The Financial Foundation of Divorce

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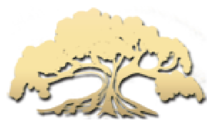

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Homes Retirement Accounts Investments Pensions

Introduction

The financial foundation of a couple going through a divorce should never be tended to as an afterthought or used as a last minute, strong arm negotiation tool under pressure. The fairness and sustainability of any negotiated divorce settlement in this area is probably the most critical aspect of the whole process because it largely determines sensitive and important quality of life issues for both spouses going forward.

Divorcing individuals need to take responsibility and realize they have a vested interest in knowing and understanding all the options available; the strengths and weaknesses, and pros and cons of each action taken. Any lack of attention or understanding on these issues, careless or otherwise, may lead to mistakes leaving one or even both individuals in a position of financial or income taxation vulnerability in both the short and long term at a time when they can least afford it.

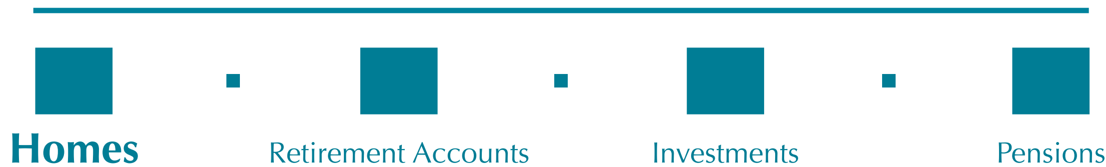
In my role as a Divorce Mediator, sober financial analysis of these matters is part of every mediation, and my experience has shown that couples who truly understand the financial implications of their choices in this area make better financial decisions and create far more sustainable settlement agreements.

There are a number of complementary professional service providers that divorcing couples may need to help them gather and understand the financial information necessary for sound decision making which can include:

- Certified Public Accountants
- Tax Attorneys
- Certified Business Appraisers
- Mortgage Loan Professionals
- Investment Specialists
- Certified Financial Planners
- QDRO Attorneys or Pension Plan Actuaries
- Real Estate Agents

One of the greatest challenges in obtaining this information is the gathering and assessing this type of information under the stressful, adversarial emotional conditions often found in a divorce. From personal experience I realize that its very reassuring knowing you have access to the information you need from objective professional sources. To this end we have personally gone to great lengths to insure that we refer our clients to only the best tenured, area professionals with the experience and skill our clients deserve and expect which have been screened by personal interviews and third party verification.

In reality there's very little room for error when it comes to divorce related financial decisions. And because we are experiencing so many economic and tax law changes, divorcing couples simply cannot run the risk of being denied for future mortgages or making income tax related or other mistakes simply because they didn't have access to the right information they needed, when they needed it.



Some of the most difficult decisions made during a divorce revolve around the home; which spouse wants to keep it, which spouse can afford to keep it or can the spouse who wants to keep it obtain the financing for the cash settlement necessary for an equity payoff to their ex and still afford it afterward.

The economic downturn of the last few years coupled with weak real estate values and stricter, ever changing mortgage lending practices have left divorcing couples scrambling for credible answers and solutions and in desperate need of help. I spent more than 14 years in the divorce related financial industry, and I don't believe there's ever been a more difficult time for divorcing individuals to either keep their homes after their divorce or at least move on with a little money to start over.

In years past, refinancing a mortgage was much easier than it is today. That was a time when providing W-2 forms, recent pay stubs, your most recent IRA/401(k) statement and documentation of child support payments awarded to you by Family Court mandate was about all that was required. However, today's lending practices have dramatically changed how potential borrowers are viewed and screened for a mortgage approval which has drastically raised the bar on who can actually be approved.

Those who who hope to buy-out a spouses' interest in a marital home need to be more aware than ever of what it will take them to get an approval before they begin shopping for a mortgage. A pending divorce makes lenders extremely cautious and discerning, and the margin of error when submitting a mortgage application is so narrow that even the slightest oversight or mistake can result in a denial.

