Financial applications in divorce

a) Generate income

- There is a budget gap for W
- Or if maintenance is short for H
- Or as an adjunct to maintenance for W
- Or as a cost of capital exercise for the H
- Or to preserve liquidity for H
- Or if alternative investment choices yields are too low for W
- Or if couple is house-rich, liquidity-poor, then monetize the equity in the home as debt and collect income.

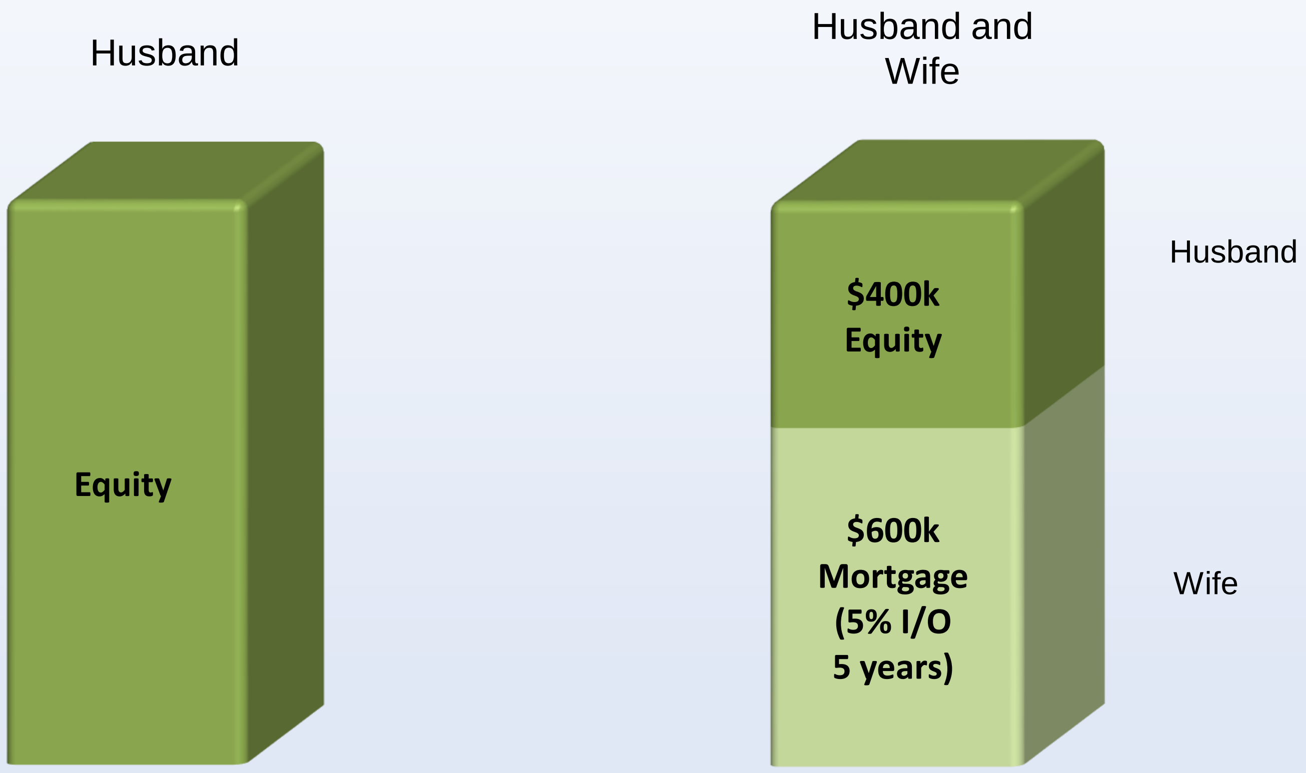
b) Security instrument

- to secure a deferred equitable distribution using a first or second mortgage
  - Single property
  - Multiple properties

