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REAL ESTATE INVESTORS AND SUPPORT CALCULATIONS

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Real estate investors create a unique situation in the determination of income available for support due to the nature of their business. To understand how to determine their gross income available for support, one needs to understand how the business of real estate investing operates.

The usual pattern of a real estate investor is to purchase real estate with borrowed funds, putting down a small percentage and using a bank loan for the balance of the purchase. If the property is a rental property that produces cash, that cash is used to pay the mortgage and property taxes, and perhaps all of the operating expenses. If the property is sold, there are several scenarios in which the sale takes place, all of which create a different picture in a family law proceeding. They are:

1. The seller receives payment in full for the property.
2. The seller receives a percentage of the sales price in cash, and the seller accepts a promissory note secured by a deed of trust on the property from the buyer for the balance due.
3. The seller buys a similar type of property at the same time that the sale consummates. This creates a tax-free exchange, with the seller acquiring a new property with a fair market value equal to the fair market value of the property that was sold.

In the first scenario, the property is sold for cash and the seller reports the sale on his tax return. The gain is reported in full, and is “visible."

In the second scenario, the gain is less visible, as it is reported as an "installment sale.” The tax form that reports the installment sale reports all of the information in the year of sale, but after that, only the portion of the cash received that is a capital gain is reported as a gain.

Therefore, if a property cost one million dollars and was sold for two million dollars and, in the year of sale, the buyer pays the seller $200,000 in cash and $1.8 million in the form of a note payable, in the year of sale, all of this information will be reported. The tax return will show that the gross profit is fifty percent (50%). Therefore, of the $200,000 received, $100,000 will appear on Schedule D as capital gain.

In the following year, assuming seller receives $200,000 in payments on the note, of which $180,000 (at 10%) is interest, the seller will report $180,000 of interest income and 50% of the principal received, or $10,000, as capital gain.

Therefore, while the property sold for a profit of one million dollars, that gain of one million dollars will appear on the tax return over a period of many years, usually in relatively small amounts because the reporting of gain follows the actual receipt of cash.

Potentially, a real estate investor involved in a family law support matter, could claim that over the past two years, he/she only earned $110,000 of real estate income (100,000 in year one, and 10,000 in year two) plus $180,000 of interest income. It is for the opponent to prove that really one million dollars was earned from the real estate investment, in addition to the interest income.

In the third scenario, the investor does not report a sale or gain at all, although the investor sold his/her property for a one million dollar profit, because the investor used the two million proceeds to buy a new property. The investor's net worth increased from one million to two million, but that information is "somewhat invisible”. No gain is reported on the first page of the return, no gain is reported on Schedule D, the form that reports capital gains, and no gain is reported on Form 4797, the form that reports the sale of business properties. Instead, the exchange is reported on Form 8824, which is usually attached to the back part of the tax return, and simply reports information about the exchange. This writer has seen tax returns from entities, that claimed to have arranged a tax-free exchange but did not attach Form 8824 to the back of that entity's tax return. Quite often, the exchange is "completely invisible.”

In the second year of sale, the investor, during discovery or a court proceeding, could claim that over the past two years, there was no income earned at all from real estate. If the investor did not file Form 8824, or if the form was removed from the copy of the tax return presented, the fact that a sale occurred may be missed.

Refinancing of real estate creates special problems in family law matters. Imagine a real estate investor who buys a property in **1990** for one million, using cash of $200,000 and a loan from the bank for $800,000. In **1997**, the property value increases to $2.0 million, and the investor refinances the loan for a new loan of $1.8 million. The first loan that was originally $800,000 is paid off but the investor keeps the extra one million plus. On the 1997 tax return, there is no gain or loss reported, because no property was sold, but the investor has one million dollars in cash that he/she never had before. Again, during discovery or a court proceeding in 1997, this investor might contend that he/she had no income over the past 7 years and will present his/her tax returns as proof. The investor who now has one million dollars in cash, will claim that it is from a new loan making it borrowed money, not income.

