10 Most Common Money Mistakes in Divorce

By Carol Ann Wilson, CFP®, CFDP®

Mishandling matters incident to a divorce can cost tens of thousands of dollars. In my over 22 years of practice, these are the most common errors I have seen:

1. Not communicating with your spouse

One of the biggest problems I find with my clients is trying to find information. Many times, the spouse with the most financial expertise will hide documents, transfer assets, not disclose information, etc. Then, time and money is spent getting that information with attorneys having to subpoena documents and perhaps even schedule depositions. These actions make getting the information almost as costly as the asset was worth in the first place. This "World War III" atmosphere can also be extremely difficult for the children to watch and it divides families even more.

Couples who are forthcoming with all the financial information find that their divorce is resolved more quickly with lower legal fees. It also helps the family to retain a sense of dignity during this difficult time.

Assets will be found - it just takes time and your money.

2. Not understanding the 72(t)(2)(C) section of the tax code

This IRS rule says that any monies coming from a qualified plan to the non-employee spouse can be spent without incurring the 10% penalty even if this person is less than 59-1/2 years old. Taxes will be paid on it. (An IRA is not a qualified plan.) If the monies are transferred from the qualified plan of the working spouse to an IRA for the non-working spouse, and then a portion is withdrawn, the 10% penalty will then apply in addition to taxes.

Example: If Melissa, age 42, is awarded one-half of Jason's 401k which is worth $420,000, Melissa, with a QDRO, can take all of her $210,000 in cash if she wishes. Since this will go into her taxable income for that year, she may wish to take a smaller amount to meet her immediate needs. She will need to pay taxes on the $210,000 but will not have to pay $21,000 in penalties for early withdrawal. If she were to take a smaller part, say $80,000, she would save $8,000 in penalties for early withdrawal.

3. Not understanding the purpose of a QDRO

The Qualified Domestic Relations Order (QDRO) is an order from the court which, among other things, tells the plan administrator what amount (either percentage or dollar amount) is to be given to the non-employee spouse pursuant to the divorce. Some plans do not allow for a QDRO! And the pension plan takes precedence over a court ruling. The plan documents need to be read to ascertain how that company handles a division of retirement assets in the case of a divorce. A QDRO should only be prepared by an attorney or someone who specializes in QDROs.

The following are some mistakes to be aware of:

A. Death of either Party

What will happen if either party dies *before* the non-employee gets the whole share of the pension? A QDRO can either miss this issue completely or get it wrong.

B. Not having the QDRO approved before the divorce is final

If the employee dies after the divorce and no order is in place, the ex-spouse may lose every bit of the interest in the retirement. This is because the non-employee is unprotected during the period between the divorce and QDRO approval. And, if the employee had remarried, the new spouse will receive all the survivor benefits. (A remarriage often happens due to the long delay sometimes in getting a QDRO submitted and approved!)

It is possible to obtain a "pre-approval" of a QDRO to avoid embarrassing mistakes. Most plan administrators gladly help at this stage because it avoids problems later. Getting a QDRO pre-approved saves the embarrassment of having the order rejected and having to go back to the judge for a revision.

C. Failing to Consider Early Retirement

There are some retirement plans that offer a substantial bonus to employees who retire early. This should be considered and thought should be given to negotiating for a portion of it, or not dividing it in exchange for some concession or property.

4. Violating the front loading of maintenance rule

An IRS rule says that if the maintenance is more than $15,000 per year and the payor of maintenance wants to deduct the whole amount of maintenance, maintenance needs to be paid for at least 3 years. The amount can change. But if maintenance drops by more than $15,000 from one year to the next during the first three years, there will be tax-recapture on the excess.

5. Not understanding the link between alimony and child support

An IRS rule says that alimony cannot end or change within six months before or after the date at which the child reaches ages 18, 21, or the age of emancipation in their state.

