

# How to Survive and Prosper in a Housing Recession

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# **I. Protecting Your Home (the New Proposed Massachusetts Homestead Statute)**

Currently, Homesteads in Massachusetts are governed by M.G.L. ch. 188. New legislation is pending that would substantially expand the scope of homestead protection and resolve a number of uncertainties about whether homestead protection is available as it relates to certain types of transactions, including life estates and trust planning.

- 1. Automatic Homestead**
- 2. The Amount of the Homestead**
- 3. Elderly**
- 4. Trusts**
- 5. Federal Bankruptcy Overrides  
for Transfers out of Trust**

- 6. Termination of Homestead**
- 7. The Effect of a Mortgage/Refinance on a Homestead**
- 8. Protection of Proceeds**
- 9. Multiple Homesteads**
- 10. Miscellaneous Rules**

- *Limitations on Homesteads:*

The homestead provides that the property shall be exempt from laws of conveyance, descent, devise, attachment, levy on execution, and sale for payment of debts and legacies, except: (1) in a sale for taxes; (2) for a debt contracted prior to the acquisition of said estate of homestead; (3) for a debt contracted for the purchase of said home; (4) upon execution issued from the Probate Court to enforce its judgment that a spouse pay a certain amount weekly or otherwise for the support of a spouse or minor children; (5) where buildings on land not owned by the owner of a homestead estate are attached, levied upon, or sold for the ground rent of the lot whereon they stand; and (6) upon an execution issued from a Court of competent jurisdiction to enforce its judgment based upon fraud, mistake, duress, undue influence, or lack of capacity.

- *180 Day Period:*

The Federal Bankruptcy Statute provides that the debtor must have been domiciled in the property during the 180 day pre-petition period. In In Re: Sparfven, 265 B.R. 506 (Bankr. D. Mass. 2001), the Bankruptcy Court ruled that a Chapter 7 debtor who filed a bankruptcy petition seeking a homestead exemption for a condominium in Florida, was not entitled to the exemption because the debtor failed to show that he was domiciled in Florida during the 180 day pre-petition period.

- *Beneficial Interest in Trust Owning a Remainder Interest in Property Not Protected*

In In Re: Blake, No. 02-10702-CJK (Bankr. D. Mass. 2003), the Bankruptcy Court denied a debtor's claim of exemption under Section 522(d)(1) of the Bankruptcy Code for his interest in a one-fourth beneficial ownership in a trust that, in turn, owned a remainder interest in real property in which the debtor resided. The trust's interest was subject to a life estate in favor of the debtor's mother. The debtor argued that Section 522(d)(1) was not limited to interests in real property, but expressly permits exemption of interests and personal property that the debtor uses as a residence. The debtor argued that his interest in the trust was personal property, but the Court disagreed stating that the mobile home in trust be protected, but a trust, being an intangible, is not.

- In In Re: Garran, 274 B.R. 570 (Bankr. D. Mass. 2002), the question was whether the debtor was entitled to claim both his \$300,000 exemption as a disabled person pursuant to M.G.L. c.188, §1A, and the \$300,000 exemption of his non-debtor spouse, pursuant to M.G.L. c.188, §1. The Bankruptcy Court found that no individual can claim more than one homestead exemption finding that the Declaration of a new homestead discharges the previously filed claim. In this case, the debtor's elderly homestead was inadvertently terminated and discharged by his wife's subsequent Section 1 declaration.

- *Legal Malpractice Issues*

In In Re: Jackson, 317 B.R. 573 (Bankr. D. Mass. 2004), the Bankruptcy Court ruled that the debtors could sue their attorney for malpractice based on a theory that they had a duty to ascertain whether a homestead exemption on their property had been filed properly prior to their filing of a bankruptcy.

# 11. Medicaid

- Homestead does not exempt home from Medicaid rules.
- Home with value in excess of \$750,000 is countable.
- Home worth less than \$750,000 will become countable as former home under Medicaid eligibility.

## **II. Housing and Economic Recovery Act of 2008 and Related Developments**

### **1. Tax Provisions**

*First Time Homebuyer Tax Credit – Summary:*

First time homebuyers are entitled to a (temporary) refundable tax credit equal to 10% of the purchase price of the home up to \$7,500 (\$3,750 for married individuals filing separately).

*Phase Out:*

The credit begins to phase out for taxpayers with adjusted gross income in excess of \$75,000 (\$150,000 in the case of a joint return).

*Effective Date:*

The credit is effective for homes purchased on or after April 9, 2008 and before July 1, 2009.

