Not always a rose: Avoiding thorny asset-liquidation issues in divorce

"A rose is a rose is a rose, but not when it comes to assets," said **Claudia Mott, owner of Epona Financial Solutions, referring to the treatment of assets as a result of divorce**.
"Every family's financial picture is comprised of a variety of assets, each of which may need to be valued differently if a liquidation is necessary," said Mott, who is also a certified financial planner and a divorce specialist.
"Each party in the divorce needs to understand how the liquidation may affect not only the next tax return but also their long-term financial future," she said.
"Mistakes are costly, like liquidating a 401(k), which means next year you have an enormous tax bill that you didn't plan on and may not have the cash to cover," Mott added. "It could start your life on a downward spiral."
Holding on to the family home could be another costly mistake, said divorce specialist Michael Black, a certified financial planner and owner of Michael Phillips Black Wealth Management.
"It might be the best emotional decision—and possibly one of the worst financial decisions if the costs to keep the house are unaffordable," he said. Citing a recent and typical case, he explained, "The wife, in this case, [had] to refinance the mortgage to take the husband off the loan, and after all the negotiations and legal costs, the wife finds out that she cannot qualify for the new mortgage."

Tax Implications

More mistakes occur when the divorcing spouses don't consider the tax implications of different asset classes, Black noted.
"For example, if the wife keeps a house with $500,000 equity, this asset generally has a gain exclusion," he said. "If the husband keeps a 401(k) worth $500,000, he will sustain an unavoidable tax liability—one-third of it could go to taxes.
"Yet a judge could say you're even," Black noted.

Liquidating assets should be a last resort in most cases, because liquidation creates a taxable event. And because transferring assets between spouses is a nontaxable event, it becomes a great motivator to trade assets back and forth, according to Black.
Many divorce lawyers forget to assess assets on an after-tax basis, said Carlton R. Marcyan, attorney and certified financial planner with family law firm Schiller DuCanto & Fleck.
"Tax considerations must be taken into account, including whether the transaction is taxed at ordinary or capital gains rates," he said. "This is especially so when dealing with dividing restricted stock, options and deferred compensation rights."
Also to be considered are operating losses and carryovers that have value in the nature of either refunds or reduction of future taxes, Marcyan explained.

Collaboration vs. Litigation

Litigation is the more limiting option when allocating assets.
"Not only are most courts restricted to what they can do to value assets, divide assets and consider potential tax effect, but judges have limited time to focus on technical and financial nuances," Marcyan said.
In collaborative, negotiated settlements, parties can apply valuations that a judge may not be permitted to take (e.g., personal goodwill, fair market value, fair value).

"Another example: Most states do not allow a court to 'tax effect' retirement accounts such as pension plans or IRAs," Marcyan said. "In a collaborative setting, the parties could tax-effect all assets, whether retirement or otherwise, so that asset values are all after tax, and therefore the final result would be fairer to both sides of the case."
In addition, courts usually require substantial evidence to establish that any nonmarital asset, such as property brought into the marriage or obtained through gift or inheritance, qualifies as nonmarital, he added. "In collaborative, the parties could acknowledge the character of such property, even though the formal, legal requirements to establish nonmarital have not been met."

The bottom line? "It's much more important to negotiate than go to court. If you must liquidate assets, do it within a negotiated, mediated perspective," Black said.

Community Property vs. Equitable Distribution

Nine states divide property according to community property law, while the rest apply equitable distribution principles. They are Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington and Wisconsin.

Community property distribution

With community property distribution, all assets accumulated by the parties during the course of the marriage are considered owned jointly by them. Courts basically add up the value of the assets and then divide that in half, distributing one half of the assets to each party. It is a simple mathematical procedure, with no other contributing factors.

In awarding spousal and child support, the courts in a community property state may consider how long the couple has been married, the age of each party or ability of either one to be employed, based on their health or employment background, even though these factors are not considered in the distribution of assets.

Equitable distribution of property

Equitable distribution states allow divorce courts a lot of discretion in dividing marital assets in an equitable, or fair, manner. Courts can consider any relevant factor in achieving an equitable distribution. The most common considerations include:

—Length of the marriage.
—Age of the spouses.
—Health of each spouse.
—Ability of each spouse to support themselves.
—The fact that one spouse did not pursue a career in order to care for children.

A court may balance a small award of spousal and child support with a greater distribution of assets. In some states, although not the law, a fair policy provides for one party to be awarded at least one-third of the assets accumulated during the marriage.

Negotiated divorce settlements allowed in all states

Whether they live in an equitable distribution or community property state, the parties can choose to negotiate their own property settlement that courts will honor. Their distribution agreement does not have to follow the laws of their state.

Source: "The American Legal Journal"

Asset Liquidation Dos and Dont's

Do:

—Understand the cost basis of investable assets.
—Make sure you know the purchase price of a real estate asset and quantify all improvements made.
—Understand what the capital gain will look like for the sale of a home.
—Make sure to obtain good business valuation (on equipment, buildings/real estate, goodwill, customer lists, customer base, etc.).
—Get an appraisal for collectibles.

Don't:

—Liquidate a 401(k) if at all possible.
—Sell something that will result in the biggest capital gain.
—Forget to be aware of the change in capital gain exclusion from $500,000 to $250,000 when the proceeds of a house sale are split.
—Sell an asset without getting a fair price.

Source: Claudia Mott, Epona Financial Solutions