THE FINANCIAL FOUNDATION OF DIVORCE

HOMES

PENSIONS

INVESTMENTS

RETIREMENT ACCOUNTS

Rhode Island
DIVORCE MEDIATION CENTER

People say knowledge is power.

I have come to learn that knowledge

is only power when it is applied.

- Lori Grover

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Introduction

The financial foundation laid out during a divorce determines almost everything about quality of life after divorce; peace of mind, the ability to meet one's own financial needs, and the time it will take to recover... And none of these should be taken lightly or overlooked.

Divorce preparation is often misunderstood as only being necessary for the wealthy or those who own businesses; and it's often not given the attention it deserves by family law attorneys which is why many couples are disadvantaged right from the start, without even knowing it. This lack of understanding results in spouses who make decisions based entirely on how they feel at that time, wanting to just get it over with, and not recognizing the importance of hashing out what they feel are 'insignificant details'. Most legally negotiated settlements aren't based on fairness, quality of life, emotional well-being or preventing future conflict, and it should be understood that the legal system does in fact profit from the failure of all these things.

Actual divorce preparation is very different from what most people think it is, and by the end of this report you'll not only understand what it is, you won't want to proceed without having done it.

Much of what ends up in legally negotiated divorce settlements or settlements created by couples without guidance is based on what I call *'snapshot in time'* decisions. These decisions tend to be random, only partially thought out and based more on emotions than factual information. These settlements are rarely fair or sustainable long term... And unfortunately we all know or know of someone who has one.

As someone getting divorced, it's important to recognize you have a vested interest in understanding that while you're financially disentangling from your spouse, you're also laying the foundation for your future.

A divorce means you're starting over.

It also means knowing all your options, understanding the pros and cons of each, and looking at the total, big picture. Only you can decide if getting information that will help you make better decisions is important.

As a Divorce Mediator, and someone who didn't score high in the financial separation part of my divorce, I work with couples all the time who remark that the financial issues and questions I pose in mediation would have never occurred to them.

Once they begin to think about these issues and mentally follow them through, they realize the importance and necessity of dealing with them instead of moving on with the process and hoping problems don't pop up after their divorce is final.

I have a simple philopsophy: We don't know what we don't know.

The problem with some divorces however, is wanting to get it over with and being willing to deal with the fallout later, which may seem like a good idea at the time... But when the repercussions occur the perspective is quite different.

A big misconception about preparing for a divorce is that doing some homework and gathering information makes a divorce cost more and take longer. I hear this occasionally, and it's what I expect people to think. But what if I told you, based on the national avaerage, an uncontested divorce handled by attorneys costs $7,500.00 per spouse and takes 12 - 18 months, while a mediated divorce in my practice averages about 25% of that, settlements are reached in 2 to 4 weeks, and spouses benefit from making well-thought out decisions they feel confident with. Then, couples can use a mediation friendly attorney to assist them with the court process if they desire, and it will still cost less than hiring one litigating attorney.

So, my experience tells me that gathering the facts you need shouldn't cost more time or money, and if anyone tells you different you may want to reconsider your sources.

Because every divorce is different, the time and cost to create the settlement that's right for you does depend on your circumstances and level of cooperation with each other, but there's no denying you'll benefit from applying the knowledge you accumulate. For this reason, my practice includes a network of neutral, tenured professionals with extensive divorce experience who provide specific guidance to couples who need it. As you progress through your divorce any of the following professionals may be very beneficial. Below is the list of professionls I commonly refer:

CPAs	Investment specialists
Tax attorneys	Financial Planners
Certified Business Appraisers	QDRO attorneys/pension actuary
Mortgage professionals	Real Estate Agents
Therapists	Bankruptcy attorneys

Mediation friendly family law attorneys

Marital Homes

The decision about what to do with a marital home can be complicated; there's the financial side where the considerations are value, equity and affordability then, there's the emotional component where maybe you're attached to the home or you want to avoid uprooting your children in addition to them having to adjust to your divorce.