When a refinance is necessary, it is essential that you work with a banker or mortgage broker who has extensive knowledge of how lenders screen a divorcing borrower and the documentation necessary ***before the application is submitted.*** Errors in the loan submission process may result in denials and/or resubmission to multiple lenders which may hurt your credit scores - making it more difficult or even impossible to get an approval - and then there's the expense of multiple real estate appraisals.

Important Points Every Divorcing Couple Should Know About Mortgage Refinancing

Real Estate Appraisals

In May of 2009 federal Mortgage lending guidelines dramatically changed, prohibiting the use of independent appraisals obtained by homeowners for real estate transactions. What this means to you is that homeowners can no longer use a privately selected appraiser to value their property for real estate purchases or refinances. Lenders now select the appraiser of their choice from a nationally approved database. In addition, by law an appraisal can only be ordered ***three*** business days following the borrower completing a mortgage application.

Facts & Myths About Closing Costs

Many people are confused about what 'Closing Costs' really are and are often led to believe that a Mortgage can be written without paying any at all. This happens for a few reasons, one being the differences in banking laws governing different lending institutions, and secondly, the advertising that often misleads consumers who fail to read the fine print. There are a number of necessary and legitimate costs that fall under the definition of closing costs and I'd like to dispel the notion that these fees can be avoided entirely. Expenses typically defined as 'Closing Costs' applying to a Mortgage transaction include: a title examination, (*continued on next page*)

closing attorney fees, deed recording fees, wire transfer and courier fees, and a Federal Flood Certification and even Federal Flood Insurance when applicable. Title insurance and funds needed to establish a property tax & homeowner's insurance escrow account; pre-paid daily interest due at the closing to fill the gap until until the first payment is made; payment of real estate taxes or homeowner's insurance premiums when necessary; then there's the lender's processing, underwriting, document preparation and internal closing fees. There may be application, Bank or Broker fees, because let's face it, everyone expects to get paid for their services, including the person you're talking to about the loan. Borrowers see a list of charges with a big bottom line number with a comma labeled as "closing costs" and often panic, believing they're being gouged and charged unfairly. Borrowers must realize these costs are part of every mortgage transaction and many of these charges are paid to other institutions on your behalf for you.

Consumers mortgage shopping see advertising touting low interest rates and "no closing cost" mortgages, and fail to not only read the fine print with the restrictions and conditions, but assume they qualify for these low advertised "teaser" rates and most people just don't. Naturally a lending institution is going to advertise it's best product to get your attention, but consumers, especially divorcing individuals, need to be aware that these preferential terms are reserved for only the very best, low risk borrowers and it's about more than just a good credit score, it's about a lender's longer term risk management and a potential borrower's money management behavior and spending habits coupled with their earning potential over time.

Now I'm trying to be gentle here so please don't shoot the messenger, but big lump sum cash out loans to pay off mountains of marital debt and buy out a former spouse's equity transmits a message that reads between the lines to a mortgage lender, **especially** after the events of the last few years in the mortgage industry. They're thinking, how financially responsible were you taking on lots of credit card debt and what did you spend it on? Secondly, your personal life is in turmoil and the income in your household is being drastically reduced by your divorce. And lastly, if we give you this big chunk of cash to pay off these debts, you'll now have a bunch of squeaky clean credit cards you can run up again which might leave you unable to afford to pay our loan back on time. Make no mistake about it, lenders do think like this! These things determine if you can get the loan and the interest rate you'll pay, but don't panic, you can still qualify for a loan. But if these these factors apply to you they will automatically lower your chances of qualifying for those rock bottom interest rate mortgages.

There are a number of ways lending institutions can jockey around, eliminate or even absorb closing costs for some borrowers, but that doesn't mean these costs aren't being paid for somewhere else, and its usually in a slightly higher interest rate. What this means to you is that you should think carefully and talk with your accountant or tax preparer before you decide what's the best way to go; a slightly higher rate and no (or minimal) closing costs, or a lower rate, (maybe even buying it down with "points", which are prepaid interest) with closing costs out front. Also, some closing costs are tax deductible so it's to your advantage to talk with a tax professional before you make a decision at such a critical time.