Summary: you can use equity as debt and debt as equity

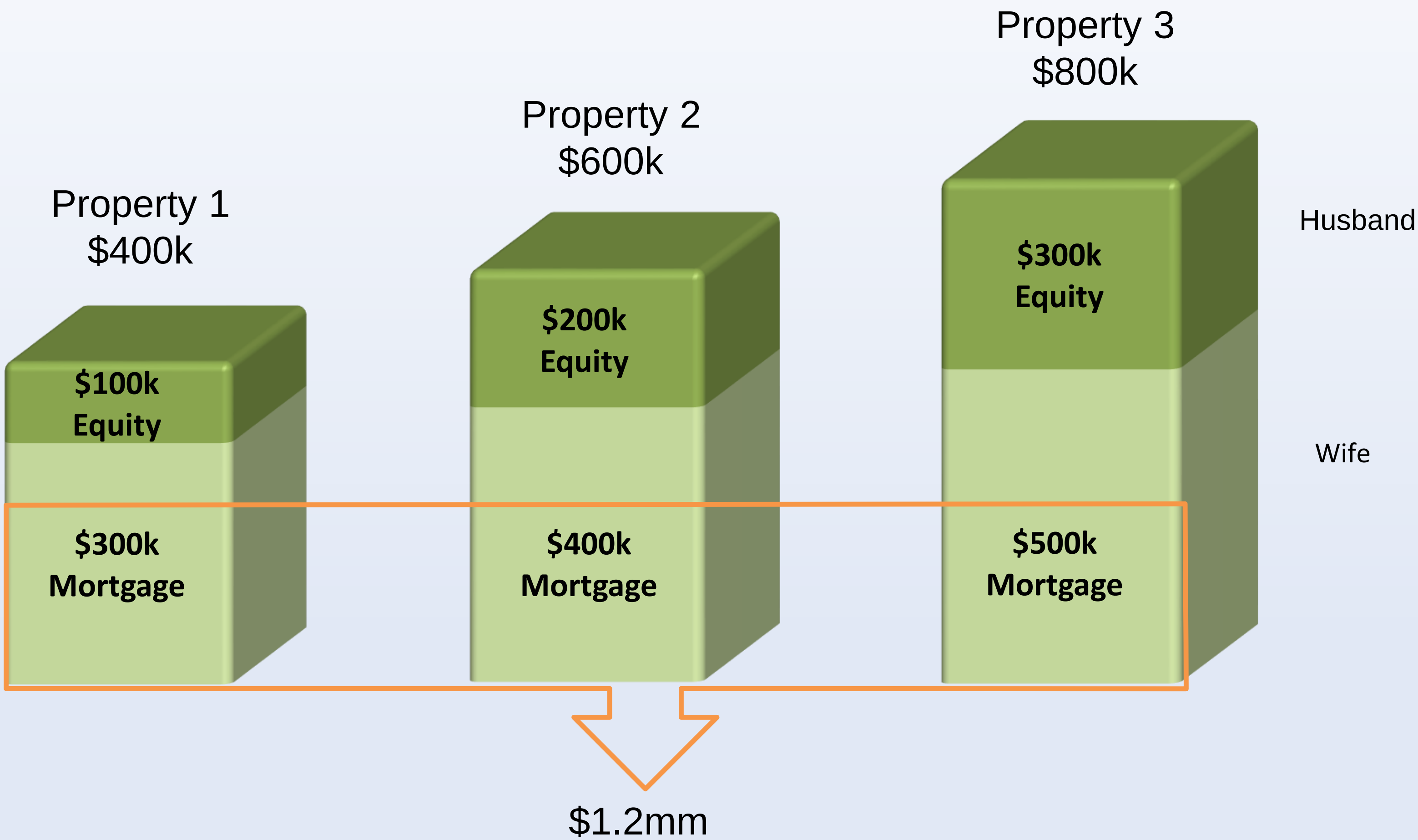
$1mm Home – Using debt as both a security instrument and income generator