Whatever the circumstances, there are a number of factors that will determine what happens to your marital home: who wants to keep it, which one of you can afford to keep it, what happens if the mortgage balance is greater than the value, and can whoever wants to keep the home afford to pay their spouse the equity they're entitled to or agreed upon?

This section takes you through the things you need to consider and factor into your decision.

Equity

When one spouse wants to keep the former marital home and there is equity to be divided between them, the first consideration must be how that equity will be paid:

- From the proceeds of a refinance,
- In exchange for a larger portion of another asset or,
- At an agreed upon time in the future

If equity is going to be paid from a refinance, the spouse retaining the home must be certain they can afford the new mortgage payment in addition to all their other monthly expenses. It's great to be approved for a mortgage, but, lenders approve mortgages based only on the financial obligations that are on credit reports, so even when they approve a mortgage it doesn't mean that mortgage is affordable to the borrower once all their other expenses are added in. A big financial consideration that's often overlooked when determining affordability is the ability to meet the costs of routine maintenance and unexpected repairs.

To sum it up, affordability must be based on the mortgage, real estate taxes, homeowners insurance, repair & maintenance costs, all personal on-going & day-to-day expenses, consumer debt obligations and child expenses if applicable. If any of these expenses are left out of the equation, the potential risk of financial hardship is high.

Paying equity in the form of a larger share of another asset such as cash accounts, stocks or retirement funds, in monthly installments, or in exchange for another asset of similar value are other possibilities that can make keeping a home affordable. This can prevent the need to refinance, unless both spouses are on the mortgage, where a refinance will be required to remove the spouse who is not retainng the home from any financial responsibility. This **equity swap** is also sometimes a couple's best, or only, option if:

- The spouse retaining the home can only qualify for a mortgage in the same amount of the current mortgage (a rate & term refinance),
- The loan to value ratio (LTV) doesn't allow for the equity to be taken out from the refinance or,
- Extracting the equity as cash from the refinance will make the new payment too high for the new borrower.

One option I often see couples utilize when they want to keep their children in the home is to push out the date when the equity will be paid to an agreed upon time in the future, for example, when a child graduates from high school or within a certain number of years from the date a divorce becomes final.

With interest rates being so low over the last few years many couples have already taken advantage of refinancing their higher interest loans, so refinancing again because of their divorce may not be an option if the spouse retaining the home doesn't qualify for a comperable interest rate or there isn't sufficient equity to refinance again.

One of the (many) reasons I became a Divorce Mediator is because the dead ends, sad endings and restrictive options that are part of the legal system don't exist in mediation... So couples are able, encouraged and supported in making the best decisions based on their circumstances, especially if they have children.

CHILD SUPPORT & ALIMONY

The second consideration is child support and/or alimony. If the spouse who wants to keep the home will be receiving child suppor it should not be included as part of the income used to qualify for a mortgage. I know this is contrary to everything you've heard however; there are two solid reason for this:

(a) child support must be available and used for the day-to-day and unexpected expenses of the child and,
(b) when child support ends, a mortgage based on having that income usually becomes unaffordable.

Many legal professionals purport that child support should be considered part of providing housing for children, and while I understand that point of view, the fact is, if child support is part of the income that determines whether or not a mortgage is approved, then that mortgage is not affordable. On the other hand, if the mortgage is affordable without child support, then including that income is not a risk. It becomes a benefit that may lower the debt-to-income ratio and possibly quailify the borrower for a better mortgage product and/or a lower interest rate.

Alimony is another form of post-divorce income that's commonly used to qualify for a mortgage but it too comes along with financial risk. Like child support, once the payments stop the home may be unaffordable. In most cases, alimony is designed to be a bridge from where the recipient is at the time of the divorce to where they will be at some point in the future, typically 1 - 3 years post-divorce. If the spouse receiving alimony is taking tangible steps to increase their income by the time alimony terminates such as schooling, retraining, etc., then including alimony doesn't pose a great risk. If, however, there is no action plan to increase income, alimony should not be included on a mortgage loan application. The caveat here is if the home will be sold or refinanced around the time alimony is set to end or if alimony will continue until a mortgage is paid off.