Declaring Child Support as Income

Another change to lending guidelines is how child support is factored in by lenders when considering a borrower's income. Previously, child support figures were provided to the lender's underwriting department and added to their other income which helped them qualify for the loan. Today, lenders require that child support will be in effect for a minimum of 3 years going forward and require proof that the support has already been in effect for anywhere between 3 and 12 months, depending on the lender. So unless you meet these two qualifying factors, child support **cannot** be used as income to qualify a borrower for a mortgage.

Home Short Sales

Divorcing couples who owe more than their homes are worth in today's real estate market and find themselves unable to somehow afford the payments and keep the home or qualify for a refinance may elect to “short sale” their homes, selling the property for the highest offer, but still at a loss to the Bank. Now, while this may be a short term solution, there are stipulations and conditions that may put couples at great financial risk of a tax liablility In some cases, an IRS 1099 Miscellaneous Income form may be issued to the you, the seller by the lender in the amount of debt the lender forgave in the short sale. Couples who short sale their home must always determine in advance if their lender will report the loss in revenue as income paid to them by consulting with a CPA, a Tax Attorney or their tax preparer before committing to this process. It's also important to note that short sale agreements can only be negotiated by real estate agents with prior approval from the seller's existing mortgage lender. A temporary fix, the **Mortgage Forgiveness Debt Relief Act of 2007**, information of which can be viewed on the www.IRS.gov website provides relief from debt forgiveness taxation liabilities for certain owner occupants until December 31, 2012. Contact your CPA, Tax Attorney or tax preparer to determine if you qualify if you suspect you may have to short sale you home.

When Refinancing Is Not An Option

A major concern for couples when one spouse will retain the home and be solely responsible for paying the mortgage, but cannot refinance the mortgage solely into their name due to credit, real estate value or an income shortfall, is the financial responsibility that remains for the spouse who is leaving the marital home behind. Under previous lending guidelines, both spouses were held financially accountable on paper for the entire mortgage debt, regardless of the fact that only one spouse was making the payments.

Current lending guidelines have changed in some instances to provide relief to spouses who are contractually obligated to mortgages that are now being paid solely by a former spouse. It's important to mention that this new guideline may change, but for now, if a divorce decree names one spouse as legally responsible for paying the mortgage debt, and that court order can be backed up with 12 months worth of cancelled checks from that individual's checking account, then the mortgage debt will not be listed as an obligation of the other spouse in the future, should they apply for a new home mortgage in their name. This makes it much easier for individuals to purchase new homes without the debt of their previous marital home being included in their expenses.

Foreclosure & Deed in Lieu of Foreclosure

Couples with homes in Foreclosure or considering a Deed in Lieu of Foreclosure may face the same tax penalties as with a short sale and must also contact their lender, and consult with a CPA, Tax Attorney or tax preparer to determine the extent of their tax liability if they’re essentially walking away from an undervalued and over mortgaged home before making final decisions on how their property will be disposed of.

Pre-Tax Retirement Accounts

Many divorcing individuals have pre-tax retirement investment accounts such as IRA's, 401k's, 403b's and others which are a part of their marital estate and whose ownership will need to be addressed during their divorce settlement negotiations. Whether these accounts were established before or during the marriage, in a divorce it is required that these types of assets be disclosed and detailed in the settlement. If and how these assets are actually divided depends on a number of factors:

- ➢ Do you live in a Community Property state where marital property is divided equally?
- ➢ Do you live in an Equitable Distribution state where "equitable" doesn't always result in an exact 50/50 division of marital property?
- ➢ Were these accounts established prior to the beginning of the marriage, and if they were...
- ➢ Does a Pre-Nuptial Agreement regarding ownership of these accounts exist, and if not...
- ➢ Do the parties agree to their pre-marital value and agree to set that portion aside as separate from the division of the rest of their marital assets.