H wants no mortgage house, W wants income, both spouses are illiquid

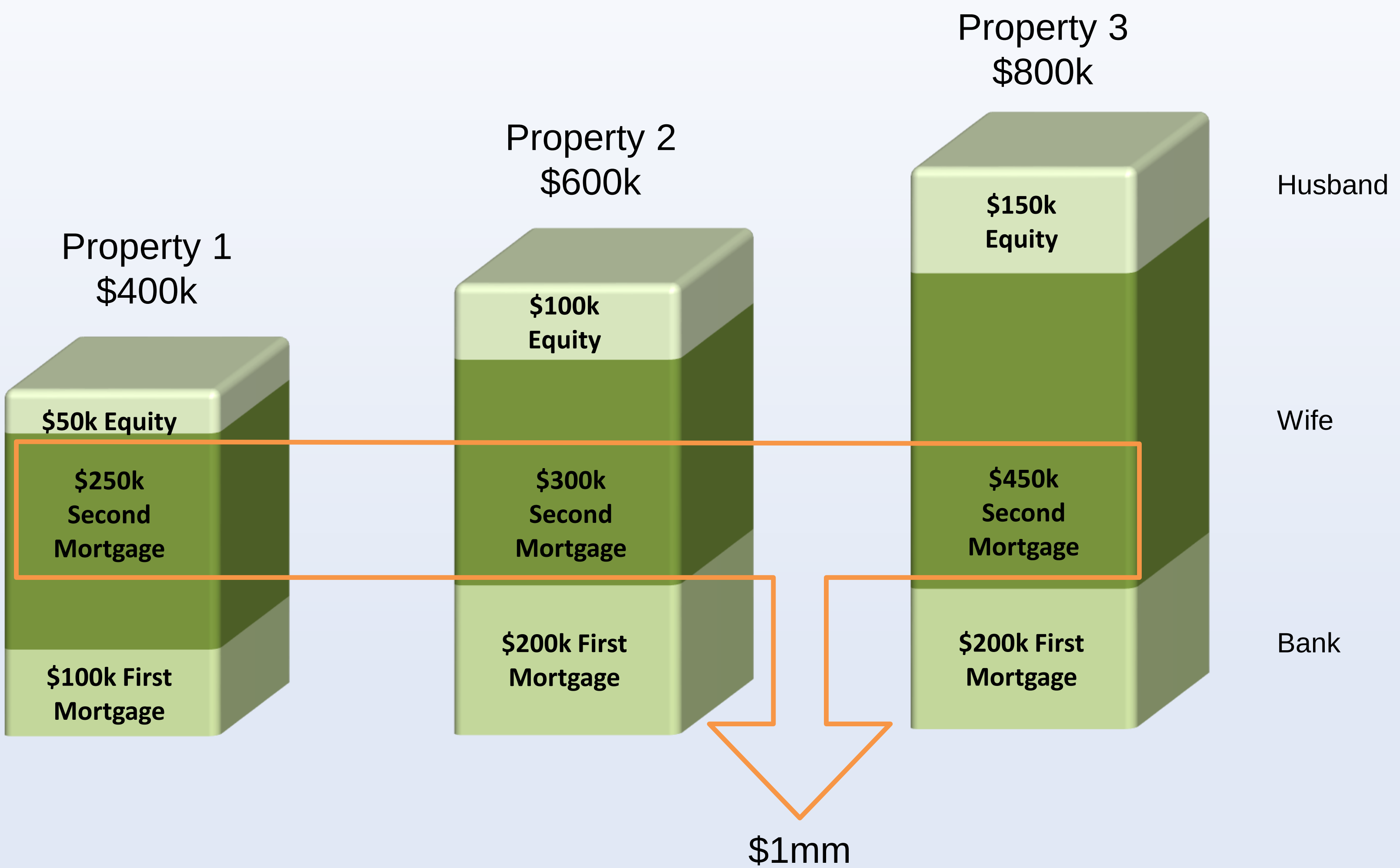


Using debt as a security instrument for a delayed ED payment with embedded investment return

Assume a deferred $1,000,000 ED payment from H to W in 5 years. H doesn't want to sell, but willing to provide a greater ED payment to avoid sales. No mortgages on multiple properties.



Second Mortgage Options: Using debt as a security instrument for a delayed ED payment with embedded investment return- second position



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*

Section 3:
Financing and Refinancing Basics

Financing and Refinancing Basics

One of the basic building blocks of real estate is the ability of the homeowner and investor to finance and refinance their real property.

Please keep in mind that the regulatory environment surrounding real estate financing is constantly evolving, and as a result, some of the data in this presentation may be obsolete by the time you apply these ideas in the field.

Always check with your local mortgage bank or mortgage broker for rates, terms and conditions.

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

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

Components of a Loan Decision:

Income Qualifications

Income qualifications are usually in terms of the borrower's ability to support debt service. The Federal Housing Authority (FHA) uses two ratios:

1. Mortgage Payment Expense to Effective Income
2. Total Fixed Payment to Effective Income

Components of a Loan Decision:

Income qualifications

1. Mortgage Payment Expense to Effective Income

Add up the total mortgage payment (principal and interest, escrow deposits for taxes, hazard insurance, mortgage insurance premium, homeowners' dues, etc., aka PITI). Then, take that amount and divide it by the gross monthly income. The maximum ratio to qualify is 31%.[7]

Example:

Total amount of new house payment:	$2,750
Borrower's gross monthly income (including spouse, if married):	$11,000
Divide total house payment by gross monthly income:	$2,750 / $11,000
Debt to income ratio:	25%

[7]http://www.fha.com/fha_requirements_debt

Components of a Loan Decision:

Income qualifications

2. Total Fixed Payment to Effective Income

Add up the total mortgage payment (principal and interest, escrow deposits for taxes, hazard insurance, mortgage insurance premium, homeowners' dues, etc.) and all recurring monthly revolving and installment debt (car loans, personal loans, student loans, credit cards, etc.). Then, take that amount and divide it by the gross monthly income. The maximum ratio to qualify is 43%.[8]

Example:

Total amount of new house payment:	$2,750
Total amount of monthly recurring debt:	$1,800
Total amount of monthly debt:	$4,550
Borrower's gross monthly income (including spouse, if married):	$11,000
Divide total monthly debt by gross monthly income:	$4,550 / $11,000
Debt to income ratio:	41.36%

[8]http://www.fha.com/fha_requirements_debt

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

Components of a Loan Decision:

Loan-to-Value (LTV)

A. The amount of debt relative to the overall price of the home. Different credit scores and property types generally require different LTVs.

B. Guidelines are state specific

C. Differences between owner occupied loans and non-owner occupied loans

   I. Lenders may require up to 25-40 percent down payment and will charge higher interest rate for non-owner occupied.[10]

   II. Loan to Value (LTV) ratio required is typically 80%. If mortgage is owned by Fannie Mae or Freddie Mac, LTV could be as high as 105% through the federal government's Making Home Affordable program.[11]

[10] http://www.freeandclear.com/programs/owner-occupied.html#.VBhd9xYXP5Q
[11] http://www.bankrate.com/finance/mortgages/solving-refinance-challenges-1.aspx

Components of a Loan Decision:

Titling

Property titling: Individually, JT COM, JTROS, Tenants in the Entirety, Trust, LLC, Corp.

Debt titling: A signatory on the debt is generally able to deduct the debt, pursuant to the following parameters:[6]

- He or she files Form 1040 and itemizes deductions on Schedule A.
- He or she is legally liable for the loan - you cannot deduct interest if you make a payment on someone else's loan.
- He or she made the payment on a qualified home.
- *Spoiler-§ 1.163-1(b)* Interest paid by the taxpayer on a mortgage upon real estate of which he is the legal or equitable owner, even though the taxpayer is not directly liable upon the bond or note secured by such mortgage, may be deducted as interest on his indebtedness.

[6]IRS Publication 936 (2013)

Components of a Loan Decision:

Valuation Methods

Sales Comparison

Cost Approach

Reviewed further in Section 5

Components of a Loan Decision:

Amount of Loan

Loan size

I. Conforming and Jumbo Loans:

Conforming mortgages are sold to Fannie Mae and Freddie mac. Loans are typically available up to $417,000 but vary by state, by county and by number of living units in the home. In Westchester County, NY, a conforming loan is defined up to $625,500 for a one family home and $800,775 for a two family home.[12]

II. Jumbo loans exceed the limits established for conforming loans and are typically held by lenders.

[12] https://sites.google.com/site/nymortgagelimits/fannie-freddie-limits

Components of a Loan Decision:

By Property Type

The differences between owner occupied and non-owner occupied loans lie in the LTVs, rates, titling, etc. There are number of reasons for the increased interest rates, lower LTVs and personal guarantee requirements.

