Surviving Financially After Divorce

How to prepare yourself to deal with the financial realities of divorce – especially in this tough economy.

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More often than not, the standard of living of both spouses drops in the first few years after divorce. Why? Because the same cumulative income and pool of assets now has to support two households instead of one. Unfortunately, most people don't prepare themselves financially or emotionally for that consequence. So what can you do to better prepare yourself for this inevitability? The answer is simple, but it's not easy to put into practice.

Divorce is an inherently stressful process. To alleviate some of the stress, it's important to be proactive and in control. Here are the "Lucky Seven" things you can do to help prepare yourself for your post-divorce financial future.

1. Expect your income to drop after the divorce is final.

You should expect your income to drop after the divorce is final. Develop a budget based on needs– not wants – and keep in mind that your expenses need to stay within your post-divorce income. Consider all sources of income – including spousal and child support, keeping in mind that they won't last forever – as well as investment income. To develop a budget, use a detailed worksheet so you don't overlook any expenses. The best source for the expense information is your check register, if that's how you pay your bills. Remember that not all your expenses are paid monthly; some insurance premiums or tax bills might be payable quarterly or annually, so make sure to account for those as well. (To help get you started, fill out the "Monthly/Annual Expenses" worksheet, which is available online at www.institutedfa.com.)

The last step in preparing a budget is to ask a reasonable and critical friend or family member to review your budget and challenge the expenses that seem unreasonable. You have to agree to keep an open mind and not to get mad if he/she challenges one of your items; remember that this person is trying to help you.

2. Consider whether you can afford to keep the house.

Here are the traditional options for the matrimonial home:

1. One spouse stays in the house (with the children, if any) and buys the other spouse's share by:
    - Cash-out refinance
    - Giving up another asset
    - Property settlement note
2. The spouses sell the house during or after the divorce process and split the proceeds.

In many cases, one spouse – usually the wife – wants to keep the house. Though this might be emotionally satisfying, it usually makes little or no financial sense. The equity in the house is illiquid, meaning it won't pay the bills.

In today's housing market, sometimes the matrimonial home can't be sold in a reasonable amount of time – or for a reasonable amount of money. Today, many couples own houses that neither spouse can afford to maintain on his/her own, and that they cannot sell for what they owe on their mortgage. If the house can only be sold at a loss, divorcing couples have a few options, such as:

1. Renting the house to a third party – or having one ex-spouse stay in the home and pay rent to the other until the market improves
2. "Birdnesting": the ex-spouses retain joint ownership of the home, they also rent a small apartment nearby, and each one alternates living in the house with the kids and in the apartment on his/her own
3. Agreeing to sell the home at a loss, share the loss, and move on with their lives
4. Short-sale, foreclosure, or bankruptcy.

If your house is "underwater" – meaning that you owe more on their mortgage than your house is worth – here are a few questions your should ask yourselves before putting the house up for sale:

1. Who is responsible for making up the difference between the sale price and the amount owed on the mortgage?
2. If you don't sell it, does the party not keeping the house get compensated?
3. Where does that money for options (1) and (2) come from?

If one spouse wants – and can afford – to keep the house, that spouse should pre-qualify for a mortgage before the divorce is final. Sometimes, a divorcing couple will decide that one spouse is going to keep the house. They take the other spouse's name off the deed – and then the spouse who wants to keep the house gets turned down for a mortgage because he/she doesn't make enough money to qualify to refinance in his/her name alone. The spouse who is leaving the marital home ends up being on the hook for the debt, has no reciprocal asset, and can't qualify for his/her own mortgage because he/she doesn't make enough to support both mortgages.

To qualify for a mortgage, most conventional lenders use credit and debt to income ratios. Many use a credit score system to qualify applicants; a credit score is based on payment history, amount of credit owing, length of time credit established, number of recently opened credit accounts, and types of credit established. Lenders generally use two different ratios to analyze credit worthiness. Generally speaking, here's how they work (check with your local lender – their guidelines may differ):

1. Housing Ratio = Total Monthly Housing Payments divided by Total Gross Income. This ratio must be 28% or less.
2. Total Debt Ratio = Total Housing Other Debt divided by Total Gross Income. This ratio must be 36% or less.

In order to qualify for a conventional mortgage, an applicant must have an acceptable credit score and debt-to-income ratios.

3. Know what you have.

Account statements have a way of disappearing when divorce proceedings start. When contemplating divorce, start by collecting statements for all your financial holdings and put together a list of your assets. When negotiating your divorce settlement, this step will prove helpful as a starting point. Here's an example of items you'll need to list on an Asset Worksheet. Remember to note the value of each asset, and who owns what portion of it:

- Retirement Assets
- Liquid Assets
- Real Estate
- Personal Property
- Cash Value Life Insurance
- Business Interests

As you work your way through the asset split negotiations, each asset can be moved to its appropriate column: “Husband” or “Wife”. To figure out the percentage split, divide the total for each spouse by the grand total.

4. Consider the after-tax values of your assets.

Accounts with pre-tax contributions and tax deferred growth come with a tax liability. Know what the after-tax equivalent value is before agreeing to take an asset. Having $100,000 in an IRA or RRSP is not the same as having a $100,000 in a checking account. The spouse with the retirement savings plan will end up with the account value minus the tax liability, and the other spouse will have the whole amount to spend.

5. Understand your financial needs.

You need to make sure that the liquidity of the assets you’re getting matches up to your needs. Let’s suppose you want to keep the marital house – which is worth $300,000 or 50% of the marital estate – as your share of the settlement. Until you take a close look at your long-term financial forecast, you won’t know whether you can afford to keep it. Suppose, for example, you’ve factored child-support payments into your income; after the payments end, how are you going to pay the mortgage? If you have to put the house up for sale in a few years, you may be solely responsible for paying all the real-estate costs and capital-gains taxes from the time you and your spouse acquired the property until you sold it – which could be bad news indeed.

6. Don’t overlook the value of a future pension.

Any portion of a pension that was earned during the marriage should be included in the marital pool of assets. Pensions can be handled in three different ways:

1. The non-employee spouse can receive his or her share of a future benefit;
2. The pension can be present valued and offset;
3. A combination of (1) and (2).

Your particular situation should determine which option makes the most sense for you. For example, a 32-year-old wife with two young children and limited resources will have different needs than a 55-year-old wife with a career and her own pension. Make sure you’re not the divorcee who has a great pension that will pay in 15 years and have no money to pay the bills today.

7. Hire a good team.

Personal recommendations from a trusted friend or business associate are a great source for professionals. However, you need to do your homework before hiring anyone. Your team should consist of a divorce lawyer and a Certified Divorce Financial Analyst™ (CDFA™) at a minimum. If needed, other members or the team could include a mediator, an accountant, a business or pension valuator, or perhaps a child or individual therapist. Although you may think that the more professionals you hire the more costly your divorce will be, this is not necessarily true. In the long run, having the appropriate help will cut down on litigation costs, and it may save you from making costly blunders regarding your settlement.

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