In some states alimony recipients are required to file documentation with the court detailing how the funds will be used so be sure to know the laws about alimony in the state you reside.

Mortgages

A divorce-related refinance is entirely different from a traditional refinance with certain criteria that must be met especially if only one spouse will be applying and qualifying on their own. It's important to understand what lenders require, when to apply, and what to avoid to increase your chances of being approved for the loan.

I've already touched on why it may be important to keep a home, now I want to share the nuts and bolts of a divorce-related refinance.

Many people don't realize a divorce is a lawsuit. If you attempt to refinance a home **after** a Petition for Divorce is filed in court, your application will be put on hold until the divorce is **final,** which is typically 60 **-** 90 days after your hearing depending on where you live. Why? Because lenders need to know the financial standing of the borrower after the divorce and any court ordered financial obligations that borrower will be responsible for.

Waiting to refinance until a divorce is final can be problematic for two main reasons: (1) one spouse may need their portion of the equity to start over and, (2) if the terms of a settlement are finalized in court and the refinance is not approved, it will require returning to court to amend the settlement. This is costly but it's also avoidable.

I've had many clients who started their divorce with attorneys and ended up in mediation because they we displeased with the legal handling of their separation. Many of them ran into problems with the financial part of their divorce because they followed advice from their attorneys that prevented them from accomplishing what they set out to do. To be clear, I'm not bashing attorneys, however; what I need to point out is that attorneys often have little if any specialized financial training, they don't understand mortgage lending guidelines and many don't realize that applying for a mortgage at the wrong time could delay a refinance or disquaify a borrower altogether.

There are only two options for refinancing if you're divorcing: (a) complete the process after a settlement agreement is reached but before the divorce is filed or, (b) wait until the divorce is final. All borrowers are required to disclose whether there are any lawsuits pending against them on a Uniform Residential Mortgage Application, and as we've already learned - a divorce is a lawsuit.

So, let's talk about what it takes to go into a divorce-related refinance with the best chances of being approved... And here's where you'll need to do a little homework.

Three components make or break a mortgage approval:

- Credit scores
- The borrower's income & work history
- The loan to value ratio

Divorcing spouses typically have greater success obtaining a mortgage through brokers because they offer more diversified mortgage products for all types of borrowers unlike banks that lend almost exclusively to borrowers with high credit scores and a long solid work history.

The critical component of a divorce refinance is working with a professional experienced with these types of mortgages and circumstances. The advantage they bring to the table is their ability to analyze your credit and suggest how your scores may be improved prior to applying. They can explain ways to repair your credit and they won't suggest a mortgage product that puts you at risk for future financial hardship.

Working with the right professional will make or break your ability to qualify and here's why: If your mortgage application is denied, chances are what's called a *tri-merge credit report* has been pulled on you. This means the banker has pulled your credit reports from all three credit bureaus. The "hit" credit scores take when a tri-merge report is pulled is greater than if only one report is accessed. So if your loan is denied due to an error relating to inexperience or oversight, and you apply with another lender, your credit scores are going to drop again potentially preventing you from obtaining financing.

So, how can you safeguard yourself? Take the time to interview different brokers - tell them your circumstances, *listen carefully to the information you're given,* but **don't allow anyone to pull your credit** until you've decided who your going to work with. As I've said before: the higher your credit scores, the lower the interest rate.

Having said all that, there are a few other actions you should avoid prior to a refinance unless you've been specifically been told otherwise by the qualified banker handing your loan:

- Do not apply for new credit or credit limit increases on existing accounts
- Do not allow your credit to be pulled unless it is absolutely necessary
- Do not change jobs or decrease your income
- Do not separate joint bank accounts or deplete any funds unnecessarily
- Limit increasing balances on existing credit accounts
- Do not close credit accounts
- Do not remove a spouse who's an authorized user on any accounts
- If money is tight and you're the borrower or co-borrower on an existing mortgage, always pay mortgages before credit cards
- Continue paying your accounts on time

By now you realize how much credit and credit scores can impact retaining or buying a home and I've only touched on the subject in this report. In my e-book, *Divorce and Your Credit*, I delve deeper into the ins and outs of managing credit and consumer debt because so much of being financially solvent and 'self-supporting' depends on how the financial aspect of a divorce is handled... Yet this is usually given the least amount of attention by many couples and attorneys during settlement discussions and negotiations.

