



Brian Rockwell, CFP®, ChFC®,
CDFA®
Associate Vice President,
Investments
Trinity Town Center
9040 Tryfon Blvd A-104
Trinity, FL 34655
727-372-2530 x:2224
877-486-2183
brian.rockwell@raymondjames.com
Website: www.BrianRockwell.com

Marital Residence

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Marital Residence

To whom does the house belong?

When a couple divorces, assets (including the marital residence) are divided in accordance with state laws. Property division rules can vary considerably from state to state, so check your state's laws (or check with an attorney) to see which rules your state enforces.

Community property states

Community property states focus on the difference between separate property (that which you bring to the marriage, inherit during the marriage, and receive as a gift during the marriage) and community property (that which is acquired during the marriage). Separate property can usually be kept by the owner-spouse after a divorce, while community property is usually divided equally between the spouses.

Equitable distribution states

The majority of states are equitable distribution states. These states generally agree that the couple's property is marital property and should be divided between the spouses equitably and fairly. Some of these states will make exceptions for separate property, such as inheritances and gifts, and some will not.

There are three types of equitable distribution states. They're categorized according to how they identify marital property:

- The first type of equitable distribution state identifies marital property as all property except that which the husband or wife brought into the marriage, or obtained by gift or inheritance at any time. This definition is very similar to the one held by community property states.
- The second type of equitable distribution state says that regardless of how property was brought into the marriage or who has title presently, all property of both spouses is subject to division and disposition at divorce. These states don't differentiate between marital and separate property. They divide property fairly and equitably, and may allow property brought into the marriage by gift or inheritance to go to the other spouse if this form of distribution is more fair, all things being considered. However, the source of the property (i.e., gift, inheritance, owned prior to marriage) is often very important in the judge's decision-making process.
- The third category of equitable distribution state is a mix of rules. Such states use equity as a means of division, but they don't exempt all gifts, inheritances, or property brought into marriage. Instead, they may exempt one or two of these types of property.

For more information about property division in general, see our separate topic discussion, Property Settlement.

Ownership of the family home--special rules apply

The marital residence or family home receives special treatment in both community property states and equitable distribution states. In a community property state, for example, the family home can be considered marital property, even if one spouse separately brought it to the marriage. This is true if both spouses lived in the home during the marriage, and if the nonowner spouse contributed to the house's appreciation in value over the years. Naturally, in equitable distribution states, a court will consider numerous factors when deciding upon an award of the house.

So, to whom does the house belong? Title on the deed is certainly a useful starting point, but it also depends on whether you live in a community property state or an equitable distribution state. It further depends on whether you owned the house prior to marriage, whether you received the house as a gift or inheritance, and whether both spouses lived in the house during marriage. Therefore, it's important to review the domestic relations law of

your own state to answer this question. Nevertheless, in general, it's safe to say that both spouses probably have a claim on the house and should be prepared to divide this asset along with other marital assets.

What factors should be considered if you want to keep the house?

In many divorces, the family home is the most valuable asset. For financial and emotional reasons, the biggest question involves who gets the house. If you wish to keep the house, these questions should be considered:

Can you afford to make the mortgage payments (if any), or is the house paid off?

Often, alimony will involve one spouse paying the mortgage for the other spouse. But, if you will not be receiving alimony from your spouse, you'll need to earn enough income to continue making the mortgage payments. To do that, you'll need a secure job and sufficient wages or salary.

Can you afford to continue the other costs of upkeep, such as insurance, taxes, and repairs?

Again, ascertain your total monthly obligation regarding the house and consider whether your income stream will be adequate. Remember that property taxes in some areas can be extremely high, and regular groundskeeping will be necessary.

Do you have the financial ability to buy out your spouse in return for keeping the house?

Often, divorcing spouses are forced to compromise and trade various assets. For example, one spouse may want the house, while the other might keep the pension. This isn't always the case, but it may be the only way to reach an amicable agreement and avoid a trial. In a community property state, you need to be aware that an award of a house to one spouse must be balanced by an award of equal value to the other spouse.

Do you have any children?

If a couple has very young children, a judge will often award the family home to the custodial parent, who often turns out to be the wife. A judge will place great importance on the welfare and happiness of the children, and will often feel that a house is a better environment than an apartment. Sometimes the trading of assets simply isn't necessary. For example, if one spouse is a homemaker with young children and the other spouse earns a good living, a judge may award the house to the homemaker, have the working spouse pay alimony and child support, and award part of the pension to both parties. Such an arrangement may be more likely in a marriage of long duration.

What are the potential tax liabilities?

Transactions between spouses incident to a divorce aren't taxable. Nevertheless, if one spouse becomes sole owner of the family house pursuant to a divorce settlement and later sells it, the entire capital gain tax liability will be his or hers alone. Nevertheless, there is always the possibility of using the \$250,000 capital gain tax exclusion (more on that later).