- Residential (owner occupied)
  - Lenders require 5 percent to 20 percent down payment.
  - Credit Score above 620 and above 740 for best interest rate.

- Multi-family and other non-owner occupied
  - Lenders require 20 percent to 50 percent down payment[13]
  - 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.[14]

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

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

Refinancing

- **Refinancing a principal residence:** Loan to Value (LTV) ratio required is typically 80%. If mortgage is owned by Fannie Mae or Freddie Mac, LTV could be as high as 105% through the federal government's Making Home Affordable program.[15]
- **Non-Owner Occupied Mortgages:** Lenders may require up to 25 percent down payment and will charge higher interest rate. 50 percent down is not unheard of.
- **Cash-out refinance:** This generally requires a longer ownership and use timeframe. It also requires a higher LTV and a potentially higher interest rate.
- **Look to other properties and other lenders:** There could be limits put in place that you aren't aware of that will get in the way of the goal.

[15]http://www.bankrate.com/finance/mortgages/solving-refinance-challenges-1.aspx

Sensitivity Analysis: Exposing the Effects of Rates, LTV & Valuation

There are a number of variables inherent in every financing and refinancing. Chief among them are variances of interest rates, LTV and property valuation assumptions.

Given these variances, you might consider developing a matrix that takes these banking differences into account. This sensitivity analysis would show likely outcomes that could vary, potentially meaningfully, against the original assumptions.

Section 4:
Property Transfers

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

Tax Consequences and Timing of Transfers

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

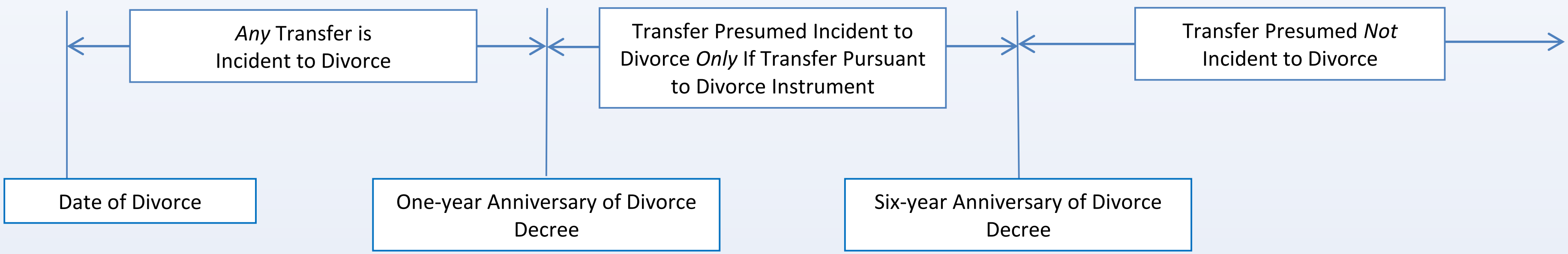
- The tax basis of the transferred property in the hands of the transferee is the adjusted basis[17] of the transferor immediately before the transfer.[18]

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

Illustration of Transfer of Property Time Line



Record Keeping Requirements

- The transferor of the property must provide to the transferee all necessary and applicable documentation for them to be able to determine adjusted cost basis and holding period at the time of transfer. There is no penalty for not providing this information.[20]

[20]Temp. Reg. 1.1041-1T

Section 5:
Valuation Metrics

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.

How to Determine Value

- Residential
  - Internet: Zillow, Trulia, Realtor.com, Redfin.com
  - Comparison approach (a CMA from a broker)
  - Cost approach, or replication cost

- Multi-family/Non owner occupied
  - Cash flow
    - GRM- Gross Rent Multiplier
    - Comparison approach (A CMA from a broker)
    - Capitalization rate- Similar to a stock's P/E ratio, or a businesses multiple of EDITDA

Capitalization Rate Example

Rental Income:		$100,000
Expenses		
	Taxes	$10,000
	Fuel	$4,000
	Property Management	$3,000
	Repairs	$4,000
	Landscaping	$3,500
	Leasing Commissions	$4,500
Total Expenses:		$30,000
Net Operating Income:		$60,000
Capitalization Rate:		7
Value:		$857,142

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.

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

Section 6:
The Marital Residence

Marital Residence

Overview

Few assets in the client's lives are as important as the marital residence, from both a financial and non-financial viewpoint. The amount of emotion, time and capital invested in the family home make its division in the divorce process one of the most important exercises to handle correctly by the financial professional. There are many non-monetary decisions that drive the client's goals, including children, history, and attachment to the property that the financial professional would be well served to pay attention to.

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.