Another important fact about divorce refinancing that isn't well known is that in addition to the tri-merge credit report pulled at the time of application, lenders pull another tri-merge report just prior to the closing. So if any of the actions I listed above were taken between the initial application and the closing that either caused your credit scores to drop or increased your debt ratio - your loan may be denied.

Consumer credit profiles are updated monthly and all activity on your accounts will impact your scores in one of three ways:

(a) Lower scores if any payments were late, additional credit was applied for or several credit reports were pulled
(b) Increase scores because of a consistent good payment history, your balance to available credit ratio decreased or,
(c) Not change credit scores at all

The exact impact of these factors on each individual depends on their entire credit history. For example, a consumer with a flawless payment history will see a sharper drop in their scores if a late payment is made especially if that late payment is a mortgage, and it will take longer for their scores to rebound in contrast to a consumer with fair credit who will not see the same impact because late payments are factored into their monthly scoring.

Divorcing couples often jump into making financial changes without the proper knowledge which can make it more difficult and expensive to separate and start over. What they often don't realize is financial mistakes can also delay or prolong finalizing a divorce if certain aspects of the settlement need to be re-addressed.

Short Sales

When the mortgage balance of a home exceeds the appraised value and neither spouse can or wants to retain it couples believe they have three options: (a) let the home go into foreclosure, (b) short sale the property, which means selling it for less than what is owed to the lender(s), or (c) claim bankruptcy.

Short sales are common for homeowner(s) who cannot, or choose not to, claim bankruptcy.

Selling a home for less than what is owed takes time and requires the assistance of experienced professional help and the cooperation of the lender who must be willing to sell for less than they are owed. But not everyone can or wants to damage their credit and hinder their ability to buy another home or qualify for a nice temporary rental. I often work with couples to avoid short sales and forecloures - preserving their credit and relieving their finanial burden.

Once a short sale has been approved by a lender the homeowners lose all control over the transaction because the lender is in the driver's seat including accepting or declining offers from potential buyers.

Once a home is sold homeowner(s) can expect one of the following to occur:

- The lender may require the difference between what the home was sold for and the balance of the mortgage to be repaid to them or,
- The homeowner(s) will receive a 1099 Miscellaneous Income form from the lender for the amount of mortgage debt that was forgiven.

On average, few lenders require their borrowers to repay mortgage deficiencies, however, the former homeowner(s) will have to declare the amount of mortgage debt forgiven at the time of their next calendar year tax filing. The *Mortgage Forgiveness Debt Relief Act of 2007*, which has been extended again through the end of 2015, exempts former homeowners who qualify from paying taxes on mortgage debt - but only of they meet the insolvency criteria. Former homeowners who do not meet this requirement will pay taxes on the forgiven debt based on their tax bracket. When considering a short sale consulting with a CPA - and in some cases a tax attorney - and obtaining a Certified Market Analysis (CMA) from a Realtor is a must because any financial liability a couple will incur must be factored into their divorce settlement.

And, FYI... If both spouses were borrowers on the mortgage, they are also both responsible for any tax liability owed to the IRS as a result of the short sale.

From a credit standpoint, a short sale will negatively impact credit scores but to what degree depends on the consumer's total credit and payment history. A short sale, just like a bankruptcy and a foreclosure, remains on credit reports for 7 years.

BANKRUPTCY

Bankruptcy is another option when a home is undervalued especially when couples have additional consumer debt providing they meet the bankruptcy means test. Having substantial consumer debt in addition to an under-valued home can make paying down these liabilities a drain on the financial resources each spouse will need to reestablish themselves after their divorce.

