

Domestic Relations and Its Impact on Closing

Description

Elizabeth Libba McKenzie is a solo practitioner in the area of family law and social security disability. Her office is located in Fairfax, Va. She has represented clients in the Northern Virginia area for more than twelve years.

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I sat down with Elizabeth McKenzie (Libba), who is a domestic relations attorney in the Northern Virginia area. Libba and I discussed the impact divorce can have on a real estate settlement. She provided insight on how she approaches client relations and situations in which a home is sold as part of divorce proceedings.

Comment/Question 1:

One of the biggest challenges we face when dealing with divorcing or divorced couples is allocation of proceeds. Often times we have sellers who do not agree on how the proceeds should be split. Sometimes the disagreement is based on language in the Property Settlement Agreement (PSA) and sometimes it is simply a difference of opinion where one party is trying to rewrite the PSA. Sellers will ask us to make a decision in some cases, which we refuse to do. How do you approach the proceeds question in your PSA's? How do you prepare your clients for settlement?

It seems to me that a Seller or agent should not be placed in a position to resolve disputes that are not within their area of expertise. The PSA should be the governing document (or the Final Order of Divorce) and should be drafted in such a way as to provide the necessary direction to avoid such disputes. The PSA language should also allow for flexibility in guiding resolutions to unforeseen disputes that arise.

In anticipating the distribution of the sale proceeds at settlement, I make every effort to ensure that the language of the PSA clearly addresses the proceeds to be distributed and the order in which they are to be distributed. To that end, I customize the PSA language the parties' particular facts and circumstances regarding the sale and settlement. That is to say, I specifically draft a provision that addresses the distribution of the proceeds by setting forth the sequence of distribution: 1) commencing with payment of expenses and fees associated with settlement; and 2) debts owing on the property such as real estate taxes, liens, or other claims. Once the expenses are paid, the remaining net proceeds are divided between the owners in a manner or percentage specified by the property settlement agreement.

The language of the PSA should also provide for deficiencies or when there is not a sufficient amount of funds at settlement to pay all of the expenses and the parties. A PSA should incorporate language as to how the parties are going to resolve the shortage of funds. Will each bear a portion of the amount owed? Will one of the parties assume liability for the amount?

With regard to the process in general, my clients are prepared through our negotiation process, settlement discussions and drafting of the PSA. I ensure that their expectations conform to the language of the agreement and that each understands the settlement process. That is, clients should be knowledgeable and educated about the process and what to expect. The settlement agent is not the attorney who negotiated the agreement and clients should be aware that the agreement is the governing document and is not subject to being rewritten by the settlement agent. Nor should clients expect the agent to resolve their disagreements.

An additional area of difficulty that is related may arise when there are repairs to be done to put the house on the market and repairs subsequent to a home inspection. A PSA should plan for this contingency and incorporate a provision that addresses the types of repairs that are acceptable, a mechanism for how the parties will decide what repairs are acceptable, a method of payment for the repairs (be it from the sale proceeds or an owner), and whether or not to offer credits or setting aside funds to address such a scenario. Couples have a difficult time agreeing on repairs due to the necessity of the repair and its potential cost. A well thought out PSA will eliminate the confusion and delay of settlement.

Comment/Question 2

We also have an issue with taxes in these situations. We have to allocate tax liability between the parties. For instance, we have a 1099 that we fill out. If there are two divorced parties the allocation typically ends up being a 50/50 split. However, if the proceeds are not split 50/50 this can lead to some element of unfairness. Does this issue come up in PSA discussions? Do your clients seem to worry about this issue at all?

We as lawyers are not trained in intricate tax matters. However, we are aware that certain transactions are incident to divorce and are not subject to taxes and/or penalties, and certain other transactions are!

The sale of the marital home can expose the parties to taxes, specifically capital gains taxes. Accordingly, it is important to educate the client as to some of the tax ramifications of selling marital property. For example, when a divorcing couple decides to sell the marital home or their principle residence prior to the finality of the divorce, there is a risk that each or both will pay taxes on the proceeds of the sale. However, each spouse is entitled to exclude up to \$250,000.00 of proceeds from any capital tax that may occur, or \$500,000.00 as a couple, if they file a joint return. (See IRS Publication 523 and Topic No. 409).

To qualify for the capital gains exclusion or Section 121 exclusion, the parties must meet the ownership test and the use test. You must have owned and used your home as your main residence for a period of two years out of the five years prior to the date of sale. Notably, the residence must have been the principle residence for the couple for two of the past five years when it is sold. Therefore, the house must be sold within three years after a spouse departs the residence in order to obtain the benefit of the capital gains tax exemption as a couple.

Further, once a spouse or party has departed the marital residence and the other spouse has the right to live in the house pursuant to the divorce, as long as the resident spouse has lived in the house for two years, he or she is entitled to the \$250,000.00 exclusion. Similarly, when a spouse purchases the other spouse's interest in the marital residence, and/or receives the marital residence in the divorce settlement, the option to exclude the maximum amount of proceeds (\$500,000.00) as a couple is eliminated. Since ownership has passed from the couple to one spouse, the exclusion changes. For

example, should the owning spouse later sell the home for more than \$250,000.00, he is subject to owing capital gains taxes.

