FPA — FINANCIAL PLANNING PERSPECTIVES

Financial Mistakes to Avoid in a Divorce Settlement

In a divorce settlement, it's common for both parties to focus on immediate financial concerns. Yet it is the long-term financial consequences of divorce that frequently are more devastating. Here are some of the most frequent mistakes and how to avoid them.

Taking the house. The spouse who will have custody of the children typically wants to keep the family home. While this may be desirable emotionally, it can be financially problematic, caution financial planners.

A home is an illiquid asset that costs money to pay for and maintain. The parent with the children—often the woman—may not have the income resources to take care of both the home and the children, particularly if they give up other financial resources in return for the house. Consequently, it may be better financially to sell the home and split the proceeds.

Assuming equal is equal. The family home is a good example of the mistake divorcing couples often make by "dividing things down the middle." Frequently the wife takes the house and the husband keeps his pension or retirement accounts. Say both are valued at $400,000. The home is a cost-burden, while the retirement account is a liquid asset that can continue to grow tax deferred, probably at a faster growth rate than the home.

Not examining earnings potential. Often, one spouse has minimized a career in order to raise children. The settlement needs to take this into account, perhaps by providing extra money to the homemaking spouse to pay for additional career training or education.

Not thinking about taxes. Say it's proposed that one spouse keeps a $150,000 individual retirement account and the other keeps a $150,000 taxable investment account. Sounds fair. But it's not. The owner of the IRA will have to pay taxes on that money when it's withdrawn, so the two accounts are not truly equal in value.

Not following through with your attorney on the QDRO. A spouse who will be receiving part of his or her spouse's qualified retirement accounts will need a court order called a "qualified domestic relations order." (Nonqualified plans such as deferred compensation or stock options do not need a QDRO.)

But mistakes can cause major problems. First, be sure your attorney is aware of *all* retirement accounts and that the attorney examines what rules each plan has for QDROs, as they vary from plan to plan.

To expedite the QDRO, have your attorney obtain pre-approval from the plans before the settlement is final. The court must sign the order before an account can be divided. Be sure the order is sent to the retirement plan and is approved by the plan early in the divorce process. If not completed before the divorce is final, you'll have to go back to the court later, and you run the possible risk of your ex-spouse cleaning out the account.

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Not including survivor's benefits in the QDRO. If you will be receiving retirement benefits from your former spouse's pension, be sure the QDRO includes survivor's benefits, if the plan allows them. Otherwise, those benefits could stop if your spouse dies before you do.

Also pay attention to Social Security benefits. For example, if your spouse makes significantly more money than you do and you've been married ten years or more, you will be eligible for Social Security benefits based on your spouse's work history. That may mean higher benefits than if you have to rely on your own work history.

Not insuring the divorced spouse. If you will be relying on your ex-spouse for child support, retirement benefits, alimony, or other financial benefits such as a commitment to pay for the children's college education, take out a life insurance policy on your spouse to ensure the money will be there. You should own the policy, so you know they are keeping up the payments. And buy the policy before the settlement is final, so you know whether they're insurable.

Only using a lawyer. Have a CERTIFIED FINANCIAL PLANNER™ professional trained in divorce financial issues work alongside your attorney. A planner can objectively examine long-range issues such as budgeting, appreciation and tax ramifications of proposed settlement assets, and long-term costs associated with settlement proposals. By working with your attorney, a financial planner can help ensure the divorce settlement is financially fair to you.

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