HIGHTOWER
Westchester

Costly Mistakes to Avoid in a Divorce

Very few divorces are "easy". There are emotions involved; when children are included, the process only becomes more complicated. And for couples in a high income bracket, or those with complex investments or privately held businesses (just as examples) – divorce can be drawn out for months, even years – at great expense to the couple involved.

You've heard the expression "choose your battles"? It's a good one to remember when weighing the costs of fighting (emotional costs as well as financial). Are the things you are fighting for going to cost you more in the long run?

Creating financial settlements within the divorce process also has the added layer of permanence: if something is missed during the initial discussions and the divorce is finalized, it can be difficult (and exponentially more expensive) to go back and revise any agreements.

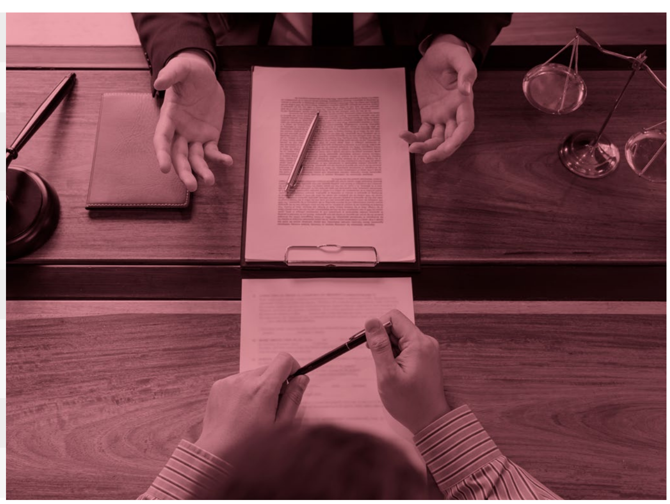
One of the first calls many divorcing couples make is to attorneys, and that is often appropriate. However, it makes sense to also involve a financial advisor from the outset; many divorce attorneys, in fact, have specific advisors they work closely with and vice versa, so either are a good place to ask for a referral to the other.

Complex financial situations may require bringing in professionals for business valuations, forensic accounting, and more. In this paper, we will look at several financial situations that would merit greater expertise than an attorney may be able to provide. We are happy to discuss these situations at greater length, if it is helpful to you.

Complex Income Structures

Determining a financial settlement incorporating splitting of assets, alimony, and child support – while certainly not easy – can be fairly straightforward, in part because many of these splits are driven by formulas. Attorneys work within these formulas and guidelines every day; they know where there is wiggle room and where a judge will not give. However, the situation is different when one of the spouses has a non-linear compensation structure—for instance, partners at various businesses who often have multiple layers of compensation:

BASE SALARY
CASH BONUSES
CO-INVESTMENTS Equity stakes in underlying investments
STOCK INCENTIVES Private or public
DEFERRED COMPENSATION PLANS
RETIREMENT PLAN CONTRIBUTIONS & MATCHES
INTERNATIONAL ASSETS
COMPLEX TRUSTS



Simply following formulas in this case may be a very unbalanced approach; this is a situation for which the involvement of a financial advisor who understands these types of compensation arrangements can be helpful, to model income projections and suggest a settlement fair to both parties.

One additional consideration: for some high-net-worth couples, the formulas may become less prescriptive – especially if one spouse is working with an attorney particularly skilled in pushing for alimony or spousal support beyond guidelines. Put simply, it's important to know the type of lawyer the other side has, and prepare adequately; this may be a good conversation to have with a financial advisor who likely has referrals based on different circumstances; advisors know all divorces are not the same.

Private Investments

Private investments include a number of different situations; some more common examples include:

One-off investments to family or friends	Direct investments into companies	Residential or commercial real estate	Private equity or hedge funds

There are a couple nuances to these investments which bring them beyond the straightforward (i.e., you can't simply ask for an up-to-date account statement like you might for a bank or brokerage account). It is important to gather a detailed inventory of all these one-off investments.

Almost always, these investments have stale valuations and/or are difficult to value; if valued incorrectly, you are losing out on a source of income for which you were part of the initial investment. Likewise, they can be difficult to split, so there is discussion involved in who takes what—and what do you get in lieu of the investment. In addition, you might be subject to asymmetrical information regarding these types of investments; your spouse may say "that's not worth anything" and you may not know any better, so agree.

Having an initial list of what you believe is out there is a good starting point for discussion with your attorney.

Some spouses think that they can simply transfer their valuable assets to a third party such as a business partner or child from a former marriage. These kinds of transfers can, and usually are, seen as fraudulent, thus impacting one of the most important factors in a courtroom: trust and credibility. if you believe you are in a situation that one partner is hiding assets, you will definitely need the assistance of an attorney and the experienced professionals they would recommend. Forensic accountants can help uncover hidden assets, business evaluators can assess commercial holdings and vocational experts can help determine whether support should be awarded to a non-working spouse.

Business Owners

Spouses who are business owners warrant special attention. The spouse who is not the owner is at a disadvantage in being able to properly value the current and future prospects of the business; there is a natural incentive for the owner to undervalue the company. Many times, depending on the nature and size of the business, a business appraisal will need to be retained.

And not all businesses are created equal. For instance, is a consulting business with no assets other than the owner's contacts and relationships by definition of no worth? That's a difficult argument for the owner to make if he or she has been generating an income on which the family depended; valuing such a business might take into account long-term contracts, past revenues, and a myriad of other factors.

Once a fair valuation is ascertained, what to do with the valuation also poses many challenges. It may not be feasible to simply split the business down the middle with the owner paying out half the value, if it will cripple the ongoing success of that business. It's also rarely advisable for ex-spouses to continue to act as co-owners of the business, as there are too many chances to act in bad faith and hurt the business.

