Six Ways To Protect Yourself During The Upcoming (Likely) Real Estate Correction

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Apr 22 · 5 min read

Nadine Lewis, a top real estate attorney in Los Angeles, says that all signs point to a correction in real estate prices either later this year or certainly next year. After having represented hundreds of homeowners who were wiped out by the 2008 real estate crash, she says she's seen this movie before.

"It was the most stressful time for my clients — and for me — when the market crashed," she says. "People were losing their homes left and right. Our office was literally calling the banks three times a day to make sure that there were no new foreclosures for our clients. It was crazy. Everything I'm seeing suggests that, while we're not looking at anything nearly as severe as last time, the inevitable correction is coming. So the question is, what can you do to be prepared for it?"

Lewis has worked as a real estate litigator, working with homeowners who were being taken advantage of by the banks, and she also has put venture capital deals and multi-party investment transactions together, as well as doing commercial leases, tenant deals, and pretty much anything else related to real estate and law. So it's fair to say that she's seen it all.

"A lot of economic indicators that were present in 2008 and 2009," she says, "when the real estate market crashed, are present now. Everything cycles. There will be a correction. There's a lot of uncertainty with what's going on in Washington, tax laws are changed, and it's just a question of cycles."

Lewis offers six thoughts about how to keep from getting into trouble if and when the correction occurs.

"Most of the people who lost their houses in 2008," she cautions, "either were taken advantage of by banks and mortgage brokers or they just didn't understand that if the market crashed and they had refinanced, that their property would have no value."

Lewis says that leaving equity in your house is the smartest thing you can do.

"It's really the saddest thing," she says, "when you see people who were pretty conservative when they bought a house, and then they either got into trouble or they wanted to remodel, or help a child with school, or God forbid someone got sick. They were able to refinance, but then they got in trouble when the market crashed because they had no ability to refinance then, or get a lower rate. So even if you can, don't do it. If you don't leave equity in your house, then your house will have no value if you have to sell in a hurry."

2. Don't get bitten by the "phantom income" tax.

Let's say your bank offers you loan forgiveness — your house was worth a million dollars, and it went down to $800,000. So your bank will restructure your loan on the fair market value. You feel as though you're better off, right?

Wrong. From the perspective of the IRS, that $200,000 the bank lopped off your loan is treated as actual income…and you have to pay taxes on it.

"At the end of the year," Lewis warns, "you'll get a 1099-C from your bank because they charged off the $200,000 in debt. So the IRS sees that as income, even though you didn't get any money. Loan forgiveness equals income in the eyes of the IRS. We started doing a lot of offers and compromises with the IRS after the crash. Maybe 25 or 30 a year back then, because people simply didn't have the money to pay taxes on that phantom income."

3. Short sales are not a cure-all.

A "short sale" is a situation where the bank literally "comes up short" — the money received from the sale of the house does not equal all of the expenses that need to be paid off at the time of closing.

"Let's say your house is worth $800,000," Lewis says, "and your loan is for $800,000. You're home free, right? Actually, you aren't. Closing costs can be up to 7.25% of the sales price, so not only will you have to pay that off immediately, but it will also affect your credit for seven years. It becomes a devastating long-term effect. So don't think a short sale solves everything. If you do a short sale, there will be unexpected financial consequences that you might not even have considered." However, a short sale is much better than doing nothing and allowing your house to foreclosure.

4. Right now, only flip houses if you're a pro.

Lewis says that it's fine for builders to buy houses and flip them, because builders are savvy, they know their margins, and they'll probably be able to sell their houses for a profit.

"I don't think it's the time for inexperienced people who want to flip houses to get into the market," she says. "If you're buying a home and it's going to be a long-term hold, it's a great investment. But what happens if the market corrects as I expect it will, and there you are with a house that you were hoping to unload? Guess who's holding the bag."

5. If you need a house, then buy it.

"Real estate is always a great investment, no matter what's happening with the market," Lewis says. "If you're walking around eight months pregnant and you've got the money in the bank and you're ready to buy a house, then you should buy your house. Once the market drops, it actually becomes even more competitive to buy. When I was negotiating short sales, sometimes you would have 70 or 75 offers on a single house. If you're not a cash buyer in that market, you won't even be looked at."

"But it's always a good time for a family to buy a home. That's never going to be a bad investment if you're holding it for the long term. So if you need a house and you can afford it, buy it now. It might go down in value temporarily, but what do you care? You're there for the long term. It will definitely go back up over time."

6. Look into "Opportunity Zones."

Opportunity Zones are new IRS regulations that allow individuals to invest in areas like inner cities or rural communities where investment is sorely needed.

"If you put money into one of these Opportunity Zones," Lewis says, "and you hold it for ten years, you're not going to pay capital gains tax on your profit. This just took effect in October 2018, but it's something to watch and discuss with your CPA or attorney. This is a significant benefit for all investors — it's a great way to increase your net worth by avoiding capital gains, and it also help communities that really need investment.