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REAL ESTATE LAW UPDATE

WHAT IS THE HOMESTEAD EXEMPTION, HOW DOES IT WORK, AND WHAT HAS CHANGED?

By Nathan Hannah

I have been getting more questions lately about the homestead exemption. Most homeowners have probably heard of it, but it's likely that many don't fully understand how it works. After the Arizona Legislature made changes to it in their most recent session, I'm not even sure that I understand some of the fine details.

What is the homestead exemption? Under current law, the homestead exemption protects up to \$150,000 of equity in your single family residence, condominium, co-op apartment, or land with manufactured home, from the claims of creditors (with some important exceptions that I will discuss in a moment). If you own your home without a mortgage and its current market value is less than the exemption amount, it is completely exempt from claims of your creditors. If you own your home without a mortgage and it is worth more than the exemption amount, your creditors can take the excess over the exemption amount to satisfy your debts, but you get the exemption amount. If you have a mortgage, the difference between the value and the mortgage balance (your equity) is exempt from creditors' claims up to the exemption amount. The changes by the Legislature, which will take effect on January 1, 2022, include an increase in the exemption amount to \$250,000.

To fully explain how the exemption works, a little background on the debt collection process is necessary. If a creditor files a lawsuit against a debtor, the creditor's objective is to obtain a judgment against the debtor. If the judge rules that the debt is legally owed, a judgment is entered

against the debtor. After obtaining the judgment, the creditor will usually record the judgment in the office of the county recorder of the county where the debtor lives. Recording the judgment creates a lien (a "judgment lien" in lawyer lingo) against any real estate the debtor owns in that county.

The creditor can enforce the judgment lien by either undertaking the legal process for a sheriff's sale of any real estate the debtor owns, or waiting until the debtor sells any of his real estate. Now, let's assume that the judgment lien is \$100,000, the only real estate the debtor owns is his home, and the home is worth \$200,000. If the home is sold at a sheriff's sale, or if the debtor sells the home while it is subject to the judgment lien, the creditor gets only \$50,000, while the debtor gets the remaining \$150,000.

The debtor's \$150,000 remains exempt from the judgment lien (and the claims of any other creditors) as long as he invests the money in a replacement homestead (residence) within eighteen months. In our example, then, he still owes the creditor \$50,000, but the creditor can't collect the remaining debt from a sale of the debtor's home.

The changes that the Legislature made earlier this year, which take effect next year, did two things, as I understand it, in addition to increasing the exemption amount from \$150,000 to \$250,000. First, they set up a process for creditors to collect debts from the proceeds of a sale when there are proceeds in excess of the exemption amount. Second, they made it clear that if a debtor obtains cash from a refinancing of the debtor's home, that cash is not protected by the homestead exemption.

As I have said many times before in this space, the explanation in the above paragraph is my attempt to provide an understandable description of complex law. A lawyer who specializes in debt collection law should be consulted if those circumstances may apply to your situation.

In years past, in order for a homeowner to assert his or her rights under the homestead exemption, it would have first been necessary for the homeowner to record an affidavit declaring that the home was subject to the homestead exemption. It was usually referred to as a declaration of homestead. The requirement that a declaration of homestead be recorded in order to claim the homestead exemption was done away with many years ago, although you can still do it (or a creditor can demand that you do it) if you own more than one house and it isn't clear which one you claim as your residence for purposes of the homestead exemption.

In the above example I assumed that the debtor's home had no mortgage on it. I did so only to keep the explanation simple. The presence of a mortgage doesn't change how the homestead exemption works. The exemption attaches to the debtor's equity, that is, the difference between the value of the property and the amount the debtor owes on the mortgage.

There is an important distinction between a mortgage and a judgment lien. If the debtor's equity in the homestead is less than the exemption amount, the homestead exemption prevents the creditor from using a sheriff's sale to satisfy the judgment lien. If the debtor doesn't make his or her mortgage payments, however, the homestead exemption doesn't prevent the mortgage lender from forcing a sale of the property to satisfy the mortgage. The distinction arises from the fact that the mortgage, unlike the judgment lien, is a consensual lien, meaning that it was placed against the homestead property with the consent of the debtor. The debtor agreed to let the mortgage lender place the lien against the homestead property in exchange for the mortgage loan, so the debtor shouldn't then be able

to claim that equity in the property is exempt from that lien.

Another example of a consensual lien (although it may not seem like one) is a homeowners' association lien. When homeowners' associations became unpopular several years ago, legislation was proposed to restrict the ability of homeowners' associations to enforce their assessments by making liens for those assessments subject to the homestead exemption. Such a law would be contrary to the concept that the homestead exemption is ineffective against consensual liens. A lien for unpaid homeowners' association assessments is consensual because the homeowners agreed to such a lien when they bought a house in a subdivision governed by documents granting such a right to the association. If the homestead exemption did apply to homeowners' association liens for unpaid assessments, the practical effect would be to severely limit a homeowners' association's ability to collect unpaid assessments from homeowners who have less than the exemption amount of equity in their home.

Aside from consensual liens, two other important categories of liens that the homestead exemption doesn't cover are child support and tax liens. Not surprisingly, legislators don't want to make most taxpayers' largest single asset exempt from the collection of taxes or child support. So if you don't pay those obligations, the authorities can in most situations put a lien on your house and enforce that lien without regard to the homestead exemption. The legislature can do this because they make the rules on both the homestead exemption and the collection of child support and taxes.

So if you live in a neighborhood that is governed by an association, you can't rely on the homestead exemption to protect your home if you get behind on the assessments. Also keep in mind that the homestead exemption will not protect the equity in your home if you get behind on taxes. But even if you have never recorded a declaration of homestead, the exemption amount of equity in your home (\$250,000 as of January 1) is protected from creditors by the homestead exemption.