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DIVORCING YOUR MORTGAGE

DID YOU KNOW?

Fannie Mae may consider a short sale as a financial hardship in a divorce situation when the mortgage loan is current or less than 31 days delinquent.

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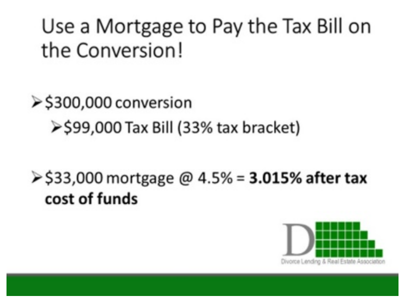
Divorcing Clients & ROTH IRA Conversions

When you have divorcing clients who have Individual Retirement Accounts (IRAs) as part of their marital assets it's important to identify what type of IRA it is as there may be future tax liabilities you can't overlook as the attorney or financial planner.

A traditional IRA is an IRA where you invest money before you pay taxes on it. The money invested grows in the account tax-free requiring that you pay taxes on the income earned when you withdraw the funds.

A Roth IRA on the other hand is a retirement account where you invest after-tax dollars and withdraw the funds tax-free. Since taxes are paid on money prior to investing, you do not have to pay taxes when you withdraw the funds.

In 2010, the limits were lifted on the amount of money you could convert in your traditional IRA to a Roth IRA. This was part of the Bush Tax Cuts and would be a smart option for anyone with a traditional IRA not just divorcing clients.



Let's look at an example of how to utilize a mortgage to pay for the ax bill on the conversion. Assume that Clint and Terri are getting a divorce and they have a traditional IRA with a value of $300,000 which through the divorce settlement agreement is going directly to Terri. They are in a 33% tax bracket which would equate to a future tax liability of $99,000 for Terri. If Clint is retaining the marital home valued at $300,000 and Terri is getting the $300,000 IRA – there's not an equitable division of assets if the future tax bill is not addressed.

Now let's assume that Clint wants to make sure that Terri does not have to be worried about a tax bill when she reaches retirement age and since he is working and able to afford it he wants to look at options to pay the conversion tax bill for Terri. A very smart option for Clint to find this $99,000 is to take it out of the equity in the marital home he is keeping rather than paying cash for the tax bill.

Let's look at the financial advantage of using a mortgage to pay for the conversion. In this example, we are comparing the consequences of paying the tax bill with cash vs. paying the tax bill using a new mortgage. The amount of cash needed is $99,000 due to the 33% tax bracket. If Clint was to keep the $99,000 in his investment account earning a 6.5% return, he would lose $6,435 per year in income in the investment account (Opportunity Cost).

When Clint takes out a new mortgage where he gets the $99,000 cash out of the equity in the home at an interest rate of 4.5%, his after tax mortgage cost is actually only 3.015%. This is because Clint is in a 33% tax bracket. The after tax mortgage rate is a simple calculation.

Regardless of how you calculate the after tax mortgage interest rate on $99,000 the after tax mortgage cost of borrowing the $99,000 is only $3,118 during the life time of the loan. This equates to an annual benefit of $3,317 per year and appears to be a very smart option for Clint to pay the tax bill for Terri.

As mentioned earlier, a ROTH IRA Conversion is a smart choice right now for anyone regardless of whether or not they are going through a divorce. A conversion benefits anyone who wants to convert some or all of their traditional retirement account funds into a Roth IRA while there are no limits to the amount you can convert.

Payment vs. Cost

Payments are what you make, costs are what you spend.

The actual cost of your payment can be substantially lower than your monthly payment. Your payment is made up of many things.

Typically, a monthly home loan payment will include principal, inter- est, taxes, insurance and if applicable, any mortgage insurance. Example: $250,000 home, $4,000 per year in taxes, $800 per year insurance with a 20% down payment with a 30 Year Fixed Rate loan @ 4% would be$1,354.83.

Costs are different from the payment.

Making a payment by transferring money to your lender doesn't mean you're actually "spending" all of that money. In fact some of it is little different than actually putting money IN the bank as opposed to giving money TO the bank. This of course is the principal portion of your payment for every month you pay, you now gain more equity. Using the example above, this alone would be an average of $294 per month for the first year and it climbs steadily from there. This brings the actual cost of your payment down to $1,061.32.

Tax Deductions.

It won't apply to everyone and some will argue that these should also be discounted by the standard deductions you may already be entitled to yet reality is that if you itemize, you can usually deduct the costs of interest and real estate taxes from your taxable income. If your effective tax rate is 29%, the payment example here would be reduced by a total of $279 per month. This brings the actual cost of your payment down further to $782.82 (avg. 1st yr. mo. Interest paid of $661 + taxes of $333.33 x 28% = $279)

Appreciation.

From the peak of the market in 2006, values just about everywhere have fallen and for those that purchased then, there may be very little appreciation to be had depending on your market. Historically, this is not the case however as over the last 50 years, the average appreciation rate across the country is over 5%. Let's be conservative and use the low end of appreciation at 3% for our example as even at that pace, the monthly value for the first year equals a tidy $625. This knocks the real cost of the payment down to a mere $157.82/Mo.

As you can see—The real cost of owning a home is far less than what the payment is. However, it is still the payment that we have to be able to afford each month as things like appreciation will only be realized when we sell, tax benefits could change in the future and there's always the expense of maintenance to be considered. Still, over time, the amount of principal you pay and price gains realized will continue to increase and this actually tips the balance from having any cost to one where you are actually making money by owning.