Marital Residence

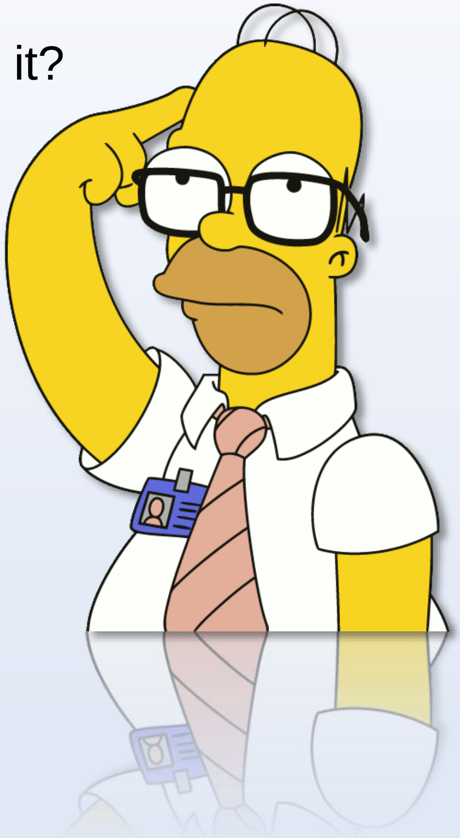
Can vs. should

- Can I Afford to Keep the Marital Residence? *Should* I keep it?
- Non-financial discussion
- Children and age of emancipation
- Spite

Marital Residence

Can vs. should

- Can I Afford to Keep the Marital Residence? *Should* I keep it?



- Non-financial discussion
- Children and age of emancipation
- Spite

Marital Residence:

Should I Get a Mortgage or Pay Cash

Installing leverage creates a 3rd dimension in the housing discussion. This dimension creates both risks and opportunities and underscores the need for careful analysis.

- Ask the client which do they feel more comfortable with? Ask why they shouldn't get a mortgage?
- Client's risk profile
- Will I be able to get a mortgage?
- Interest rate spread- What are the borrowing costs today versus after tax return on investments? Today mortgage rates are historically low.
- Investment alternatives for the capital (a.k.a. opportunity cost risk)

Case study: John & Mary

Focus: Liquidity needs vs. risk and return – mortgage or not?

John 52, Mary 48, married 12 years. Wife doesn't work and hasn't worked, he is well-employed with an income of $350,000, agreed to pay her $120,000/yr maintenance for 7 years. Agree to a 50/50 split of a $4.5mm marital estate:

- $1mm Fidelity investment account
- $1mm Chase account in CDs
- $1mm E-Trade IRA
- $1.5mm home w/ no mortgage

Case study: John & Mary

Mary's Interests:

- Concerned about retirement and would like to remain in the family home.
- Extremely risk adverse

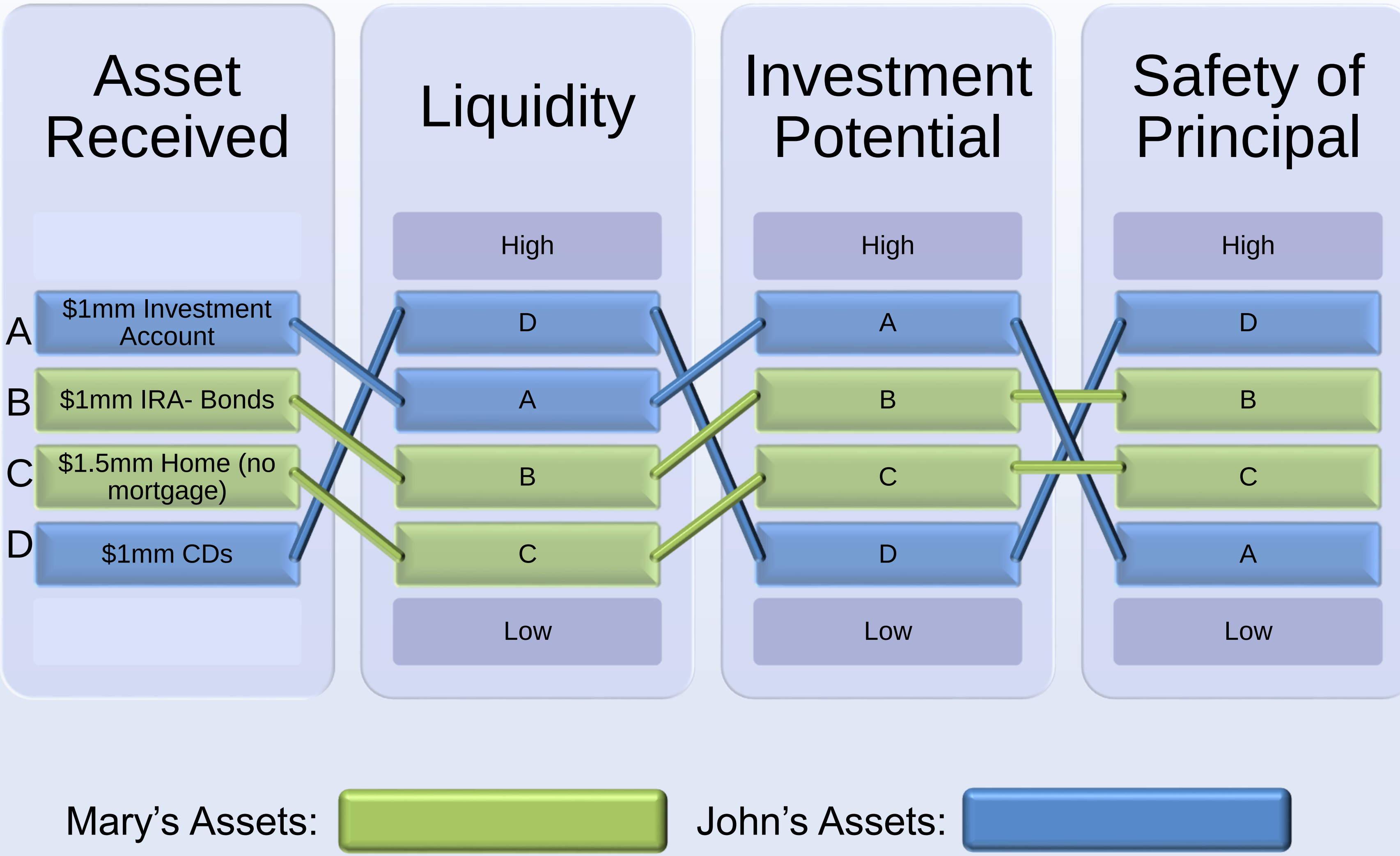
John's Interests:

