5 Errors Financial Planners Commonly Make When Working with Divorcing Clients

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With approximately 1.2 million divorces occurring annually in the United States, financial planners are likely to encounter divorcing clients. The author of this article points out five common mistakes made by planners when assisting clients with divorce-related financial issues.

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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, more of those in the process of divorce are seeking the help of financial planning professionals. Clients ask how to divide their assets, they ask about the effect of liquidating accounts, what taxes are to be paid on transferring property, and how they should put together their property settlement. It is important for planners to be aware of some of the specific financial and tax aspects in divorce that can help divorcing couples.

Mishandling financial matters incident to a divorce can cost your clients tens of thousands of dollars. In 14 years of practice, I have seen the same problems over and over. I have heard stories of how financial planners advised their clients incorrectly, putting planners at risk for a malpractice suit. Many problems can occur when working with divorcing clients but these are five of the most common errors financial planners make.

1. Not Understanding the Purpose of a QDRO

A 1986 amendment to the Retirement Equity Act gives state courts the power to order the division of certain pension and retirement plans. The plans covered under this federal law are public employers that are covered by the Employee Retirement Income Security Act of 1974 (ERISA).

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. However, some plans, such as government plans, nonqualified deferred compensation plans and IRAs, may or may not allow for a QDRO. In that case, the pension plan takes precedence over a court ruling. The plan documents need to be read to ascertain how that employer handles a division of retirement assets in the case of a divorce. A QDRO should be prepared only by an attorney or someone who specializes in QDROs.

Plans divisible by a QDRO include

1. Defined-contribution plans and defined-benefit plans
2. 401(k) plans
3. Thrift savings plans
4. Some profit-sharing and money-purchase plans
5. Keogh plans

6. Tax-sheltered annuities
7. Employee stock option plans (ESOPs)

Plans not divisible by a QDRO include some plans of small employers not covered by ERISA, and many public employee group funds such as police and fire groups, and city, state, and other governmental employees including federal employees. Planners should be aware of the following mistakes.

Not planning for the death of either party. What happens if either party dies before the non-employee gets his or her entire share of the pension? A QDRO can either miss this issue completely or get it wrong.

According to ERISA, a spouse is always entitled to a survivor annuity unless it is waived. But this isn't true for an ex-spouse. The only way to provide an ex-spouse with a survivor annuity is to spell it out specifically in the QDRO.

One alternative is to have the plan divide the account when the employee retires, and use a portion of this account to fund a lifetime annuity for the non-employee. This can be a good idea if the employee plans to remarry, since the employee will still have the option of providing a new spouse with a survivor annuity.

What if the employee's ex-spouse dies? If the employee spouse is taking a reduced benefit because of a survivor option for his or her ex-spouse and then that ex-spouse dies, the employee is likely to think that their benefit will then increase to the normal amount. This will not happen unless addressed by the QDRO.

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 has remarried, the new spouse will receive all the survivor benefits. (A remarriage often happens due to the long delay 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.

Failing to consider early retirement. Some retirement plans 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.

2. Not Understanding Code Section 72(t)(2)(C)

Any monies coming from a qualified plan to the non-employee spouse can be withdrawn without incurring the ten percent penalty even if this person is younger than 59 1/2, though regular income taxes will be paid on it. However, because an IRA is not a qualified plan, the ten percent penalty will apply, along with the taxes, if the monies are transferred from the qualified plan of the working spouse to an IRA for the non-working spouse, and a portion is then withdrawn.

Example 1. Esther was married to an airline pilot, Jeff, who was nearing retirement. They were both age 55. He had $640,000 in his 401(k) and the retirement plan was prepared to transfer $320,000 to her IRA.

She could transfer the money to an IRA and pay no taxes on this amount until she withdraws funds from the IRA. But Esther's attorney's fees were $60,000 and she needed another $20,000 to fix her roof. The QDRO asked for a withdrawal of $100,000 to be sent to Esther and the remaining $220,000 to be sent to her IRA. She received $80,000

($100,000 minus 20 percent withheld for taxes).

IRC Section 72(t)(2)(C) says that when you take money out of a qualified plan in accordance with a written divorce instrument (a QDRO), the recipient can spend any or all of it without paying the ten percent penalty. Esther has to pay the taxes on the entire amount because she had to declare the $100,000 as income, but she does not have to pay the ten percent early-withdrawal penalty.

However, after money from a pension plan goes into an IRA, which is not considered a qualified plan, Esther is held to the early-withdrawal rule. If she says, "Oh, I forgot—I need another $5,000 to buy a car," it is too late. She has to pay the ten percent penalty and the taxes on that money.

An IRA is not considered a qualified plan and a rollover may take place without the 20 percent withholding for taxes. In a divorce situation, IRAs may be transferred in whole or in part. Since an IRA is not a qualified plan, a QDRO is not needed to transfer or divide it, but the trustee may need to see the divorce decree. Check with them about their requirements.

Annuitization of an IRA (substantially equal payments for the longer of five years or the number of years to age 59 1/2) can prevent the imposition of the ten percent excise tax.