Retirement Accounts

Because of tax implications, splitting retirement accounts isn't as simple as adding up the totals and dividing in half. In some cases, couples choose to use retirement accounts as an offset for another asset — i.e., keeping a retirement account whole and offsetting that by forfeiting a share of the family home. When they are split, it is done by qualified domestic relations order (QDRO), which is an evaluation of the assets, a split of said assets, and payment of one share to the other party's retirement account without triggering tax consequences.

Oftentimes, splitting retirement accounts by QDRO can take a significant amount of time to be fully transitioned to the other spouse's name. During this time, the market is still open and trading daily. If the verbiage of the QDRO, and ultimately what gets submitted to the plan administrator for processing, does not incorporate market return, you could leave a lot of money on the table.

In dealing with QDRO's, the goal should be to resolve the QDRO during the court process while everyone is motivated to work together for an overall resolution. The QDRO submission process becomes more complex as time goes by with various changes that may occur that could impact the benefits awarded such as market gains/losses, employment changes, unexpected life changes such as death or even remarriage that impacts beneficiary status and survivor benefits.

Lastly, if you are taking a retirement asset and your partner is taking a taxable asset, you have to account for the difference in taxes and liquidity. A retirement account is generally not liquid unless you are 59.5 or older and can avoid the 10% penalty. Even then, every dollar from a retirement account (unless it is a Roth vehicle) is taxed as earned income. For example, 500k in a 401(k) is really more like 350k after accounting for 30% in taxes.

Additional Financial Hurdles

Keeping the Primary Home — The Importance of a Plan

Often, women want to stay in their pre-divorce home, particularly when there are children involved. There's a lot of upheaval and moving only adds to a chaotic situation. However, the home is very often more expensive than can be afforded on the new solo budget, which can cause a cash strain.

This can lead to bad long-term financial decision making; for instance, if the homeowner chooses to dip into savings. If the only source of savings is retirement, the homeowner can get hit with penalties and taxes on each withdrawal, making it a very expensive source of funding. Furthermore, gambling against the future to pay for immediate expenses is not a good long-term OR short-term strategy. Beyond that, homes are also traditionally not a highly appreciating asset. All the sacrifice to stay in the home can come at the cost of keeping an asset that might not serve the owner as well as other assets would have leading to less assets in retirement.

As mentioned previously, one consideration could be one spouse keeping the greater share of a retirement account while the other gets the house outright; another scenario is the spouse who retains the house also takes on an additional financial burden, such as sole responsibility for paying for college for the children of the marriage.

All of these plans are also impacted by tax considerations. The tax bracket may change for both spouses shifting the amount owed; alimony is also taxed, while child support isn't. These are good conversations to have with a financial advisor skilled in this specific space — one who understands all of the emotional and financial considerations involved in these important financial decisions. This is a time to look at creating a financial plan and budget; looking at pros and cons and priorities to determine the best course forward financially and realistically. There may be alternatives that are more than numbers on paper, and a financial advisor who works with divorcing couples likely has seen any number of mutually successful outcomes.

Health Care

Most of the time one spouse is going to need to get new healthcare after a separation and certainly after the divorce (in some cases, separated couples can stay on one healthcare plan), because they will fall off the other's health care coverage. Premium cost and prescription costs can be shockingly expensive, especially if the spouse who needs insurance does not have options through an employer. Pre-existing conditions can also add an additional layer of planning; also, important, including the premium, prescription and other costs of covering children's ongoing healthcare needs. In some cases, even if one spouse maintains the coverage for children, out of pocket costs are still split (arrangements should be made to formalize payment structure for those costs). It's an additional financial consideration that should not be overlooked in reaching a settlement as it can lead to an additional financial stress if not planned for upfront.

Capital Losses on Tax Returns

In this case, we are talking about a hidden gem often overlooked from prior tax returns. The provision allows whoever retains the rights, per the divorce agreement, to offset future gains. Here's an example: the couple saw a 200k capital loss in 2019 — then divorced. In 2020, there is a 300k gain. The spouse who kept the loss will only pay taxes on 100k of this gain. If the loss is not retained, tax will be paid on full 300k gain. The point? Financial settlements are rarely straightforward and a financial advisor who knows what to look for can often make a significant impact in a very short time.

Emotional Impact

One of the last things that is important to consider are the emotions that are inevitable in working through a divorce — these emotions can often lead to mistakes that cannot be reversed.

In some cases, one spouse may be feeling guilty; more often than not, that spouse tends to give more than they should (i.e. a spouse entitled to alimony waives all claims; a spouse with lucrative premarital assets agrees to give those non-marital assets to the other spouse).

Another emotion-charged issue: a rush to leave the marriage. Several things can push this feeling — perhaps you think you'd give anything to get away from your spouse (note — in some cases, both spouses may stay in the marital home until the divorce is final — that may exacerbate this feeling). Maybe you've fallen in love with someone else and feel the need to speed up this process to start a new life. But agreeing to terms such as non-required alimony, or division of assets and liabilities just to get away from a person or just to be with someone else, can have devastating effects on you financially short and long-term. Settling an additional amount beyond what is "required" for children's welfare is one thing; settling too much just to escape shouldn't be a driver.

How do you "escape the emotions"? When it comes to money, think of a divorce as the equivalent to the dissolution of a business. Decisions should not be made on emotions or without sound and objective professional advice. Working with an attorney and a financial advisor, collaboratively, means that your interests are protected so you can focus on your emotional well-being and long-term financial success.

HIGHTOWER

Westchester

440 Mamaroneck Ave., Suite 506

Harrison, NY 10528

hightowerwestchester.com