What can be done with the house when a divorce arises?

When considering the issue of who gets the house, there are four options that are most frequently used: sell the house, buy out the other spouse, joint ownership, or agree to give to the homemaker.

Sell the house

One of the easiest ways to deal with the marital residence, particularly when there are no children involved, is to sell the house and divide the profits that remain after the mortgage is paid and the selling costs have been paid. Profits can be divided equally or otherwise, based on the parties' wishes. Most people will want to have an independent appraiser value the property, hire a real estate agent to sell it, consult with a real estate attorney, and obtain a mortgage payoff figure. These selling costs can sometimes be significant. For information about deducting settlement costs and other costs involved in the sale of a house, see our separate topic discussion,

Sale of Principal Residence: Tax Considerations.

The divorcing spouses will both need to find new residences and weigh the costs and benefits of purchasing a new home versus renting an apartment. If there are no children, selling the marital residence is probably a much simpler solution for a younger couple than for an older one. An older spouse, particularly a homemaker, may have stronger emotional ties to the home and may fear the loss of security associated with a sale of the home and a new life in an apartment.

Buy out the other spouse

If one party wants to keep the family home, buying out the other spouse might be an attractive solution. You can buy out your spouse by trading another asset (like a pension), forgoing alimony, paying cash, or granting a mortgage (or second mortgage) to your spouse.

If you wish to buy out your spouse, the first thing you'll need to do is to value the property. An independent appraiser should be hired to fix the value. Next, obtain a mortgage payoff figure (if any). The value minus the mortgage shall be viewed as your equity in the property and, once divided in half, can serve as the buyout figure. Alternatively, the couple can decide on a buyout figure of their own choosing. It doesn't necessarily have to be one-half of the equity. For more information, see our separate topic discussion, *Selling a Home*.

The method of payment is the next question to be considered. Certainly, trading assets is one option. If one-half of the net equity in the house amounts to \$25,000, for example, and the husband has a pension worth approximately \$15,000, the wife might wish to relinquish her rights in the pension in return for keeping the house. Of course, she'd need to carefully weigh such a decision in light of the fact that the pension will probably increase dramatically over the years and she may be left with no retirement income. A cash exchange is another method of payment if one party has an inheritance or trust fund. Refinances and mortgages should also be considered. The house could be refinanced to provide enough cash to pay the other spouse. Alternatively, a note payable (with reasonable interest) or private mortgage can be drawn up between the spouses. However, this approach could present some problems.

Example(s): Debby and Jose are seeking a divorce and own a home with \$20,000 worth of equity. Debby wants to keep the house, but has just started a new job and doesn't have sufficient cash on hand to buy out Jose. Debby promises to make a balloon payment of \$10,000 to Jose seven years after their divorce date, securing this promise with a \$10,000 private mortgage to Jose. When Debby tries to refinance the house some years later in order to payoff Jose, she finds that conventional mortgage lenders will not grant her a mortgage unless Jose subordinates his mortgage claim to theirs. If Jose refuses to subordinate, Debby will have difficulty finding the cash to pay off Jose.

Tip: If private notes and mortgages are used, the divorce agreement should stipulate that subordinations and other accommodations will be freely given by the creditor-spouse. Also, if one spouse merely deeds his or her interest in the house to the other spouse while a mortgage is outstanding, both spouses shall remain liable for the mortgage if both signed the mortgage initially. For example, if the spouse who lives in the house stops making mortgage payments, the other spouse may be liable and may suffer severe credit consequences.

Joint ownership

Joint ownership is often used when the parties envision selling the house at some point in the future (e.g., when the minor children reach age 18 or when the resident spouse remarries). The parties might agree that the spouse who lives in the house shall be responsible for making the mortgage payments, or that both parties will pay the mortgage, insurance, and taxes until the children graduate from school.

Property values should be a concern if you promise to pay a certain dollar amount in the future. Rather than promising to pay \$20,000 when the property is sold 15 years from now, you might wish to promise one-half or one-third of the net sale proceeds. This would protect the resident spouse if the property value declines. If you're the creditor-spouse, a dollar amount might be better.

Agree to give to homemaker

There are cases when assets won't be traded in any significant sense. Rather, the parties will simply agree to give the greater portion of assets to one spouse. This can be particularly true when a homemaker of many years is involved. For older women who sacrificed a career for the care of children and the upkeep of a house, it may be impossible for them to jump into the working world at age 58 and earn a sufficient living. In such cases, judges may decide simply to award the house to the homemaker. Additionally, the judge may order alimony payments for life and a portion of the pension set aside. Such measures may be deemed equitable under the circumstances.