## 2. Property Tax Deduction for Non-Itemisers

### *Current Law:*

Property tax deductions are available only to persons who itemize deductions. Many taxpayers do not itemize and take advantage of the \$10,900 standard deduction for joint filers and the \$5,450 standard deduction for single individuals.

### *New Law:*

Under the new law, the taxpayer may take the standard deduction and, in addition, a \$500 (\$1,000 for married individuals) deduction attributable to the payment of real estate property taxes, in effect, increasing the standard deduction.

### *Limitation:*

The temporary deduction is applicable only to the 2008 tax year.

### 3. New Limits on Home Sale Exclusion

#### *Current Law:*

IRC § 121 provides that up to \$250,000 of capital gain (\$500,000 in the case of a joint filing) can be excluded from income.

#### *New Law:*

A portion of the gain will no longer be excluded attributable to periods that the home was not used as the principal residence.

#### *Applicable Date:*

The new rule applies to home sales after December 31, 2008. The limitation is based only on non-qualified use periods that begin on or after January 1, 2009.

#### *Amount of Exclusion:*

The amount of gain required to be allocated to periods of non-qualified use, is the amount of gain multiplied by a fraction, the numerator of which is the aggregate period of non-qualified use during which the property was owned by the taxpayer and the denominator of which is the period the taxpayer owned the property, noting that non-qualified use does not include any use prior to 2009.

*Example:*

Taxpayer purchases property on January 1, 2009 for \$400,000 and rents the property for two years claiming \$20,000 of depreciation. On January 1, 2011, Taxpayer begins to use the property as his home. Taxpayer moves out of the house on January 1, 2013 and sells it for \$700,000 on January 1, 2014. The two-year period of 2009 and 2010 is non-qualifying use. Of the \$300,000 gain, 40% (2 years out of the 5 years owned, or \$120,000) is not eligible for the exclusion. The balance of the gain (\$180,000) may be excluded. The \$20,000 gain attributable to depreciation is recaptured as ordinary income as under current law.

#### **4. \$500,000 Exclusion is Extended for Surviving Spouse**

In the case of a sale or exchange of property by unmarried individuals whose spouse is deceased on the date of sale, the spouse may exclude \$500,000 rather than \$250,000 from gain if such sale occurs not later than two years after the date of death of such spouse and the general rules relating to the capital gain exclusion are met. New IRC § 121(b)(4). This amendment applies to sales or exchanges after December 31, 2007. The home must have been owned by one spouse and used by both spouses as a principal residence for two years prior to the date of death.

## **5. Interest in Property Taxes Deductible Even if Payors are Not Owners**

In a very unusual win for the taxpayers, in Rachel v. Commissioner, U.S.T.C. Summ. Opinion 2008-84 (July 15, 2008), the Tax Court ruled that a couple would be entitled to deductions for mortgages, interest, and real estate taxes paid on residential property because they were the beneficial owners of the property even though the property was titled in their son's name. The facts showed that the couple's son took title to the property and was mortgagor on the property and agreed to do so because the parents were unable to secure the loan because of financial difficulties.

**6. Section 2122 of the "Housing and Economic Recovery Act of 2008," deals with reverse mortgages as follows:**

## *Counseling Provisions:*

The Act provides that a borrower must have received "adequate counseling as provided in subsection (f) by an independent third party that is not either directly or indirectly, associated with and compensated by a party involved in: (i) originating or servicing the mortgage; (ii) funding the loan underlying the mortgage; or (iii) the sale of annuities, investments, long term care insurance, or any other type of financial or insurance product.

## *Funding for Counseling:*

*The Secretary may use a portion of the mortgage insurance premiums collected under the program to adequately fund the counseling and disclosure activities required, including counseling for those homeowners who elect not to take out a home equity conversion mortgage, provided that the use of such funds is based upon accepted actuarial principles.*

*Authority to Insure Home Purchase Mortgages:*

Notwithstanding any provision of this section, the Secretary may insure, upon application by a mortgagee, a home equity conversion mortgage upon such terms and conditions as the Secretary may have prescribed when the home equity conversion mortgage will be used to purchase a one to four family dwelling unit, one unit of which the mortgagor will occupy as a primary residence and to provide for any future payments to the mortgagor based upon available equity.

*Limitation on Amount.*

The home equity conversion mortgage insured will involve a principal obligation that does not exceed the dollar amount limitation determined under Section 305(a)(2) of the Federal Home Loan Mortgage Corporation Act for a one-family residence. (A single national loan limit of \$417,000 that can increase up to as much as \$625,500 in high cost areas.)