It's important for divorcing couples to know that if they file a joint bankruptcy it must be discharged **before** they file for divorce because it opens many doors for creditors to collect their debts. Bankruptcy on a federal level trumps divorce on a state level. When there aren't any joint debts filing an individual bankruptcy has no impact on the other spouse. Couples considering bankruptcy should consult with a reputable bankruptcy attorney prior to finalizing any creditor or divorce settlements.

FORECLOSURE

If a home will not be retained by either spouse and the mortgage balance exceeds the home's value couples may elect to walk away and let the lender foreclose on the property which avoids the time and effort of a short sale. Once a mortgage becomes 90 days delinquent lenders will make notification of their intent to foreclose. Depending on the state in which you reside lenders must follow certain state specific procedures when foreclosure proceedings are initiated including exploring options for the borrower to bring the account current or a modification of the existing mortgage.

A *deed in lieu* of foreclosure is a transaction where the title to the property is voluntarily transferred to the lender in exchange for the homeowner(s) being released from the mortgage obligation. A *deed in lieu* should be carefully considered **only** after obtaining advice from a real estate attorney and/or a CPA.

The impact of foreclosure, a *deed in lieu*, or short sale on credit are pretty much the same. The only caveat is whether or not the lender reports the deficiency to the credit bureaus. If they don't, the negative impact and recovery time is less.

RETIREMENT ACCOUNTS

Pensions, annuities, retirement and investment accounts are all part of a marital estate and must be disclosed and addressed in a divorce, regardless of whether they are pre-marital, accrued during the marriage or a combination of both.

Couples have a lot of lattitude in deciding how to divide these types of assets as long as the final division is equitable. However, pre-marital retirement accounts are not subject to spousal division in a divorce unless the couple decides otherwise. For example if the balance of a 401(k) was $100,000.00 just prior to a marriage and is valued at $250,000.00 at the time of divorce the amount subject to division is $150,000.00. Accounts opened and contributed to during a marriage are subject to equal or equitable distribution regardless of their value, which spouse opened the account or the amount each spouse contributed.

When pre-tax accounts are divided a Qualified Domestic Relations Order (QDRO) must be prepared and signed by a judge authorizing the plan administrator to distribute the funds, at the allowable time and in the proper amount, to the spouse who will be receiving them. A QDRO is a legal order prepared by attorneys specializing in this type of asset division that should be completed by the date of a divorce hearing. QDROs are the only way to divide pre-tax retirement accounts without incuring an early withdrawal penalty and taxes on the amount going to the receiving spouse. If a cash distribution is taken from a qualified account a penalty of 10% plus state and federal taxes will be owed based on the amount of the distribution.

Brokerage accounts or Roth IRAs are not subject to penalties or taxes as they are after tax accounts, so spouses are free to divide these accounts at a time they mutually agree upon.

The division of military and union pensions are more complex than corporate pensions and the amount a former spouse is entitled to depends on a number of factors including the length of the marriage. A Plan Administrator or Commanding Officer will provide specific details about dividing these accounts.

It’s important to note that spouses will not receive benefits from their husband/wife’s pension and certain types of annuities until the account owner reaches the appropriate age to receive these benefits themselves. Most other types of accounts, such as 401(k)s, 403(b)s and the like are divided and distributed by the plan administrator once a divorce becomes **final**, not before.

If a distribution will be taken from a pre-tax account rather than transferring funds with a QDRO it’s best to pay the penalty and taxes at the time of the distribution to avoid a tax liability that will be owed by both spouses when their final tax return is filed.

If funds have been transferred with a QDRO and the receiving spouse withdraws any funds, the penalty for early withdrawal and any tax liability will be their sole financial responsibility.

When couples have one or two basic retirement accounts to divide it’s simply a matter of math, however, if they have numerous and/or diverse accounts including stock portfolios I always advise them to consult with their advisor to determine the best way to divide their accounts PRIOR to making any decisions for two reasons.The first is to prevent either of them from an unfair loss or gain over the other and second, is to get the full picture of their options and the longer term forecast of each. This information can, and should, be used during their settlement discussions and negotiations.