Here is a terrific planning opportunity when working with your client. Many times you will see couples whose main assets are retirement plans. The divorce expenses in themselves may take most of their liquid assets, so when it is time to divide what is left, they may only have retirement plans.

Assume that Esther, in Example 1, had no other liquid assets; she had only the money she would receive from the 401(k). She saved $10,000 in penalties by taking some cash from the plan up front.

What if Esther's husband, Jeff, needs cash? Even though Esther can access Jeff's 401(k) in a divorce, he can't. IRC Section 72(t)(2)(C) applies to the alternate payee only. They could put together an agreement (drawn up by an attorney) that Esther would withdraw $200,000 from the 401(k), save the $20,000 penalty of ten percent on early withdrawal, then divide the remainder with Jeff. Each would receive $80,000 (after the 20 percent withholding). This would allow the husband to get money from his 401(k) without paying the ten percent penalty.

Jeff's company might allow the 401(k) to be split so that Esther has her own account with the company. If this happens, she cannot withdraw funds without the ten percent penalty because she is now the payee, not the alternate payee. She needs to withdraw the funds while she is the alternate payee to escape the ten percent penalty.

Note: Section 72(t)(2)(C) exclusion from the ten percent penalty is only applicable when the withdrawal is made according to a QDRO. You may have heard about the case where the husband was told by his attorney that he would have to split his 401(k) with his ex-wife. The husband then contacted his 401(k), withdrew one-half and sent it to his ex-wife. He paid taxes and penalties on the amount he sent to her. She received that money tax-free and clear.

3. Violating the Front Loading of Maintenance Rule

The Internal Revenue Code Section 71(f) states that if maintenance is more than $15,000 a year, and the payor of maintenance wants to deduct the entire amount of maintenance, maintenance needs to be paid for at least three years. The amount can change, but if maintenance drops by more than $15,000 from one year to the next, there will be tax-recapture on the excess. The recapture rules were designed to prevent nondeductible property settlement payments from being deducted as alimony. The rules come into effect to the extent that alimony payments decrease annually in excess of $15,000 during the first three calendar years.

To the extent that the payor spouse has paid "excess alimony," the excess alimony is to be recaptured in the payor spouse's taxable income beginning in the third year after divorce. The payee spouse is entitled to deduct the recaptured amount from gross income in the third year after divorce.

Example 2. Trish tells her husband Robert that, after the divorce, she plans to go back to school for two years to finish her degree. Then she will be able to get a certain job that, after a year, will pay her $30,000 a year and she will no longer need alimony. She asks Robert if he will support her for those two years. He agrees. Her expenses for those two years, including school costs, are $60,000 the first year and $30,000 the second year.

A friend tells Robert about tax law stating that if he wants to deduct everything over $15,000, alimony must go for at least three years, but the law doesn't stipulate as to the amount he must pay. Robert wants to deduct the entire amount, so he offers to pay Trish $1,000 the third year to satisfy the law. Here's what it looks like.

1st year $60,000

2nd year $30,000

3rd year $ 1,000

However, the friend didn't tell Robert about the second part of the law. Some friend! If the payments drop by more than $15,000 from one year to the next, there is tax recapture on the amount over $15,000. In Robert's case, the alimony dropped by $30,000 from Year 1 to Year 2, and by $29,000 from Year 2 to Year 3. Robert will have to pay tax recapture.

The recapture rules do not apply if:

1. Either spouse dies before the end of the third post-separation year or the spouse entitled to receive the payments remarries before the end of the third post-separation year.
2. The amount of payments fluctuates for reasons not in control of the payor spouse. For example, the payments might be a fixed percentage of income from a business or property, or from compensation for employment or self-employment.
3. The payments are temporary support payments
4. The alimony payments decline for $15,000 or less over the three-year period.

Example 3. Bert agrees to pay Maggie 25 percent of the net income from his farm each year for a period of three years. In the first year, the net income from the farm was $120,000 and Bert sent Maggie a check for $30,000. During the second year, the area was hit by severe weather and most of his crops were wiped out. That year, the farm's net income was only $32,000, so Bert sent Maggie a check for $8,000. In the third year, the farming business suffered a loss of $10,000 and Bert did not make a payment to Maggie that year. In this case, no recapture is required, because payment fluctuations were not in his control.

Example 4. Tim, a successful attorney, was ordered to pay his ex-wife 25 percent of his income from his practice annually for the next four years. Six months after the final decree, Tim walked away from his law practice and moved to the mountains to grow mushrooms. Tim will not be able to avoid recapture because the fluctuation was within his control.

Example 5. The divorce decree says that Tom pays Helen, as alimony, the sum of $315,000. This sum is payable as follows: $60,000 in 1999, $55,000 in 2000, and $50,000 in 2001, 2002, 2003 and 2004. The recapture provisions do not apply since the alimony payments over the three-year period do not decrease by more than $15,000.

4. Not Understanding the Link Between Maintenance Length and Child Support

Maintenance cannot end or change within six months of the time that child support ends or changes.

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 (Code Sec. 71(c)(2). Reg. Section 1.71-1T(c) (Q&A) 18).

