Case Study: Financial Planning & Decision Making During a Divorce

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Life can come at you unexpectedly and even throw you a curve ball. Planning for it can be difficult if not tricky. Divorce is one such event as evidenced by the divorce rate recently cited at 3.6 per 1,000 people by the National Vital Statistics Reports. As in many stressful life situations, individuals are often so focused on the emotional impact, they are not thinking about the long term financial impact. While the true cost of divorce is its effect on family, making the wrong financial choices during the process can be just as devastating. Consider the following case study:

Background

Sam and Diane are 50 years old and have two teenage boys, ages 15 and 17. Sam has a retirement plan through work that is worth $1,000,000. In addition, they have done a great job saving outside the retirement plan, with taxable savings of roughly $3,000,000 in a mix of stocks, bonds, certificates of deposits and money market accounts. Sam is in a professional practice with annual income of $550,000. Diane is a social worker and earns roughly $35,000 a year. Their residence is valued at $1,500,000 with a mortgage of $900,000. An appraiser recently valued Sam's equity in his practice at $1,000,000.

Sam and Diane have decided to get a divorce and are in the initial stages of the legal process when Diane came to our office for help. Understandably, Diane's focus has been on the well-being of her boys. Her initial goals were (1) to make sure she was able to keep and live in the current home and (2) that Sam would take care of the college costs for the boys. However, like many parents in her position, she was not considering her own well-being and the financial impact of the divorce on her lifestyle and long term goals. People facing divorce often are too anxious to "get it over with" and move on with their lives, that they may not take the time to plan and protect themselves.

The courts will determine what an equitable distribution of marital assets between Sam and Diane will be. The vagueness in this decision is what can cause many of these cases to be burdensome in that parties do not always agree that what is equitable is actually fair. In planning, a useful and effective approach to take is to first determine the quantity and type of assets needed to maintain Diane's current lifestyle. From there, Diane and her attorney can use this information as the baseline in their decision making.

We started with a list of assumptions to use for our cash flow analysis. Diane put together a budget of her current monthly expenses to determine how much she would need in order to pay the bills and provide for her boys. Below are the assumptions:

- Retire at Diane's age 62
- Spend $15,000 per month while the boys are living at home and spend $12,000 each month thereafter
- Diane would have 20 years left on her 30-year mortgage of $900,000 of which her monthly payments are $6,000. Once the mortgage is paid off, her monthly expenses would be reduced.
- Diane wants to make sure there are enough funds set aside to provide a 4-year private college education for her two boys. The current estimated tuition cost is $40,000 annually.
- Diane does not have any retirement savings but will receive $1,200 per month from Social Security beginning at age 62 (Diane qualifies for the

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50 percent spousal benefit since she was married for ten years or longer)

- Diane is a conservative investor and does not like to take a lot of risk. Her preference is income with more downside protection rather than reach for higher growth.
- Planning to age 90

The following results will be helpful to Diane and her attorney, not only from the standpoint of planning for her future, but also because it will give her the insight to determine what type of divorce settlement she will need to fight for and what additional assets may not be "worth" the extra legal costs to pursue. The analysis gives both Diane and her attorney leverage in the process and provides the insight to make better decisions throughout a stressful and emotional process.

We started with an initial possible settlement scenario where the assets are split 50/50 in which Diane keeps the home (and takes over the mortgage payments of $6,000 per month) and Sam keeps his equity share of his practice. In addition, Sam will pay Diane alimony of $5,000 per month for 7 years and child support of $3,000 per month. Sam will also fully fund the boy's college education.

Children

In order to fully fund a private college education, Sam will need to set aside $350,000 in savings earmarked for these upcoming costs. Our analysis assumes a private university tuition of $40,000 per year in today's dollars, a four year education, inflation of seven percent, and a portfolio return of five percent (with college quickly approaching, we assumed a conservative allocation with a lower expected return).

In addition to the college savings, child support payments of $3,000 per month will be paid. Diane and her attorney may want to consider asking the court for a higher alimony payment (or over a longer period), or an additional lump sum payment to cover the extra expenses, such as room and board, the boys will incur during their college years as child support payments end at the younger son's age 18.

Home

Diane wants to keep the home since the boys are comfortable there and she feels it will help if they continue to live there during this difficult transition period. However, does it make sense financially for Diane to keep it?

Not only would Diane be getting the home in this scenario, but she would also be taking over the $900,000 mortgage. The mortgage payments are a considerable expense in Diane's budget. Once the boys leave the nest egg, the $6,000 per month cost will make up 50 percent of Diane's monthly spending. With utility bills, maintenance, upkeep and property taxes, the cost of keeping the home will put significant risk in Diane's ability to maintain her lifestyle throughout her retirement.

However, in order for Diane to take over the mortgage, her bank would have to approve it, as not all mortgage loans are assumable. The lender will need documentation (salary, alimony and child support) to determine if Diane can pay the mortgage solely based on her own income. This is an important consideration for Diane to look into before discussing terms of a potential settlement. Especially if the bank determines that she does not have enough income or assets to assume the mortgage.

One option for Diane to consider is co-ownership. Often, divorcing couples will co-own the home for two or three years until the children leave for college at which point Diane could downsize and sell the home. This would allow Diane to keep the home before the boys are off to college and qualify for the mortgage with Sam's income. Co-ownership, however, is not always the best solution, especially if the divorce is not amicable.

Retirement

Running a cash flow projection is essential in determining whether a 50/50 split of marital assets will provide enough income for Diane's retirement. A 50/50 split will result in Diane owning a retirement account worth $500,000 (Diane must work with her attorney on a qualified domestic relations order (QDRO) to make sure this is done correctly) and taxable savings of $1,700,000. This is in addition to the current equity in the home ($600,000). We will leave the equity in the home out of the calculation for now as we do not want to depend on this to provide retirement income.

