Home Owner News

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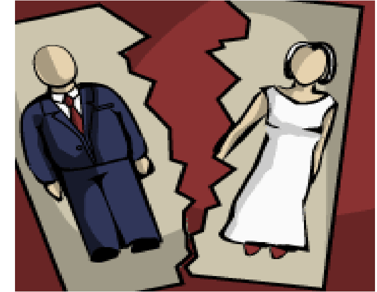
Divorce & The Family Home



Divorce is a huge emotional and financial upheaval in the lives of all the parties involved. Emotion and anxiety make this a very difficult time to be making sound financial decisions but when a marriage ends, making these decisions may be your most important job.

Unfortunately, with the break-up of the marriage comes a break-up of the combined income. The same money that was used to "carry" the family home will now have to be used to support two households and this can mean that some unpleasant compromises may have to be made. The following is a brief overview of what to expect when it comes time to redefine the status of a married couple's "single largest asset", the family home.

Deciding What To Do With The Family Home:

Basically, There Are Three Options

1. Selling the House And Splitting The Proceeds

Be careful not to assume that there will be a 50/50 split of the sale proceeds. Your share may depend upon your divorce settlement, on the source of the original down payment money or the laws of your particular state. Many state matrimonial laws follow equitable distribution principles which may favor a particular spouse. Others are community property or common law statutes that usually result in 50/50 property settlements.

2. Buying Out Your Spouse's Share Of The Home

When a property is transferred from one spouse to another due to a divorce, the lender cannot "call the loan". However, if the departing spouse is a co-signer on the mortgage, it is unlikely the lender will relieve the departing spouse of his/her obligations on the original mortgage note (even though the departing spouse will no longer have an ownership interest in the home). This obligation as a guarantor could adversely affect the departing spouse's ability to obtain financing for another home (even though the property settlement may say that you are not responsible for the mortgage payments on the former home).

3. Retaining Some Sort Of Joint Ownership And/Or Joint Occupancy After The Divorce

Even though only one partner will most likely be occupying the home, the two former spouses can have a joint ownership and/or joint occupancy arrangement defined in the divorce agreement.

The Taxpayer Relief Act of 1997 created a very generous capital gains tax exclusion for homeowners. Under this legislation, single homeowners are entitled to keep $250,000 in profit on the sale of a principal residence tax-free and married couples $500,000 in profit, tax-free.

Whether you sell your home at the time of divorce or one of you continues to live in the home as part of the divorce agreement, it is important to structure the agreement properly to avoid unnecessary capital gains taxation when the home is eventually sold. Whether a divorcing couple will be entitled to the single taxpayer's exemption of $250,000 or the married couple's exemption of $500,000 depends upon the method and sequence in which they define their separation.

THE GOAL: Don't blow the $500,000 exclusion.

If You Sell The Home While Still Married

If you sell your primary residence and are still married at the end of the calendar year, you should be able to shelter up to $500,000 of profit from federal capital gains taxes. There are two ways to qualify for the full $500,000 federal gain exclusion.

1. By filing a joint return

   In this case, the home must have been:

   - **Owned by one OR both** of you for at least two of the five years preceding the sale, and
   - **Used by both** of you as the principal residence for at least two out of the five years preceding the sale.

   In other words, only ONE spouse needs to meet the two-year ownership requirement, but BOTH spouses must meet the two-year use requirement.

2. By filing separate returns

   If the home is owned jointly or is community property, you can file separate returns and each exclude up to $250,000

of your respective shares of the gain, provided you BOTH pass the two-out-of-five-years ownership and use tests. This allows you to convert your home equity into tax-free cash and go your separate ways.

Gains that exceed the exclusion will generally be taxed at capital gains rates (20% maximum; 25% to the extent of any gains from depreciation deductions from periods after May 6, 1997).

NOTE: Even though you may not owe any federal capital gains taxes, you might still owe state and local taxes.

If Your Home Is To Be Sold After the Divorce

The federal gain exclusion rule can help here too.
Say ex-spouse B winds up owning a residence formerly owned by ex-spouse Z. No problem. B gets to count Z's period of ownership if necessary to meet the two-out-of-five-years test when B eventually sells the property. Of course, B's maximum gain exclusion is only $250,000, because he or she is now single.

However, if B remarries and lives in the home with the new spouse for at least two years before selling, B can apparently qualify for the larger $500,000 exclusion by filing a joint return with the new spouse. The same would be true if B owned the home before the divorce.

When A Departing Spouse Retains An Ownership Interest In The Home After The Divorce

Often, a departing spouse continues to co-own the residence after the divorce while the remaining spouse continues to reside in the home. After three years of being out of the house, the house will no longer meet the two-out-of-five-years residency requirement to qualify as a principal residence for the departing spouse. That means when the home is eventually sold, the departing spouse’s share of the gain will be fully taxable. However, if the departing spouse has moved out of the house and the remaining spouse continues to live in the house **pursuant to a divorce or written separation agreement,** the remaining spouse's residency in the house will satisfy the departing spouse’s residency and use requirement and preserve the departing spouse’s capital gains exclusion.

In order to protect the maximum capital gains exclusion, your divorce agreement will probably need to include a stipulation defining one of the following scenarios **as pursuant to the divorce**:

- The departing spouse is allowed to reside in the home.
- One spouse will be buying out the other’s ownership interest in the future or
- The sale of the home will be triggered by a future event such as a specific date or the last child’s completion of high school or college.

This arrangement allows the departing spouse to get "credit" for the remaining spouse's continued use of the property as his/her primary residence. When the home is finally sold, the departing spouse is still entitled to the $250,000 gain exclusion to shelter all or part of his/her share of the profit.

If the departing spouse will be retaining 100% ownership of the home after the divorce but only the remaining spouse will be residing there, the same precautions should be taken to make sure that the divorce papers include language that defines the departing spouse’s retention of ownership and the remaining spouse’s residency as **“pursuant to the divorce”**. Once again, this ensures that the departing spouse will still qualify for the $250,000 gain exclusion when the home is eventually sold, even though the home is no longer his/her principal residence.

Vacation Homes

If you sell a vacation home for a profit, you will owe capital gains taxes. But consider this. Say you would like to use the home as your main residence after the divorce. Arrange to keep it as part of your side of the property settlement. Now if you live there for at least two years, you can sell the property and take advantage of the $250,000 gain exclusion. The only catch is you cannot have already taken advantage of the gain exclusion privilege within the previous two years (for example when you sold your share of your former primary residence). If you remarry, you and your new spouse can live in the former vacation home for two years and exclude up to $500,000. Heckuva deal.

For more information, refer to the following IRS Publications:

Divorced or Separated Individuals
IRS Publication 504
http://www.irs.gov/pub/irs-pdf/p504.pdf

Community Property
IRS Publication 555
http://www.irs.gov/pub/irs-pdf/p555.pdf

Selling Your Home

IRS Publication 523
http://www.irs.gov/pub/irs-pdf/p523.pdf

IRS Publication 17 (page 17)
http://www.irs.gov/pub/irs-pdf/p17.pdf

(You’ll need Adobe Acrobat Reader in order to view these documents.)

NOTE:

This article is intended as a general overview.
It should NOT be taken as legal or financial advice.

Before making any decisions, you should consult an attorney and/or a professional tax advisor regarding your specific situation.