If any amount of alimony specified in the divorce decree is reduced (a) upon the happening of any contingency related to the child or (b) at a time that can be clearly associated with a contingency related to the child, then the amount of the reduction will be treated as child support, rather than alimony, from the start.

Example: Many attorneys say "Johnnie is graduating from high school in 5 years, so let's give Mom alimony for 5 years." Or they will say, "Since Johnnie is graduating in 5 years, let's give Mom alimony of $2,000 a month for 5 years and then reduce it to $1,000 a month for an extra 3 years."

This is creating a serious tax problem for Dad. If the IRS considers the reduction of $1,000 a month to be child support, they will make it retroactive from the beginning or 5 years (60 months) times $1,000 is $60,000 that he will have to pay tax recapture on!

6. Not insuring maintenance

Since maintenance usually stops upon the death of the payor, the stream of payments can be covered by life insurance on the life of the payor if there is no other adequate source of security for the future stream of income. This should be part of the final divorce settlement.

We always recommend that the wife own the life insurance policy and make the premium payments. This prevents any changes in the policy without her knowledge.

7. Not understanding that the wife should not always get the house

Many women count on alimony to support a very high house payment - many times 2 to 3 times what they could rent for. This does not make good financial planning sense. One can never count

on alimony. If, in a few years, the wife finds she cannot afford to keep the house, she may lose money due to taxes that were not considered at the time of divorce (see #8 below).

8. Not considering the basis in property

Felicia wanted to keep her dream house after the divorce. They had paid $190,000 for it 18 years go and it had appreciated so much that it was now worth $690,000. But after a few years of being single in a large house that needed lots of repair, Felicia decided to sell the house. After considering costs and improvements that had been done over the years, the taxable capital gain on the sale of the home was $560,700. She could deduct her $250,000 exclusion, but she ended up owing over $77,000 in federal and state taxes! If this had been considered at the time of divorce, it could have been structured so they could have taken the full $500,000 exclusion.

9. Not consulting a trained divorce consultant

You have help out there! Financial professionals (CPAs, attorneys, and financial planners) are being trained in the intricate financial aspects of divorce. They know the tax loopholes and show the long-term financial result of any given settlement proposal. This gives you more information that helps you come to a better solution for both parties involved. To find a Certified Financial Divorce Specialist nearest you, go to www.fdadivorce.com or call 888-332-3342.

10. Not hiring a family law attorney

Divorce law is so different from other areas of law that even those lawyers who specialize in it find it difficult to keep up with all the changes that happen constantly. However, they do have more knowledge in the intricacies of divorce than other lawyers. We recommend you do not use the friend next door, the acquaintance at church, or the corporate attorney, unless they are experts in family law. You may find yourself later hiring a divorce lawyer just to fix the mistakes of the first lawyer.

Another area to consider is Collaborative Divorce. You and your spouse each hire a lawyer who has been trained in the Collaborative process. The four of you sign an agreement that you will settle and not go to court. All information is shared and there is open communication among all four of you. It is more dignified, less abrasive, and helps keep the family together instead of tearing it asunder. It has also taken less time and has been less costly for most couples.

Summary

Divorce isn't something that happens to "other people" anymore. In fact, there are about 1.2 million divorces every year in the United States. That's at least 2.4 million people who must face the challenges a breakup can cause - not counting their children, in-laws, relatives, and friends.

With the increased awareness of the role that financial planners play in people's lives, even those in the process of divorce are seeking out the help of their financial professional. It is important to be aware of some of the specific financial and tax aspects in divorce that can help the divorcing couple today.

Given the fact that divorce can and does happen, the solution is often not to prevent divorce but to help the process and the settlement be as equitable and as painless as possible.

Article written by Carol Ann Wilson, CFP®, CFDP®, who is widely recognized as the foremost expert on marital financial issues and the leader in the field of divorce financial planning. *Copyright 2000-2008 by Carol Ann Wilson. All rights reserved. This article has been reproduced with the prior written permission of the copyright owner.*