What we often see during Divorce Mediation sessions is that couples prefer to address the division of these types of assets last after the more liquid assets like bank accounts, CD's and mortgage equity payouts and other marital property have been settled, for not only the obvious emotional reasons but also to try to avoid the expense and hassle involved in having them divided by a judge via court order by what's known as a Qualified Domestic Relations Order or QDRO (qua-dro), which is how this is done.

For those who will be needing to divide retirement accounts, we recommended discussing your plans with your financial adviser or planner, CPA, Tax Attorney or tax preparer to fully understand the potential long term effect on your retirement income strategy (**especially** if you have imminent plans for retirement) before you decide how these accounts will be divided during divorce negotiations. Expert guidance should be sought before dividing or parting with these types of investment accounts especially if they are realizing a good rate of return to minimize potential loss of future income. But aside from all this bothersome information gathering, the good news for divorcing couples is that there are no tax or early withdrawal penalties assessed by the IRS when these assets must be divided via QDRO in this fashion, for this purpose.

Once a QDRO has been ordered by a Family Court Judge, the spouse receiving the assets will be obligated to place his or her share of these deferred income, pre-tax assets in a similar qualified deferred income investment account of their choosing such as an IRA, or if conditions allow, into a presently owned 401k or 403b plan, for example. A spouse who takes possesion and elects **not** to roll these funds over and withdraws the funds for personal use, placing them in a savings or checking account for example, will be **solely responsible for a whopping income tax bill and the penalties for early withdrawal** the following January. Anyone considering using their portion of a pre-tax retirement account divorce settlement for personal use should thoroughly understand what their income tax liabilities will be before taking this action.

Important Note

If your ex-spouse elects to **not** to roll over the pre-tax, deferred income assets awarded them in your divorce settlement and keeps the money for personal use, **but doesn't pay the taxes and penalty at the time of withdrawal**, and you then file a **joint tax return** in your final year of marriage **you'll also be liable** for the income taxes and penalties as if it went into your pocket. Always consult with a CPA, Tax Attorney or your tax preparer in these circumstances.

Financial Investments

In addition to the customary pre-tax, deferred income retirement accounts such as IRA's and 401k's most couples accrue during their marriage, many also invest after tax cash in various capital investment instruments such as annuities, mutual funds, CD's, Roth IRA's, cash value life insurance, and of course, stocks and bonds. And because the analysis required regarding certain kinds of investments (such as annuities) will need to take into account not only the increase in face value over time, but also whether or not the asset is a source of actual dividend income paid monthly or quarterly in the form of a check, couples should always sit down with a financial professional **before** negotiating to determine the true total asset value, as they have the specialized knowledge and computer software needed to make extended, long range income projections based on market conditions and the specific type of asset.

Businesses

Business valuations can become quite complex and may require an actual Business Evaluation, usually performed by a CPA or an Accounting Firm with special training, which will determine a company's overall total asset value. This takes into consideration a wide variety of factors such as market conditions, location, income history, current and future income potential, expenses, hard assets, financial liabilities and debt, stock holdings when applicable, accounts receiveable, maintainance costs and more. Most businesses, other than very small owner operated companies (D/B/A's, Sole Proprietorships) with few or no employees, should be professionally evaluated to ensure any proposed division or settlement terms are realistic based on real world market value and doesn't compromise the company's cash flow, sustainability or growth.

Commercial or Residential Investment Real Estate

Couples who own real estate property other than a marital home should have a professional evaluation by a qualified Commercial or Residential Real Estate Appraiser to determine their asset value and then consult with a CPA, Tax Attorney or tax preparer prior to making decisions about how these types investments will divided in their divorce. Capital Gains, Inheritance or Estate Tax liability may come into play, or even a loss of asset value may result from poorly made decisions during a stressful time such as a divorce.