To prevent recharacterization of the payments, it is necessary to avoid a reduction of alimony at a time associated with the occurrence of a child-related contingency. Sidestepping this trap is made easier by the fact that there are only two situations in which payments that would otherwise qualify as alimony will be presumed to be reduced at a time clearly associated with the occurrence of a contingency related to the child.

1. Six-month rule: The first situation occurs when the payments are to be reduced no sooner than six months before or after the date on which the child reaches age 18, 21 or the age of majority in their state.

Example 6. Michael is to pay Susan $2,000 a month in alimony. The amount of alimony is to be reduced to $1,000 beginning with the January 2002 payment. Their child, Todd, was born April 5, 1984, and will reach the age of majority (18) on April 5, 2002. The date six months before April 5, 2002 is October 5, 2001, and the date six months after is October 5, 2002. Thus, any reduction in payments during the period from October 5, 2001, through October 5, 2002, may be presumed to be a reduction that constitutes child support and not alimony. Only $1,000 a month will qualify as alimony because the reduction in the payment occurs six months before the occurrence of a child-related contingency.

2. Multiple reduction rule: The second situation is when there is more than one child. In this instance, if the payments are to be reduced on two or more occasions that occur not more than one year before or after each child reaches a certain age, then it is presumed that the amount of the reduction is child support. The age at which the reduction occurs must be between 18 and 24, inclusive, and must be the same for each of the children.

Example 7. Ralph is to pay Theresa $2,000 a month in alimony. Theresa has custody of their two children, Heidi and Thor. However, the payments are to be reduced to $1,500 a month on May 1, 2002, and to $1,000 a month on May 1, 2006. When the first reduction occurs, Heidi will be 20 years and 3 months old. On the date of the second reduction, Thor will be 21 years and 8 months old. Under these facts, it is presumed that $1,000 of the payments constitutes child support rather than alimony. Both reductions in payments occur not more than one year before or after each child reaches the age of 21 years.

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

This is creating a serious tax problem for Dad. In the first case, if the IRS considers the $2,000 per month to be child support (because it ceased upon Johnnie's graduation from high school), they will make it retroactive from the beginning. Five years (60 months) times $2,000 is $120,000 on which Dad will have to pay tax recapture.

In the second case, if the IRS considers the reduction of $1,000 a month to be child support ($2,000 minus $1,000), they will make it retroactive from the beginning, which is 60 months times $1,000 or $60,000 on which Dad will have to pay tax recapture.

5. Not Insuring Maintenance

There are three common methods of insuring maintenance: life insurance, disability insurance, and an annuity.

Life insurance. 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. Always recommend that the beneficiary own the life insurance policy and make the premium payments. This prevents any changes in or lapses of the policy without her knowledge.

Example 8. Joan was receiving $400 a month in alimony from her ex-husband Jerry. The court had ordered Jerry to carry life insurance on his life payable to Joan as long as alimony was being paid. After three years, Jerry was tired of making the insurance payments so he stopped and the insurance was canceled. Nobody knew about it until one year later. Jerry was in a car accident and died two weeks later of complications from his injuries. Alimony came to an abrupt halt and there was no life insurance! Yes, Jerry was in contempt of court but it didn't make any difference now, because his estate was insufficient to pay the claim of the wife.

If new insurance is needed, make sure that the insured applies before the divorce is final. Then, if he or she cannot pass the physical and cannot get new insurance, there is still time to modify the final settlement to make up for this possibility.

If the court orders the spouse paying the alimony to purchase insurance to cover maintenance or child support, and the other spouse owns the policy, those premium payments are treated like alimony for tax purposes and the insured can deduct them from his or her taxable income. Likewise, the recipient will need to declare them as taxable income, unless the parties agree in their separation agreement to exempt the payment from the alimony tax treatment.

Is term insurance ever considered a marital asset? Yes, in some states it is if the insured has since become uninsurable.

Disability insurance. A second way to protect the stream of alimony income is to have disability insurance on the payer's ability to earn income. Assume, for example, that the husband pays his ex-wife $1,200 a month based on his salary of $6,000 a month. Then he becomes disabled. If he had disability insurance, he might then be able to receive $4,000 a month tax-free and could continue making maintenance payments. If he had no insurance and no income, he would probably go back to court and ask to have alimony reduced.

Annuity. A third way to protect alimony is to have the payer buy an annuity that pays a certain amount each month that equals the alimony payment. To do this, the payer of the alimony needs to make a large lump-sum deposit to an annuity with an insurance company and instruct it to make the specific payment. The annuity, in turn, will send a monthly check. Once the alimony obligation has been met, payment will revert to the payer.

Summary

Given the fact that divorce can and does happen, the financial advisor's role is to help make the settlement process as equitable and as painless as possible. This has created a real market niche for professionals who are needed in all phases of the divorce process.

Well-informed financial advisors can do a lot toward helping people achieve equitable settlements and minimize the negative, destructive forces of divorce. In fact, the wave of the future is having teams of experts who can help people through the difficult times of breaking up a family. This team can help the divorcing couple stay out of court. And in the end, Americans will have more money available to keep them on the positive side of cash flow instead of being in debt, and children in divorced families will have fewer emotional scars.