Property Settlements - When Equal is Not Equal

by Nancy Hetrick, CDFA™

Dan and Sue are preparing for their divorce and to them it seems pretty straightforward. Here is a list of their assets:

1. Principal Residence	
Market Value	$750,000
Mortgage Balance	$ 150,000
HELOC	$ 200,000
Equity	**$400,000**
2. Vacation Home	
Market Value	**$300,000**
3. Dan's 401k	**$150,000**
4. Checking and Savings	**$30,000**
TOTAL ASSETS =	**$880,000**

Dan says that he wants to keep the primary home and he will let Sue keep the vacation home. Sue is in agreement with this plan and therefore, to provide a 50/50 split, Sue will get half of the checking and savings, $15,000 and $125,000 of the 401k for a total of $440,000 each. Ah, a perfect 50/50 split. No problem!!

	Dan	**Sue**
1. Principal Residence	$400,000	
2. Vacation Home		$300,000
3. 401k $150,000	$25,000	$125,000
4. Checking and Savings $30,000	$15,000	$15,000
TOTAL ASSETS = $880,000	**$440,000**	**$440,000**

Dan plans to live in the primary home for 2-3 more years and then sell it and downsize. Sue plans to sell the vacation home and buy a new residence for herself. Since she's only 50 yrs old, she is also going to take advantage of her one-time opportunity to withdraw $100,000 from the 401k subsequent to divorce with no penalty, although she will have to pay income tax on the money. Hmm, could these plans impact this settlement? Let's take a new look at each party.

About 6 months after the divorce, Dan realizes that the upkeep on the home is more than he can afford on his own and decides to go ahead and sell. He's able to sell it for $775,000. He pays off the $350k mortgage and HELOC and has to pay 6% for sales fees or $46,500 leaving him with $378,500 in equity. The original price of the home, bought with his wife 25 years ago, was $150,000. That means he now has a capital gain of $228,500. As a single person, he can exempt $250,000 of gain on a principal residence, avoiding any capital gains tax.

Let's look at Sue. She moved into the vacation home for 6 months before putting it on the market. She was able to sell it for $325,000 with selling expenses of $19,500 leaving her with $305,500. The property had been in her family for generations and the basis was $60,000 so she assumed that her gain of $245,500 was well under her personal exemption and she sold the property and used the money to buy a new condominium. When tax time came around, her accountant looked at her with big eyes and broke the bad news. The exemption is only applicable to a primary residence. In order to use it, she would have had to have lived there for 2 years. Since she didn't, the **entire gain is taxable.** She's also a highly compensated individual so her rate is not 15% but 20% and oh, don't forget to add the new Medicare surcharge which raises it to 23.8% so her **tax bill is $58,429.**

And let's not forget she also got 401k assets and had to pay tax on those too! Let's look at a revised chart.

	Dan	**Net**	**Sue**	**Net**
1. Principal Residence *net after sales cost and tax, no appreciation added	$400,000	$378,500		
2. Vacation Home			$300,000	$222,071
3. 401k $150,000 *Dan@28%, Sue@39% tax	$25,000	$18,000	$125,000	$76,250
4. Checking and Savings $30,000	$15,000	$15,000	$15,000	$15,000
TOTAL ASSETS = $880,000	$440,000	**$411,500**	$440,000	**$313,321**

Dan's assets are worth $98,179 more than Sue's. Once Sue figures this out, how do you think she will feel about the "fair" division that she agreed to?

There were much better ways to structure this settlement that would have been more equitable. But as you know, once that decree is written, it's pretty tough to go back and fix things. Take the time to really evaluate your settlement results or bring in an expert who can. At the very least, review the plan with a CPA or CDFA™. Mistakes like these could turn your dream of the next phase of your life into a nightmare.

Questions? Contact Us

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