Not All Assets Are Created Equally

Donna KLINE, MBA, CDFA®
Financial Advisor

By definition, the terms equal and equitable mean different things, particularly so during divorce negotiations.

Consider assets such as the marital home, vacation residences and rental properties. What is their true value? It is more than just the equity (the difference between the market value of the home and the mortgage balance that may be remaining) in the property; it is the expense or income generation of the property as well.

MARITAL HOME

Depending on the length of marriage, there may be substantial equity in the home. However, the home may be large, children may be grown and the tax burden based on the higher value of the home may be high. What is the cost of maintaining the home? Not just the taxes and remaining mortgage payments, but the maintenance and upkeep. How much is spent every year on landscaping? Snow removal? Repairs? What would the costs be to sell the property? Real estate fees, closing costs and possible capital gains? All of these things need to be considered before dividing assets.

VACATION HOME

What is the cost of upkeep here? Property insurance? Is the family utilizing the home as much as in the past? What is the net value of keeping it? What is the tax consequence of selling it?

RENTAL PROPERTY

What type of income do the properties generate? Is it enough to cover the associated expenses? How is the income treated on a tax return? Does the family or an LLC own the property? Often, a CPA should be brought into the discussion to analyze the potential tax benefit or consequence of the property before making a final decision.

Now consider other assets such as investment and savings accounts, 401(k)s, IRAs and Pension plans. All of these investment vehicles have different levels of liquidity, taxation and risk associated with them. Let us look at some examples:

INVESTMENT AND SAVINGS ACCOUNTS

These are non-qualified, or taxable accounts. There could be stocks, bonds, mutual funds and even hedge funds held in these accounts. What is the cost basis of the assets? Have they experienced gains or losses over time? How are they taxed? What is the risk associated with the assets? How much are they likely to fluctuate in value over time? What about their liquidity?

Can they be easily sold on the market or are there regulated terms of liquidation? Hedge funds (and some mutual funds) have specific requirements regarding when and how many shares can be liquidated at a time. Sometimes, there is a financial penalty for selling the asset before a specific date. These types of brokerage assets are considered less liquid than most, and sometimes, the investor must be accredited (meets high income and asset requirements) to own them. What if one spouse qualifies as accredited, but the lower earning spouse (on his or her own) would no longer qualify? Is that an appropriate asset to divide among the parties? Or should the qualifying spouse keep the asset in entirety and offset the value with another, more liquid or less risky asset?

Qualified accounts such as 401(k), 403(b) and pensions require a Qualified Domestic Relations Order (QDRO) to be filed with the court before they can be divided. This takes time and money to accomplish. In addition, retirement assets such as these may not be accessible without IRS penalty until the owner is at least 59-and-a-half years old. Even if the tax penalty can be avoided (as is the case currently when division and liquidation is the result of divorce) there will still be income tax owed on any distribution. For these reasons, $100,000 in a non-qualified account could worth more (or less) to the recipient than $100,000 in a qualified account.

Pensions are another complication. Is any cash available to the parties today? Or is it only payable as a stream of monthly payments after retirement age? Social Security is a pension of sorts. An individual cannot access any current cash from the government plan, but is promised to be paid a stream of monthly payments after a certain age.[1] Pension benefits to be paid at a later date can be separated due to divorce (again with a QDRO), but is it better for one spouse to accept an offsetting payment now instead of waiting a period of years. Special software is used to determine what the value of future payments would be worth to a spouse in current dollars.

To sum it up, not all assets are created equal. It is extremely important to have a qualified financial professional oversee the proposed distribution of assets before signing an agreement. You must be very clear on what the costs, taxes and risks are associated with each asset to make an educated decision — one that could dramatically affect your financial future.

[1]Ex-spouses have options when it comes to Social Security payments as well.

Donna Kline, MBA, CDFA®

Principal, Senior Financial Advisor, HBKS® Wealth Advisors

Donna combines experience as an investment advisor and wealth manager, a proven approach to long-term financial planning and the unique skills of a Certified Divorce Financial Analyst® to help her clients understand and address the financial issues associated with divorce and obtain a fair and equitable divorce settlement.

Donna's background includes seven years in Chicago as a derivatives broker. She joined HBKS® Wealth Advisors in 2015.