Comment/Question 3

How do you deal with household expenses in the PSA? It seems like this is especially complicated. You may have one person living in the home while the divorce is litigated. They may have to maintain the home. However, the other party may be paying the mortgage. How do you deal with this issue?

Household expenses can be a sensitive subject area; however, the spouse or party living in the home retains the benefit of such an arrangement. Therefore, it seems reasonable that they bear the burden of paying the certain expenses when living there. The PSA should contain a provision that a spouse has exclusive use and possession of the marital residence AND that he or she shall be solely responsible for payment of • . . . I insert language that requires the party living in the home to be financially liable for certain expenses, such as utilities, mortgage payments, HOA dues, real estate taxes, assessments, minor repairs, and insurance. I additionally incorporate language including, but not limited to • with respect to additional expenses in order to capture the majority of expenses that one may incur while simultaneously providing flexibility to capture the unknown expenses.

PSA language should also provide that the party paying for the mortgage will also receive credit for the payments made during the pendency of the divorce to the date of settlement. Possible provisions may include, but are not limited to, that party being reimbursed for the funds expended to pay down the mortgage or awarding a higher percentage of the net proceeds to the payor spouse or awarding the payor spouse a higher percentage of ownership. This can also be addressed as a line item in the order of distribution of the proceeds.

Lastly, a spouse should always be sure to discuss these tax implications with their accountant and/or tax preparer as a precaution!

Comment/Question 4

How big of an issue is confidentiality for you? As you negotiate with the other side, how difficult is it for you to draw the line on what you can say and what you need to keep to yourself? Did it take a long time for you to find a comfort level with this issue?

As an attorney, confidentiality is sacred. However, in the process of negotiation, your goal is to resolve the matter such that each party receives some of the benefits they were seeking and a sufficient amount of assets to begin life after divorce. There most assuredly will arise during negotiation discussions an opportunity where you will be called upon to explain the reasons why your client cannot or will not accept an offer or certain aspects of an offer. I generally am guided by the premise that honesty is the best policy. I ask myself, What would I ultimately have to explain to a Judge and how will I convey my client's reality. In explaining to a Judge, I want a Judge to connect with my client, to have compassion and to be persuaded to our position. I also am trying to persuade my opposing counsel to see my position. I may offer explanations as to why my client cannot agree that will expose some of my client's vulnerabilities. For example, if my client is financially unable to purchase the interest in the marital home from the other spouse, I let the other attorney know the reasons why, which may be that it is financially unreasonable and not a possible avenue worth developing as my client may not have the funds or the opportunity to borrow the funds. Being willing to

expose certain vulnerabilities can work in your favor. However, I would never put my client at risk so counsel must be cautious and clever as to when and what should be disclosed to the opposing counsel.

In weighing what and when to disclose information, it takes experience and the ability to ascertain the motives of your opposing counsel. Some opposing counsel are in the law as a sport and winning is all that matters. On the other hand, some attorneys are interested in truly helping a family move through the trauma of divorce and are willing to work with you in reaching a resolution. I determine what I reveal based in part on the attitude of my opposing counsel and my sense of timing, which is always key.

Comment/Question 5

I can tell you from personal experience that I have sellers who cannot agree on how the proceeds should be split well after closing. What tools do you use when it seems like there is no way to get the parties to agree?

I like to be candid and frank with my clients about the process of divorce and the likelihood of success or failure in maintaining a particular position. I want my clients to understand the various avenues of resolution, i.e., negotiation and settlement, mediation, collaborative and litigation. I view my role as that of a legal advocate, educator and counselor.

I first want to educate my client about the reality of their case. I talk my client through the legal process, the applicable law, their goals and our strategy for obtaining those goals. We discuss the likelihood of success and failure, and importantly, the cost both emotionally and financially to the client and the family.

One of my roles as an attorney is that of counselor to my client. During the divorce process, we see clients at their very worst moments; their family is being dismantled along with their finances. They worry about their ability to provide financially and emotionally for themselves and their children, if they have any. I listen, console and advise on behavior during this changing time and the importance of being able to communicate with your soon to be ex-spouse. Communication between the parties is usually damaged. One of my tasks is to coach my client in obtaining a means of communication and one that moves the parties forward.

In addition, I typically provide my client with an honest evaluation of their case, the options that are available to them, and the benefits and pitfalls of each option (negotiation, mediation, collaborative and litigation). We, the client and I, determine the primary goals and then develop together a strategy as to how to achieve it. If a client is recalcitrant and not willing to compromise, it is my duty to fully inform them of the consequences of their decision to retain an untenable position; the reasons why I advise as I do; and the possible repercussions of moving forward. I put this in writing so that the client can refer to it as they process the information and attempt to reach a decision. If the client persists in moving forward, so long as it is within the bounds of the law, I do the best I can to achieve the client's objectives. Some people just have to have the Judge tell them what it is going to be!



Donald W. Tomlinson currently serves on the VLTA Board of Directors as the Director/Editor of the Examiner Monthly Magazine. Don received his B.A/B.S degree from West Virginia Wesleyan College and earned his J.D. law degree from George Mason University Scholl of Law. Don is Regional Vice President/Attorney for RGS Title in the northern Virginia area.

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