- Motivated by his concern that he'll lose his job at large bank due to age, he'd like the investment account and CDs.

Settlement:

- He chooses the CDs and the investment account
- She chooses the IRA and the no-mortgage home and a reasonable maintenance package.

Case study: John & Mary



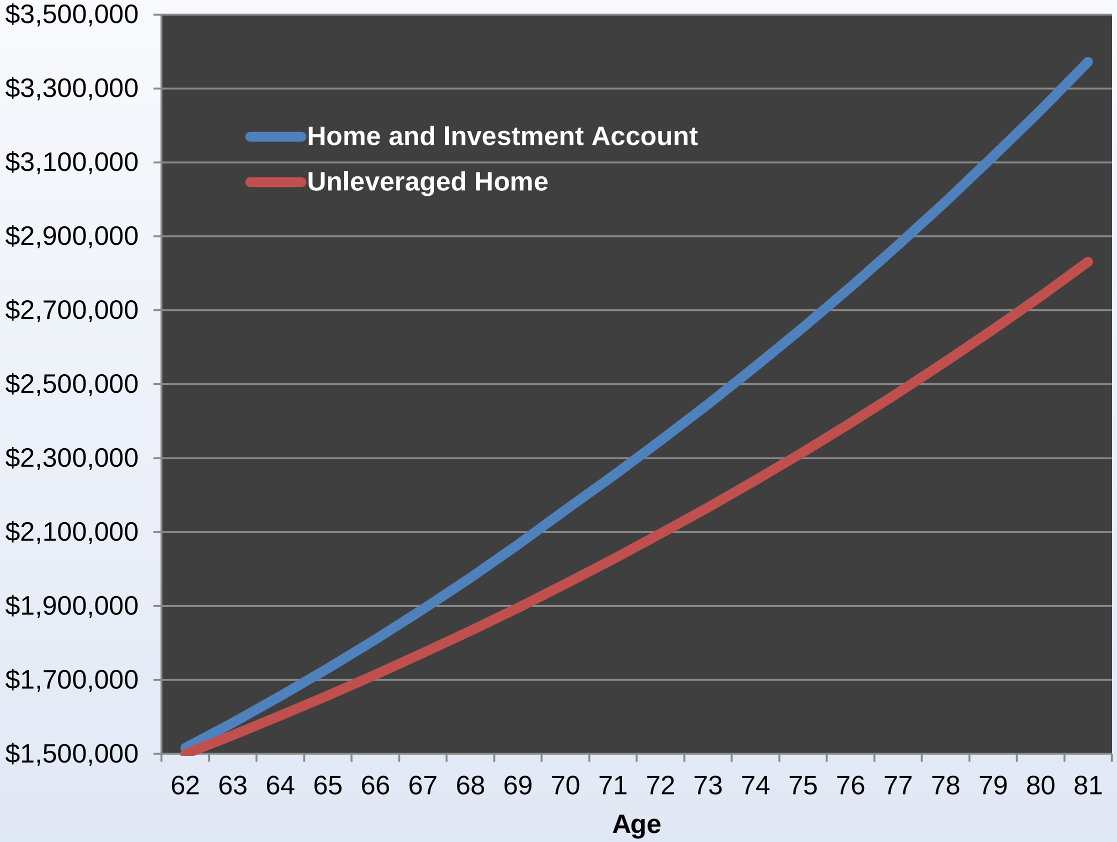
Case study: John & Mary

John has CDs, an investment account, and is well-employed, is he financially safe?

Mary has a home with no mortgage and with her retirement handled, is she financially safe?

How would you define safe?

Case study: John & Mary



$3,372,162

$2,831,271

DIFFERENCE
$540,891

Housing assumptions:

- $650,000 mortgage
- 10/1 ARM, 3.75% Interest Only
- 30 year amortization
- Appropriate call provisions
- 3.4% annual housing appreciation

Investment assumptions:

- 3.0% dividends
- 3.5% annual appreciation
- Annual compounding

Not to reflect any investment product or investment programs, past performance is no guarantee of future success, not tax impacted.

Samalin's Rule #1:

If cash is king, liquidity is queen

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

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.

Expenses for a Jointly-Owned Home

Table 4. **Expenses for a Jointly-Owned Home**

Use the table below to find how much of your payment is alimony and how much you can claim as an itemized deduction.

IF you must pay all of the ...	AND your home is ...	THEN you can deduct and your spouse (or former spouse) must include as alimony ...	AND you can claim as an itemized deduction ...
mortgage payments (principal and interest)	jointly owned	half of the total payments	half of the interest as interest expense (if the home is a qualified home).[1]
real estate taxes and home insurance	held as tenants in common	half of the total payments	half of the real estate taxes[2] and none of the home insurance.
	held as tenants by the entirety or in joint tenancy	none of the payments	all of the real estate taxes and none of the home insurance.