Real estate investment properties should be carefully evaluated much like a business, with market conditions, maintenance costs and income potential used as determining factors in if, when and how to divide equity interests between the divorcing parties. In such cases, a professional appraisal should be obtained in addition to an examination of the Rent Role (rental income history), any existing Lease or Rental Agreements and Profit & Loss and Balance Sheet statements when available prior to negotiating any division of these assets.

Inheritances, Trusts & Lottery Winnings

Married Individuals who are in possession of, or will come into future possession of a Trust Fund, an inheritance or substantial long term lottery winnings payouts should always consult with a Tax Attorney to understand specifically how the Domestic Relations Laws in their state will apply to their particular situation. The laws vary and different states have different statutes on how these assets are handled during divorce. Some states will consider a future inheritance or multi year lottery payout when dividing marital estates and awarding alimony, for example.

If an inheritance, trust or lottery winnings jackpot is part of a divorce settlement to be divided between a couple the individuals should be well advised of potential tax liability or other expenses that may come with taking sole possession of a portion of such an asset. An estate planner or Certified Public Accountant should be consulted in such cases to devise a strategy to avoid costly tax liability mistakes or other pitfalls.

Pensions

Divorcing individuals will need to obtain their Company Pension Plan guidelines in writing from their human resources department or pension plan administrator prior to any divorce settlement negotiations regarding their division if applicable. Regardless of when one party began earning their pension, full disclosure of the value and benefits must be disclosed and determined in a divorce proceeding if any portion of it was earned during the marriage. This portion is known as the Coverture Period. What will need to be determined is how much of the future pension benefit payout will be awarded to the former spouse when the pension recipient retires and begins receiving their pension at some point in the future. This is a rather complex process which will need to be performed by an Actuary or Attorney qualified to calculate the value earned during the marriage, and takes into consideration a number of factors, such as mortality rates, overall dollar contributions to the pension and so forth. There are many different types of pension plans and each has it's own set of guidelines and conditions, and also must be performed by a QDRO like pre-tax retirement plans. Another important consideration for pension holders is who their designated beneficiary is. Some pension plans automatically disallow a former spouse from receiving pension benefits upon the death of the pension holder, so again these details need to be obtained prior to final settlement agreements.

Military and Government Pensions

Military, State and Federal Government pensions have specific spousal benefit stipulations that must be met in order for a former spouse to receive pension benefits. These benefit entitlements are also dependent on factors such as years of service and the portion earned during the marriage and are divided by QDRO in a similar fashion as civilian pensions.

Social Security Benefits

A former spouse can receive Social Security benefit payments from their former spouse's Social Security record if he or she was married to the former spouse for at least 10 years, is at least 62 years of age, is unmarried and is not entitled to a higher social security benefit on his or her own record. In addition, a former spouse may be entitled to receive his or her own retirement or disability benefit. If the former spouse is eligible for a benefit, but has not yet applied for it, the divorced spouse can still receive a benefit if they meet the eligibility requirements above and has been divorced from their former spouse for at least two years.

Generally, these benefits cannot continue if the divorced spouse remarries someone other than the former spouse, unless the latter marriage ends (whether by divorce, dearth or annulment), or the marriage is to a person entitled to certain types of Social Security auxiliary or survivor's benefits.

A person can receive benefits as a surviving divorced spouse on the Social Security record of a former spouse who died fully insured if he or she is at least 60, or 50 and disabled, was married to the former spouse for at least 10 years and, is not entitled to a higher Social Security benefit on his or her own record. If the surviving spouse, age 60 or over, applying for benefits remarried after age 60, or after age 50, and at the time of remarriage was entitled to disability benefits, the marriage is disregarded. If an individual is already entitled to benefits as an aged or disabled surviving divorced spouse and remarries, benefits continue regardless of the person's age at the time of remarriage.

Questions about what benefits you may be entitled to receive as a divorced or surviving divorced spouse can be directed to the Social Security Administration at 1-800-772-1213.