How Will Divorce Affect Your Financial Future?

By Bob Burger, CFP®, CDFA™

When a couple decides that divorce is in their future, they typically know how to proceed with the legalities. When it comes to an economic perspective, however, many questions arise that can impact their financial future. Will one person want to keep the house, rather than selling it and splitting the proceeds? How should retirement accounts or pension plans be divided? How might one's living expenses and lifestyle change after the divorce papers are signed?

Divorce brings with it a wide range of emotions; and making major financial decisions in the throes of emotional upheaval invites disaster. It's important to take a step back and objectively review one's current financial landscape before signing divorce agreements. Working with a qualified financial advisor, such as a Certified Financial Planner™ or a Certified Divorce Financial Analyst™, can help dilute emotional reactions and help ensure that important considerations are not overlooked.

Having realistic financial expectations will help move the process along and help create a solution that is equitable to both parties.

Whether assessing the financial considerations on your own or with a professional, begin by taking inventory of the assets involved in the divorce process. Assets may include house(s), financial accounts (savings, checking, taxable and retirement plans) as well as automobiles and other household items. Next, consider the liabilities that will be involved such as mortgages, credit cards and other debt, living expenses, and possibly the costs associated with raising children or rejoining the workforce.

Pitfalls to Avoid

Going forward, there will be two households to fund rather than one. A common mistake that couples make is underestimating the cost of their post-divorce lifestyles. This goes back to having realistic expectations, but it also can be difficult to measure because individuals often change or increase their spending habits after a divorce. They may either spend to make themselves "feel better" or spend more as they rejoin the single lifestyle.

Another potential pitfall can be the desire of one spouse to keep the house without considering the cost of maintaining it. Most people consider the mortgage, insurance and taxes, but overlook other costs such as cleaning, yard work and large-scale maintenance or repairs. If one spouse is going to keep the house, a detailed projection of current and potential future costs should be considered.

One surprise that can come up when a party decides to keep the house is the potential to have to reapply for a mortgage as a sole owner with one income (at potentially different interest rates than the current mortgage). Another constraint that may be overlooked is if, during the divorce process, the parties decide to keep the house in both names. That decision can come back to haunt the couple when one person wants to later sell the house and the other does not. Deliberation about this potential hurdle, prior to signing the decree, can save a potentially costly trip back to court.

When considering whether the settlement will enable each spouse to maintain the desired lifestyle, it is important to use "net" numbers rather than "gross" data. An example would be an arrangement where one spouse receives a taxable investment portfolio of $500,000. Without looking too deeply, one might assume that the spouse could sell the portfolio and raise $500,000 to cover living expenses (barring any market movement). However, there is the potential that the portfolio has a cost basis (cost of original purchases) of less than $500,000. For this example, suppose the cost basis of the portfolio is $400,000. When selling the assets, Uncle Sam will want to collect his portion of the gain through capital gains taxes. There will also be transaction costs, but these should be small in today's market.

The previous example can also apply to the sale of a home. Although the home may currently be valued at $500,000, suppose it was originally purchased for $150,000 many years ago. The difference of $350,000 will be subject to taxes as a capital gain. Under current tax law, the couple would be exempt from paying taxes on any gain less than $500,000 (with specific limitations). The single taxpayer only has an exemption of $250,000 and would therefore pay taxes on $100,000 (again, with certain limitations). Realtor fees, closing costs and potential repairs would also take away from the potential proceeds.

If a spouse is receiving alimony, it's important to remember in many cases it is taxable income. This is important when considering lifestyle expenses. Again, it is the net figure that needs to be considered, not the gross amount.

Potential Opportunities

An often overlooked opportunity is the ability to remove money from a tax-deferred account without the early-withdrawal penalty in certain circumstances. If the parties are splitting retirement accounts, they should consult their tax, legal and financial consultants to ensure the transaction is done properly.

Although this transaction is complicated, here is a relatively simple example. One spouse has a retirement plan valued at $400,000. It is decided that the account should be split so that each spouse receives half. Let's also assume that the receiving spouse needs this money for living expenses and is younger than 59 ½ years. In certain cases, the money can be removed from tax-deferred status without penalty for early withdrawal; however, income taxes would still apply.

If the money from the account is "rolled" to another tax-deferred account and six months later the receiving party needs to withdraw that money, he or she would have to pay income tax, as well as an early-withdrawal penalty. Thus, thoughtful advance consideration of future financial needs and current tax laws is critical.

Maintain Perspective

The only guarantee with divorce is that things will change. And change can bring a wide range of emotion – from fear or anger to relief and excitement. Maintaining an objective perspective on financial matters can help keep such emotions in check and help safeguard one's financial future.

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