[1] Your spouse (or former spouse) can deduct the other half of the interest if the home is a qualified home.
[2] Your spouse (or former spouse) can deduct the other half of the real estate taxes.

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**

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.

Section 7:
Rental Property

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.

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

Depreciation

- Depreciation is the economic recoupment of the useful economic lifespan of real property. This means that it must be something that wears out, decays, gets used up, becomes obsolete, or loses its value from natural causes. Land is not depreciable. The tax benefit received from owning depreciable property is that depreciation expense allows a deduction for depreciation on the property that can offset ordinary income earned by the taxpayer. If a client does take depreciation expense, that benefit may be subject to depreciation recapture, which is covered later in the presentation.

    - **Effects on cash flow**
    - **Cash flow vs. taxable income**
    - **Depreciation schedule**
    - **The effects of depreciation on taxable income from Schedule E**

Depreciation Example

Depreciation example for multi-family rental property:

$1,000,000 - $200,000 (land cost) = $800,000.
$800,000/27.5 years = $29,090.90 non-cash expense/year.

Revenue is $100,000
Property Expenses of $55,000 =
$45,000 Net Operating Income (NOI).
$45,000 - $29,090 for depreciation expense = $15,910 taxable income.

At a 39.6% tax bracket, that $29,090 non-cash deduction is worth $11,519.

Schedule E: Depreciation Effects of Cash Flow

Income: Properties:		A
3 Rents received	3	36,990
4 Royalties received	4	
Expenses:		
5 Advertising	5	
6 Auto and travel (see instructions)	6	
7 Cleaning and maintenance	7	1,779
8 Commissions	8	
9 Insurance	9	1,391
10 Legal and other professional fees	10	
11 Management fees	11	
12 Mortgage interest paid to banks, etc. (see instructions)	12	10,265
13 Other interest	13	
14 Repairs	14	5,244
15 Supplies	15	
16 Taxes	16	13,332
17 Utilities	17	
18 Depreciation expense or depletion	18	13,164
19 Other (list) ▶ See Statement 2,3	19	5,048
20 Total expenses. Add lines 5 through 19	20	50,223
21 Subtract line 20 from line 3 (rents) and/or 4 (royalties). If result is a (loss), see instructions to find out if you must file Form 6198	21	-13,233
22 Deductible rental real estate loss after limitation, if any, on Form 8582 (see instructions)	22	(862)

Depreciation Recapture

Depreciation recapture should be thought of as recapturing a tax benefit already enjoyed which now must be repaid due to the sale of the asset. For a divorcing couple, think of the benefit of depreciation as the meal enjoyed by the couple, and now the bill *needs to be paid upon disposition* by (potentially) one spouse who owns or will come to own, the property.

1. **Depreciation recapture should be considered a potential tax liability** When a taxpayer sells an asset for a gain after taking deductions for depreciation, depreciation recapture is used to tax the gain. Because the taxpayer received a deduction from ordinary income for the depreciation of the asset, any gain the taxpayer receives, up to the depreciation amount, must be included as ordinary income to offset the earlier deduction. This gain is taxed at 25%.

2. **Types of depreciation recapture**
   - **Section 1250**
     - Generally applies to depreciable real property (buildings and their structural components).
   - **Sec 179**
     - To qualify for the section 179 deduction, your property must have been acquired for use in your trade or business.
     - The maximum section 179 expense deduction that can be taken for qualified section 179 real property is limited to $250,000.
   - **Sec 1245**
     - Non-Sec 1250 property

Depreciation Recapture Example

Depreciation recapture example:

Rental property purchased 2004 for $1,000,000. Assuming a 39.6% taxpayer. The amount subject to depreciation is the building, not the land, so $1,000,000 - $200,000 (land cost) = $800,000. $800,000/27.5 years = $29,090.90 annual depreciation taken. This is a non-cash expense per year. Since you held the property for 10 years, the total amount of depreciation taken is $290,090.90. Rental property is Sec. 1250 property and subject to depreciation recapture. Property is sold for $1,500,000.

$1,500,000
-$709,091 ($1mm purchase price - $290,090 accumulated depreciation)
$790,909 taxable gain

The $790,090 is taxed as follows:
$500,000 @20% capital gains rate (we'll ignore the 3.8% Medicare, State taxes) = $100,000
$290,090 @25% recapture rate = $72,727
$172,727 tax (72% more than the simple capital gain calculation from original basis)

Note: the purpose of including depreciation and depreciation recapture in the presentation is to familiarize the planner with the concepts and to be aware of it in their casework, not to become an expert on the topic. Always consult an accountant for tax advice.

Passive Activity Losses

1. Generally, losses from passive activities are used to offset passive activity income. Any losses in excess of passive activity income are carried forward into the future and are used when the tax player has passive activity income. They don’t expire or have a time limit. There is an economic value to those losses which in turn have value to the divorcing spouses. Therefore you’ll want to determine the amount of the passive activity losses, ascertain the asset(s) that is (are) generating those passive activity losses, and the amount of unused, or suspended, passive activity losses.

2. You can determine those underlying assets as well as the amount of the losses from Form 8582 and the supporting worksheet. Form 8582 is not included in the filing of a federal tax return. However, the client tax preparer would have a copy, and you might consider requesting a copy while you are doing your planning.