Plugging in these assets with the assumptions and Diane's goals into a straight-line retirement analysis shows that Diane will run out of liquid assets at age 79. Although a 50/50 split will not work in Diane's favor, she does have options:

1) Diane could downsize her home once the boys are in college thereby reducing a significant mortgage

expense. With $600,000 of equity, Diane could buy a smaller but still adequate home for the needs of an empty nester and drastically reduce her spending. Eliminating the $6,000 per month mortgage expense in three years results in Diane achieving her goals.

2) Another option would be for Diane and her attorney to negotiate for more alimony. In order for Diane to keep her home and not downsize, she would need alimony payments of closer to $10,000 per month and lasting 10 years rather than the original $5,000 per month for seven years.
3) A third option would be for Diane to be more aggressive in her investment portfolio, although based on her tolerance for risk this may not be a viable option.

We ran a Monte Carlo simulation to see what effect the sequence of variable rates of returns will have on Diane's retirement spending. This analysis will help us determine the optimal amount of assets and spending for Diane to achieve her goals and invest based on her conservative preference. The analysis shows that if Diane were to invest in a lower risk portfolio, she would need a lot of luck as she would have a 60 percent chance of running out of money by age 90—certainly not a good result as evident by our previous straight line analysis. If Diane was more aggressive in her investment approach, she could increase her chance to 65 percent of meeting her retirement goals, an improvement, but still not enough and perhaps not the most ideal means of getting her there. While being more aggressive gives Diane a better chance, it also increases the degree of volatility in her portfolio value from year to year. Diane is not willing to take on more risk to meet her goals and would prefer to have a lower allocation to stocks in her portfolio. Our analysis further shows that Diane must reduce spending by 30 percent to get to a more favorable result (96 percent chance).

This is a crucial point in our planning work for Diane in that she became more open to selling the house in three years to achieve a healthier financial position. Diane and her attorney also have the tools to determine whether it is worth fighting in the courts for more alimony or larger percentage of marital assets should she want to stay in the house longer.

A marital asset split of 60 percent to Diane and 40 percent to Sam would put Diane in a more favorable position with her retirement needs and goal of keeping the house. This appears to be a reasonable settlement in that Sam is giving up more now since it is expected that he will recover quicker with his earnings potential. However, even then, based on our Monte Carlo analysis, Diane would still need to reduce spending to make this work in her favor. The house will be an expensive asset for Diane to own for a longer period of time even if she receives a higher percentage of marital assets from the divorce settlement.

Taxes

Taxes are a vital part of financial planning and divorce planning is no different. The tax impact of any financial decision made by Diane must be a consideration. We walked through these issues with Diane: the tax impact of post-divorce payments, child support versus alimony; the after-tax value of their taxable savings versus the retirement account; and the primary residence exclusion amount falling from $500,000 as married taxpayers down to $250,000 as a single taxpayer. Taxes play a huge part on the long-term growth of any retirement strategy and ignoring them can have a devastating effect on the success of the plan.

Insurance

Another important, but often overlooked issue for divorcing couples is insurance. Should Sam be obligated to pay child support and alimony over a specific period of time, an unexpected disability or even death could be catastrophic to Diane's ability in meeting her goals. Diane needs to protect herself from this risk in making sure that Sam has adequate coverage and specifically including this in the divorce decree.

In our 50/50 settlement scenario, Diane is awarded $5,000 per month in alimony and $3,000 per month in child support for seven years. In addition, Sam is also required to pay for the boys' college tuition from which we determined a "set aside" amount of $350,000 earmarked for this goal. We determined that in this scenario, a life insurance policy with a $1,000,000 death benefit on Sam will protect Diane and recommended Sam buy a 10-year term policy to keep the overall costs down. Sam will also have more flexibility in that he could stop paying the premiums after year seven when his alimony and child care obligations have ended (assuming the court decides that alimony will end in seven years). It is essential that Diane works with her attorney to make sure that the title and beneficiary information on the life policy is correct, and that the premiums are being paid to keep the policy in force.

Most people do not think about becoming disabled, but statistics show that individuals under the age of 65 are twice more likely to become disabled than they are to die. It is sound planning for Sam to have enough disability coverage to protect his assets from depleting to the point where he may not have enough to not only meet his divorce obligations, but also meet his own retirement goals. We recommended that Sam's financial advisor run a needs-analysis to determine the amount of adequate coverage. For Diane's protection, her attorney will recommend including Sam's disability policy in the divorce decree.

Post-divorce planning

While we helped Diane provide a foundation going into the divorce proceeding, it is just as important to do additional planning once the details of the settlement are finalized:

- Periodically update the Monte Carlo analysis to make sure Diane stays on track with her goals based on her spending
- Design a customized investment portfolio that is aligned with Diane's income needs and risk tolerance
- Update Diane's property and casualty insurance. The umbrella policy should provide adequate liability coverage especially with the anticipation of two teenage drivers living at home
- It is not uncommon for a single parent to consider some type of long term care insurance to protect their current retirement savings and prevent from being "a burden on their children." Diane's health is very good and she is still young enough where the costs for some level of insurance are reasonable.
- Diane will need to work with her estate planning attorney to update her wills, trusts and powers of attorney for property and for heath. Just as importantly, Diane must make sure the assets are titled correctly and beneficiary designations updated to reflect the change in her documents.

Summary

Divorce can be sudden and the trauma can often cause inaction. While an initial focus on the division of marital assets are important, it is just as important to understand the long-term financial consequences of these decisions. A multi-step planning method (before, during, and after the legal proceedings) is crucial to the success of reaching ones goals. Planning throughout the process can reduce the negative financial impact on the family and likely mitigate the level of stress in the process.

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