Considering Divorce? Beware the Financial Pitfalls

Steve McBride, Certified Divorce Financial Analyst.

You have probably heard the horror stories.

- When she reached retirement age, she did not receive the portion of her ex husband's pension that was agreed in the divorce 15 years earlier because the documentation had not been done properly with the pension company.
- The IRS did not allow six years of maintenance as a tax deduction because it was considered by the IRS as a payment in lieu of child support. Thus, the payor had to repay the amount of the deduction over the 6 years.
- A husband paid a large but rapidly decreasing amount over three years in maintenance, and was denied the tax deduction by the IRS.
- Maintenance and child support were agreed and being paid, but the husband died two years after the divorce and there was no life insurance to cover the payments, leaving the ex wife with three children ages 5, 7 and 9.
- In the property settlement of a 30 year marriage, the wife retains the house worth $1.2 million, but when she sells the house 3 years later, finds she has an unexpected $180,000 capital gains tax bill to pay.
- A wife receiving maintenance was not told that she would have to pay income tax on it, and thus found at the end of the year that she owed the IRS $10,000 in income tax which she did not have.
- The husband was to receive half of the wife's pension of $60,000 per year, but she died and had not specified survivor benefits on a shared interest pension division, so all of the pension reverted back to the pension company upon her death.

The financial aspects of a divorce settlement can be complex. Following are several areas to which should pay special attention, perhaps with the help of a financial advisor.

Insurance. Life insurance should almost always be purchased to protect child support, maintenance payments, and property settlement notes in case of death of the payor. Health insurance premiums are expensive, so they need careful consideration when budgeting for the future and when deciding who is going to pay for the children's health insurance coverage and non-covered health costs

Tax issues related to maintenance and child support. Maintenance is tax deductible for the payor and taxable as income to the payee. Child support is neither tax deductible nor taxed as income. Normally this is not a problem, but the IRS has set up some rules to keep people from playing games with it. For example, instead of a property settlement at the time of the divorce, some spouses will want to pay out the property settlement over 2 or 3 years and call it maintenance so that they the tax deduction. There is an IRS rule that makes doing this difficult if the maintenance payments decrease too quickly over the three year period. Similarly, maintenance that ends within 6 months of key dates related to the children (birthdays, leaving school, etc) can be considered child support rather than maintenance, thus losing the tax deduction.

Equitable Division of Property.

Generally, property obtained before the marriage is considered separate property and can be excluded from the division of marital property. Property obtained during the marriage, and gains from separate property accumulated during the marriage, are normally considered marital property. Division of the marital property does not necessarily have to be 50/50 if this is not considered to be equitable. Also, you will want to consider the tax implications of different types of property. Qualified retirement accounts will not be worth their face value because income tax will need to be paid on the proceeds when money is taken out. A house may have capital gains tax that needs to be paid at the time of sale if the seller has exceeded their capital gains exclusion.

Retirement Plans and Pensions.

Division of retirement assets can be complicated and often are the largest category of assets in the marriage. One should be cautious not to give up retirement plan assets in exchange for the family home. Houses cost money to run and may be a luxury that you cannot afford. Retirement assets can be difficult to replace on limited income and are critical to long-term financial health.

Once you have identified all of the retirement assets, whether pension funds or 401(k)s or deferred compensation plans from various employers, or Individual Retirement Accounts, then it is a matter of working out their value. For defined contribution plans, such as 401ks and IRAs, you can obtain up to date statements of their value. Pension plans, or defined benefit plans, generally require a valuation. Federal government, military, local government and union plans have their own rules and can be tricky to deal with.

IRAs can be easily divided through the transfer from one spouse to the other's qualified plan, but this must be done properly to avoid penalties or taxes.

401(k)s and traditional pensions must have a Qualified Domestic Relations Order prepared. This is a formal order from the court that tells the plan administrator what the divorce agreement has stated regarding the division of these assets. It must be done very carefully as errors in the QDRO can result in unexpected consequences for one or both of the parties. For example, most plans can be divided as a separate interest or shared interest QDRO. In separate interest division, each spouse gets a separate interest of the pension fund and the resulting annuity is based on their individual circumstances, such as age and when they decide to start drawing their pension. In a shared interest division, the pension value and decisions regarding the payout of the pension are based on the age and retirement date of the pension holder. This can be a problem if the pension holder decides not to retire and thus not allowing the ex spouse to obtain his or her pension payout. Equally troublesome is when survivor benefits are not taken into account in a shared interest division and the pension holder dies prematurely.

Seek professional help. The financial issues of divorce can be complicated, and many attorneys are not as familiar with the complexities of the financial issues as are financial analysts and planners. Financial professional are able to take all the issues into account, project cash flow and net asset scenarios, and help both parties to really understand the financial implications of the decisions they are making as part of the settlement process.

Steve McBride, MPIA, CDFA, is a Certified Divorce Financial Analyst based in Greenwood Village. He can be reached at 720 404 1607 or through his web site, www.DivorceFinanceColorado.com. .