## *New Rules Relating to Mortgage Originators:*

The mortgagee, and any other party that participates in the origination of a mortgage to be insured, shall (A) not participate in, be associated with, or employ any party that participates in or is associated with any other financial or insurance activity; or (B) demonstrates to the Secretary that the mortgagee or other party maintains, or will maintain, fire walls and other safe guards designed to insure that, (i) individuals participating in the origination of the mortgage shall have no involvement with, or incentive to provide the mortgagor with, any other financial or insurance product; and (ii) the mortgagor shall not be required, directly or indirectly, as a condition of obtaining a mortgage under this section, to purchase any other financial or insurance product.

*Prohibition Against Requirements To Purchase Additional Products:*

The mortgagee or any other party shall not be required by the mortgagor or any other party to purchase an insurance, annuity, or other additional product as a requirement or condition of eligibility for insurance, except for title insurance, hazard, flood or other peril insurance, or other such products as are customary and normal.

## **7. Mortgagee's Cooperatives are Now Eligible for HECM**

### *Limitation on Origination Fees:*

The origination fees now reduced to 2% on the initial \$200,000 or maximum claim amount (lesser of the home value or county lending limit) and 1% on the balance thereafter with a cap of \$6,000. Note that previously, fees were capped at 2% of the maximum claim amount. This \$6,000 maximum origination fee is to be adjusted by a cost of living adjustment in increments of \$500 only, when the percentage increase in such index, when applied to the maximum origination fee, produces dollar increases that exceed \$500.

### **III. Reverse Mortgage Rules**

Be sure to consider using a life estate in connection with a reverse mortgage.

#### **1. Transfer of Property After Reverse Mortgage is Obtained Does not Affect Reverse Mortgage in Most Reverse Mortgage Debt Instruments**

*HECM Reverse Mortgage provides in Section 9, Grounds for Acceleration of Debt.*

- (a) Due and Payable. Lender may require immediate payment in full of all sums secured by this Security Instrument if:
  - (i) A Borrower dies and the Property is not the principal residence of at least one surviving Borrower; or
  - (ii) All of a Borrower's title in the Property (or his or her beneficial interest in a trust owning all or part of the Property) is sold or otherwise transferred and no other Borrower retains (a) title to the Property in fee simple or retains a leasehold under a lease for less than 99 years which is renewable or a lease having a remainder period of not less than 50 years beyond the date of the 100th birthday of the youngest Borrower, or retains a life estate (or retaining a beneficial interest in a trust with such an interest in the Property).

Consider the following example:

Assume Borrower is age 75 and obtains a reverse mortgage in the amount of \$100,000. At age 86, Borrower is admitted to a nursing home. The reverse mortgage note provides that the loan is due if Borrower ceases to use the property as their principal residence, (specifically, the failure to physically occupy the home for 12 consecutive months because of physical or mental illness), instead of bringing Borrower home for a night. We'll assume the property is sold for \$850,000 when Borrower is age 87 and the balance on the note is \$200,000.

## 2. Computation of Allocation of Sale Proceeds of Property if Held in a Life Estate

|                        |                      |  |
|------------------------|----------------------|--|
| Sale Price             | \$850,000            |  |
| Broker's Commission 5% | < <u>\$ 42,500</u> > |  |
| Net Sale Price         | \$807,500            | <i>(after sales commission &amp; expenses)</i> |
| Life Estate Rate       | <u>.25638</u>        | <i>(from 90 CM Table)</i>                      |
| Borrower Proceeds      | \$207,026            | <i>(life tenant)</i>                           |
| Children's Proceeds    | \$600,474            |  |
| Taxable Rate           | 15%                  | <i>(long term capital gain rate)</i>           |

### 3. Determination of Amount at Risk for Nursing Home with Reverse Mortgage and Life Estate

|                     |                  |                             |
|---------------------|------------------|-----------------------------|
| Borrower's Proceeds | \$207,026        |                             |
| Loan Repayment      | <u>\$200,000</u> | <i>(borrower's portion)</i> |
| Amount at Risk      | \$ 7,026         |                             |

#### 4. Determination of Amount at Risk for Nursing Home if no Life Estate was Used at the Time of Closing

|                     |  |
|---------------------|--|
| Borrower's Proceeds | \$807,500                                      |
| Loan Repayment      | <u>\$200,000</u> ( <i>borrower's portion</i> ) |
| Amount at Risk      | \$607,500                                      |

## 5. Other Benefits to Life Estate

- No probate since life estate ends upon death.
- Children get full step-up in basis equal to fair market value so that post-death sale is not subject to capital gain taxes.
- No estate tax (if property, together with other assets, is less than \$1,000,000) in Massachusetts and no federal estate tax (if property is worth less than \$2,000,000).