Passive Activity Losses

Form **8582**

Department of the Treasury
Internal Revenue Service (99)

Passive Activity Loss Limitations

▶ See separate instructions.
▶ Attach to Form 1040 or Form 1041.
▶ Information about Form 8582 and its instructions is available at www.irs.gov/form8582.

OMB No. 1545-1008
2012
Attachment Sequence No. 88

Name(s) shown on return | Identifying number

Part I 2012 Passive Activity Loss

Caution: Complete Worksheets 1, 2, and 3 before completing Part I.

Rental Real Estate Activities With Active Participation (For the definition of active participation, see **Special Allowance for Rental Real Estate Activities** in the instructions.)				
1a Activities with net income (enter the amount from Worksheet 1, column (a))	1a	1,228		
b Activities with net loss (enter the amount from Worksheet 1, column (b))	1b	(30,678)		
c Prior years unallowed losses (enter the amount from Worksheet 1, column (c))	1c	(103,777)		
d Combine lines 1a, 1b, and 1c			1d	-133,227
Commercial Revitalization Deductions From Rental Real Estate Activities				
2a Commercial revitalization deductions from Worksheet 2, column (a)	2a	( )		
b Prior year unallowed commercial revitalization deductions from Worksheet 2, column (b)	2b	( )		
c Add lines 2a and 2b			2c	( )
All Other Passive Activities				
3a Activities with net income (enter the amount from Worksheet 3, column (a))	3a			
b Activities with net loss (enter the amount from Worksheet 3, column (b))	3b	(735)		
c Prior years unallowed losses (enter the amount from Worksheet 3, column (c))	3c	(8,593)		
d Combine lines 3a, 3b, and 3c			3d	-9,328
4 Combine lines 1d, 2c, and 3d. If this line is zero or more, stop here and include this form with your return; all losses are allowed, including any prior year unallowed losses entered on line 1c, 2b, or 3c. Report the losses on the forms and schedules normally used			4	-142,555

If line 4 is a loss and:
- Line 1d is a loss, go to Part II.
- Line 2c is a loss (and line 1d is zero or more), skip Part II and go to Part III.

Passive Activity Losses

3. If the property that generated the passive activity is part of an equitable distribution under IRC Sec. 1041(b)(1), the suspended losses are added, or capitalized, to the basis of the property being transferred. They do not carryover to the recipient spouse.

4. Practice tip- Passive activity losses lose some of their potency when they get transferred under Section 1041 as they are added to the basis of the property at the time of the gift from the transferor (a benefit that they taxpayer may enjoy later, but not now), as opposed to being used to offset passive losses, or used to offset ordinary income in the year of sale. To avoid capitalization of the losses, consider deferring the transfer to allow time to burn off the losses to both parties benefit.

5. Practice tip- Passive activity losses have economic value, just as capital loss carryforwards do. There is an opportunity to integrate these losses into the settlement conversation outside of the scope of the real estate assets.

Exclusions

Exclusion May Still Apply in Conversion to Rental from Principal Residence

Given the state of flux in the plans and finances in the divorce process, different properties may be re-purposed at the end of the divorce itself. This may include converting a principal residence into a rental property. Following a settlement, it may be advantageous to move out of the house and convert the property into a residential rental. The exclusion is available provided that the taxpayer or their spouse has 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) and that all the rental use occurred after the last day the taxpayer used the house as a principal residence. 25% depreciation recapture tax is required if depreciation was take after the conversion.

Section 8:
Vacation Homes

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.

Deductibility of Interest

If used as a second (or vacation) home —*and not used as a rental or business property* — interest on the mortgage is deductible just as interest on the mortgage on your principal residence is. This amount of deduction is limited by the amount of total indebtedness on the principal residence and the second (or vacation) home, up to $1.1mm of indebtedness.

Divorced spouses may be able to deduct qualified mortgage interest on a second home.[39] Qualified residence interest is deductible when paid on the principal residence and one other residence used by the taxpayer as a residence (including a vacation home).[40] The use as a residence requirement may be difficult to meet by one of the spouses in divorce situations. Generally, if only one spouse lives in the residence during the pre-divorce separation period, that spouse's use of the property can be attributed to the nonresident spouse under the rules for deducting interest for a second home.

[39]IRC Sec. 163(h)(4)(A)(i)
[40]IRC Sec. 163(h)(4)(A)(i)

Rental Rules

1. <14 days rented- no taxes on the income

2. >14 days rented- the rental income is taxable income, and the expenses offset the income, depreciation can be taken and passive activity losses, if any, can be suspended until the year of sale. If you and your family use a beach house for 40 days during the year and it's rented for 160 days, 80% (160 divided by 200) of your expenses are deductible.

3. If you limit personal use to <14 days or 10% of the days rented, the vacation home is considered a business and up to $25,000 in losses might be deductible each year. These losses may offset ordinary income provided the taxpayer’s income is <$100,000 (and the available losses are reduced as the AGI increases).

4. Personal use > 14 days, or more than 10% of the number of days it is rented — whichever is more — it is considered a personal residence and the loss can't be deducted.

Conclusion

1. Reasons for Owning Real Estate
2. Capital Stack in Real Estate
3. Financing and Refinancing Basics
4. Property Transfers
5. Valuation Metrics
6. Marital Residence
7. Rental Property
8. Vacation Homes

Thank you