If, in year **2000**, the investor sells the property for $2.0 million, escrow will pay off the deed of trust in the amount of $1.8 million, pay the closing costs and commissions of about $125,000 and hand the investor $75,000 net proceeds.

Although the investor has to report a gain of one million in the year 2000, he/she will produce the escrow statement showing a receipt of only $75,000.

The net result, in the above example, is that in the year **1997**, the investor will say that no income was earned and that the cash received was all from borrowed money which should not be considered "income" available for support. In the year **2000**, the investor will say that while a gain of a one million dollars was reported, there is no cash available to pay support because the one million received back in 1997 was invested, leaving him/her with only the $75,000.

Therefore, the investor who had a net worth of one million in 1990 and a net worth of two million at the end of 2000, might attempt to convince the court that only $75,000 was earned over the past 10 years.

To determine the actual income available for support, one has to look at the big picture when dealing with real estate investors. If you look only at the last twelve months of reported income, there is a great probability of error. It is similar to looking at the last twelve months of reported income of a famous actor who makes one movie every three years and the last twelve months was an "off year." With such an actor, one should average the gross income over the last three years, or over the last six years, or over the last nine years - but always in three-year groups. With real estate investors, one often must even go beyond that.

To determine the gross income available for support from real estate investors one must use a combination of approaches.

The first approach is to determine the net worth at the beginning of a period and to determine the net worth at the end of the period. The difference is part of the picture of the gross income during that period. Keep in mind that income is simply another word for "increase in net worth". If a person had a net worth of $100 and then worked for a day and earned $50, his net worth at the end of the day would be $150. If he did not go to work the next day, and instead spent $40, his net worth at the end of the second day would be $110. The gross income is determined by determining the increase in net worth - $10 - and then adding that which was spent - $40, to arrive at a total of $50 earned. Similarly, if a person's net worth was $5 million in the beginning of 1990 and is $10 million at the end of 2000, then his income was five million plus whatever was spent during that time period.

The second approach is to take the entire current fair market value of the estate and calculate a reasonable rate of return on that estate. A recent case - ***In Re Marriage of Destein,* 111 Cal. Rptr. 2d 487**- affirmed a method whereby the estate was considered sold and the after-tax dollars were then invested at a safe rate of return. The court in that case said, "*We do not find that this is the only method of determining the earning capacity for the non-income producing assets, or even, that it is the best. It is reasonable, and so, we sanction its use.*"

If the investor had a portfolio of real estate that was worth ten million dollars, and he/she did not sell it during a time period in which certificates of deposits were earning 6%, then it is clear that the real estate investor expected to earn more than 6% on the real estate. One simply has to look at very low risk alternative investments to determine the floor rate of return expected by the real estate investor. The alternative low risk rate of return times the value of the estate should be considered the *minimum* gross income available for support.

The third approach is to review the lifestyle of the parties. If the parties spent $500,000 per year, somehow, from somewhere, then any claim that the cash flow from the real estate business is only $100,000, for example, is highly suspect. People often spend only part of their income, and invest the rest, so lifestyle alone is usually only part of the total income, but it is a gauge for the minimum amount of income.

The fourth approach is to present the sales and refinances of the last few years, showing the cash flow from the sales and refinances. This is not necessarily indicative of anything, since the investor may have simply been somewhat inactive, without any refinances or sales, but the determination should be done, if possible.

After putting together the results from all of the above approaches a picture usually develops that produces a reasonable and fair result.

To illustrate and summarize the above, in an actual Los Angeles county case, the husband reported $150,000 annual income on his income and expense declaration. However, we discovered that his net worth increased $15 million over the past ten years. An analysis of the personal lifestyle indicated that $800,000 was being spent annually. Husband's current estate would earn one million dollars per year if invested at a very conservative rate of return. The trial court found husband's gross annual income available for support to be $1,000,000, not $150,000 as claimed.