Note: The upkeep of a house and its grounds might be too burdensome and expensive for certain individuals.

What are the tax ramifications when a house is sold pursuant to a divorce?

In general

Property transfers between spouses during marriage or incident to divorce aren't taxable. But the tax effects on the sale or transfer of your home incident to divorce can vary substantially, depending on whether you (as a couple) decide to keep the house, sell it to a third party, or transfer it to one spouse with a view toward a future sale.

Transfer to one spouse incident to divorce

Neither spouse recognizes gain or loss if you transfer the title of the home to your spouse incident to a divorce. A transfer of property is viewed as incident to a divorce if the transfer occurs within one year after the date on which the marriage ends, or if the transfer is related to the ending of the marriage. Any transfer of property between spouses made pursuant to a divorce or separation instrument, and occurring within six years after the date the marriage ceases, is treated as if related to the ending of the marriage.

Basis

The spouse receiving the property takes the basis of the transferring spouse, and ends up with the combined basis. This result occurs even if the spouse that retains the residence pays cash or other assets in return for the house and the transaction is basically a sale.

Example(s): Joan and John own a home that is presently worth \$170,000. Joan sells her one-half ownership of their home to her spouse, John, for \$85,000 as part of their divorce settlement. Because the property had initially been purchased for \$80,000, Joan's basis was \$40,000 and John's was \$40,000. Joan doesn't recognize any gain on the sale to John because the sale was incident to their divorce. John's basis in the property will be \$80,000.

Delayed sale of house

The parties might decide (in their divorce agreement) that the house shall be sold at some point in the future. Typically, only one spouse remains in the house, but the other spouse continues to be listed on the deed as a joint owner. This raises a question concerning exclusion of the capital gain when the house is later sold.

In general, the law states that if all requirements are met, a taxpayer of any age can exclude from income up to \$250,000 of gain (up to \$500,000 for joint filers meeting certain conditions) from the sale of a home owned and used by the taxpayer as a principal residence for at least two of the five years before the sale. Generally, an individual (or either spouse in a married couple) can use this exemption only once every two years.

Caution: For sales and exchanges of a principal residence after December 31, 2008, the \$250,000 (\$500,000 if married filing jointly) homesale exclusion does not apply to the extent the gain is allocated to periods (not including any period before January 1, 2009) during which the property is not used as the principal residence of the taxpayer or the taxpayer's spouse.

At first glance, this law would seem to preclude the spouse who moved away and has lived elsewhere for several years from claiming the exclusion. However, under the following circumstances, a separated or divorced taxpayer can add someone else's ownership and/or use period to his or her own ownership and/or use period:

- An individual is treated as using a home as his or her principal residence during any period of ownership that the individual's spouse or former spouse is granted use of the property under a divorce or separation instrument, and
- An individual who receives a home in a tax-free transfer from one spouse to another may tack on the transferor's ownership period to his or her own ownership period

Example(s): John and Mary are divorcing. Their divorce decree provides that Mary can continue living in the house until their daughter, Jane, turns 18, eight years from now. At that time, the house will be sold and the proceeds split between John and Mary. In this case, John will be eligible for the \$250,000 capital gain exclusion, even though he didn't reside in the family home for two of the past five years, since he meets one of the exceptions.

In addition, even if you don't meet the two-out-of-five-years test or the one-exemption-every-two-years test, you may qualify for a partial exclusion. You may claim a partial homesale exclusion if the primary reason for selling your principal residence is a change in place of employment, for health reasons, or for certain other unforeseen circumstances. Temporary regulations issued by the IRS specifically list divorce or legal separation as an unforeseen circumstance.

Sale of house to third party immediately

Often, a house will be sold to a third party as part of a divorce settlement. The proceeds will be split equally between the spouses. In such a case, both the husband and wife would normally recognize one-half of the gain on the sale. But, this will not be the case if they qualify for the capital gain exclusion mentioned above.

Example(s): Liz and Frank are seeking a divorce. During the course of their marriage, they purchased a house for \$100,000. The house is now worth \$200,000, and the couple decides to sell it through a real estate broker and split the net proceeds equally. If their net proceeds from the sale amount to \$186,000, Frank and Liz will each realize a \$43,000 gain. Assuming they qualify for the full capital gain exclusion, Liz and Frank can each exclude up to \$250,000 of gain from the sale of the home.

Tip: When structuring divorce settlements, the timing of property sales and the tax ramifications should always be considered, along with the domestic relations law (i.e., community property states versus equitable distribution states). Therefore it's wise to consult with a divorce attorney, even if the property settlement appears to be a simple and amicable one. For additional information, see our separate topic discussion, *Divorce and Personal Residence Considerations*.



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