

How to IPO Your House

Sweating your mortgage? Maybe it's time to bring in friendly outside investors. By *Stephane Fitch*

ARE YOU SCROUNGING for ways to cover your mortgage? Dining at home, dialing down the thermostat and visiting relatives on vacation will get you only so far. Maybe you should steal a play from Wall Street's book: Reduce your debt by raising equity from an outsider.

You are a candidate for this kind of deal if your house is worth less than it was when you last refinanced, yet you still have a decent amount of equity left. For example, you have an \$800,000 mortgage on a house that used to be worth \$1.4 million but is now worth only \$1 million. Your outside investor might put in \$200,000 of cash in return for a 50% stake. You refinance, replacing the big mortgage with a new one for only \$600,000, with more affordable payments. Your new co-owner will get half the take when the house is sold and the mortgage paid off.

Who might this outside investor be? A relative, probably. If the investors are your parents, they may be planning to pass wealth on to you but are not flush enough, or inclined, to grant a cash bailout now. Instead, present them with an investment opportunity that includes some nifty tax advantages.

"Even parents who want to help their children don't want to just give wealth

away," says Avi Z. Kestenbaum, a tax and estate attorney in Mineola, N.Y.

Last year David Keator, a financial advisor based in Lenox, Mass., began helping a retired client bail out a young niece and her husband. The couple had purchased a \$230,000 home in western Massachusetts a decade ago. They then set about loading up on home equity loans and running up large credit card debts during the housing boom. Recently they've struggled to service their \$250,000 in total mortgage debt.

The uncle had already set up a trust to benefit his niece in later years and could have opted for the trust to make an immediate cash gift to her. However, he considered the option laden with the same moral hazards as every other bailout. He also feared that if the young couple broke up, a cash gift could end up enriching a former nephew-in-law. The uncle was also keen on keeping the trust growing.

He settled on directing the trust to enter a sale-leaseback with his niece. The trust will buy the couple's home for its estimated market value of \$300,000. It will then charge the young couple rent at the low end of the range that local realty agents said the house would fetch on the market. Their new rent will be a fraction of the aftertax carrying cost the young couple is paying as owners. They will also

use some of the \$50,000 netted from the sale to retire credit card debt and fund a savings account.

The uncle's largesse comes with a potential tax downside. Since the house is held free of debt, the rent may exceed the remaining deductible expenses—property taxes, insurance, operating costs and depreciation. Because a "grantor" trust has already been established, the uncle would have to personally pay tax on the surplus as ordinary income. On the plus side, if the couple's finances improve, they will have the option of buying back the home.

If your rich relative isn't quite so generous as this uncle, try offering him or her an attractive investment return. Suppose the house you bought for \$1.4 million a few years ago is now worth \$1 million. Your \$4,800 monthly payments have barely begun to pay down your \$800,000 mortgage. With your finances pinched elsewhere as well, your spouse and you decide a \$3,600 monthly mortgage payment is all you can afford. To get there, you need to retire your \$800,000 mortgage and replace it with a \$600,000 one.

To raise the necessary capital, you turn to your well-to-do brothers, each willing to invest \$100,000. You use their \$200,000 to replace your old mortgage and take out a new \$600,000 one with a 30-year fixed

rate of 5.1%. This will result in your reducing payments below your desired \$3,600 monthly target.

Your \$1 million house now has \$400,000 worth of equity—half of it yours and the rest split between your brothers.

What's the upside for your siblings? Assume that starting this year your home appreciates 5% annually and recoups its original \$1.4 million value in 2017. That means that, thanks to the magic of leverage in a rising market, your brothers' investment will have doubled in value to

\$400,000, representing a return of 10.4% per year. If at that point you buy them out, your brothers will be liable for only long-term capital gains taxes on their profits (likely to be 20% or more by then). In the meantime you will have covered the full mortgage, property tax and upkeep yourself. But that's not a bad deal because you are enjoying 100% of the lodging.

If such prospects aren't sufficient to entice them, tax attorney Kestenbaum proposes offering your brothers a creeping claim on your equity. You start as 50-50 partners, but your brothers' stake grows 2.5 percent-

age points a year, and yours shrinks accordingly.

In year one this transfer of equity would be worth around \$10,000 to your brothers, or roughly what they could earn on a mix of medium-term Treasuries. Under this scenario, if your home's value recovers to \$1.4 million by 2017 your brothers' combined 67.5% equity stake would be worth \$540,000, giving them an annualized 15% return. Your 32.5% stake would be worth \$260,000, representing a 3.8% return.

There's a tax advantage here for them, too: Their profits will be taxed as long-term capital gains rather than at higher federal income tax rates. You, on the other hand, would have an incentive to refinance quickly, buy out your brothers and pocket the gains.

Say housing in your area flatlines and in 2017 your home is still worth \$1 million. Your brothers walk away with a 4.4% annualized return. You would suffer the fate of watching your initial \$600,000 investment wither to a mere \$130,000. You'll have to measure this potential investment pain against the value of having had a place to live and \$130,000 in debt service (gross, before tax benefits) avoided on your original \$800,000 mortgage.

If you have no family members to hit up, consider EquityRock. The San Francisco financial boutique is willing to offer up to 15% of a home's value to owners with at least 20% equity. EquityRock requires that part of its investment be used to pay down mortgage debt and that you promise to return its principal and cash equivalent to roughly half of any change in value (gain or loss) within ten years.

That would leave EquityRock with pretty nifty gains in a rising market. Perhaps, then, it's a bullish sign that even the company's chief executive, Thomas Spoonholtz, admits he's had few takers lately. **F**

