

# FINANCIAL MODELING 101

## How to Determine the Asset Split in Divorce

By Michael Black, CFP®, CDFA®, AIF®

Who gets what? A better question is “who needs what?” Until you know the needs of your client(s), it’s impossible to answer. This article is intended to lay out the general approach for deciding “Who gets what based on who needs what?”

Depending on the state of domicile, the legal standard for splitting assets/debts is either Community Property or Equitable Distribution. In the simplest sense, Community Property states split the marital property equally and

Equitable Distribution states divide the property fairly, in light of the couple’s circumstances.

More importantly, what does each party need from the divorce? The only way to know is to perform a Needs Analysis, or Financial Modeling.

Depending on whether the CDFA® professional is working in a neutral format or an adversarial one (working with one party), it is imperative to understand



the needs of your client(s) in order to determine which assets and/or liabilities fit your client(s) needs.

## A MODELING CASE STUDY

Let's examine a divorcing couple, married for 13 years. He's a 45 year old middle manager for a Fortune 500 company married to a 43 year old teacher that has taken the last 15 years off work to raise their 3 minor children. They have \$1 million in retirement funds and \$500k in personal investments. She has a small pension from working as a teacher.

They own a \$650,000 home with a \$150,000 mortgage.

The combined assets, net of debt, is \$2,000,000.

Wife has filed for divorce.

He makes \$250,000 annually, with \$12,500/month take home pay, which they spend all of for their current married lifestyle. Husband anticipates it will cost him \$7,000 per month to live post-divorce with 50/50 child custody. Wife, who is the primary custodial parent, anticipates it will cost \$9,000 per month (assuming she keeps the house) while the children are minors.

Who gets what? Without us, the attorneys see \$1,000,000 to each side without regard for needs.

If you're a neutral, you sit down with each of them independently to discuss what their expectations are for their new life: where and how they want to live, employment future, planned retirement, etc. Each has their own expectations and life plan...or they don't. If they do, you can start modeling. If they don't, the advisor/analyst needs to start the discussions (how this is done is the subject of another article).

There are finite assets and cash flows to work with, and the goal is to use the assets and incomes efficiently for both parties' benefits, which are usually defined totally differently. In our example, the husband generally would fund the transition, which may include some amount of spousal support and child support, and then focus on rebuilding retirement funds for his future.

The wife is generally focused on raising the children, finding employment, and maintaining family continuity. The first question she may have in a post-divorce world is "Can I afford to stay in the house?"

In the most general sense, her needs from the marital assets are usually *immediate*, and his needs are usually *deferred*. Both will need some cash for the divorce transition. This is starting to look like the husband may want more of the retirement accounts, and the wife may want more of the personal investments. She probably wants to keep the marital home for family continuity, which may mean that he can keep more of the retirement. But will it work?

## MODELING GOALS FOR A LIFETIME

Today's planning software (MoneyGuidePro, EMoney, etc.) is ideally suited for this type of planning. Let's take the wife's situation.

You enter her goals broken into 3 periods: while raising kids, on her own, and retirement. Each has specific needs and time periods. Next, we should factor in some level of spousal support and child support, each for different time periods. We also need to assume some sort of employment income (it will be imputed in the divorce process). Next, we allocate the marital assets (including the home) to the wife. Each party will get half of the marital estate, which means each will get \$1 million.

But the house will represent \$500k of her \$1 million. That only leaves \$500k in investments, some of which she will use for the transition from married to a single mom, which means some personal non-qualified assets. Of course, the husband is going to protest that personal assets don't have the future tax liability the retirement assets do, and that he will also need some of the personal assets to start his new life. In the negotiation/mediation stages, we as the advisor will probably need to tax-adjust the values to look at all assets on an after-tax basis.

We would then generate two balance sheets: one with

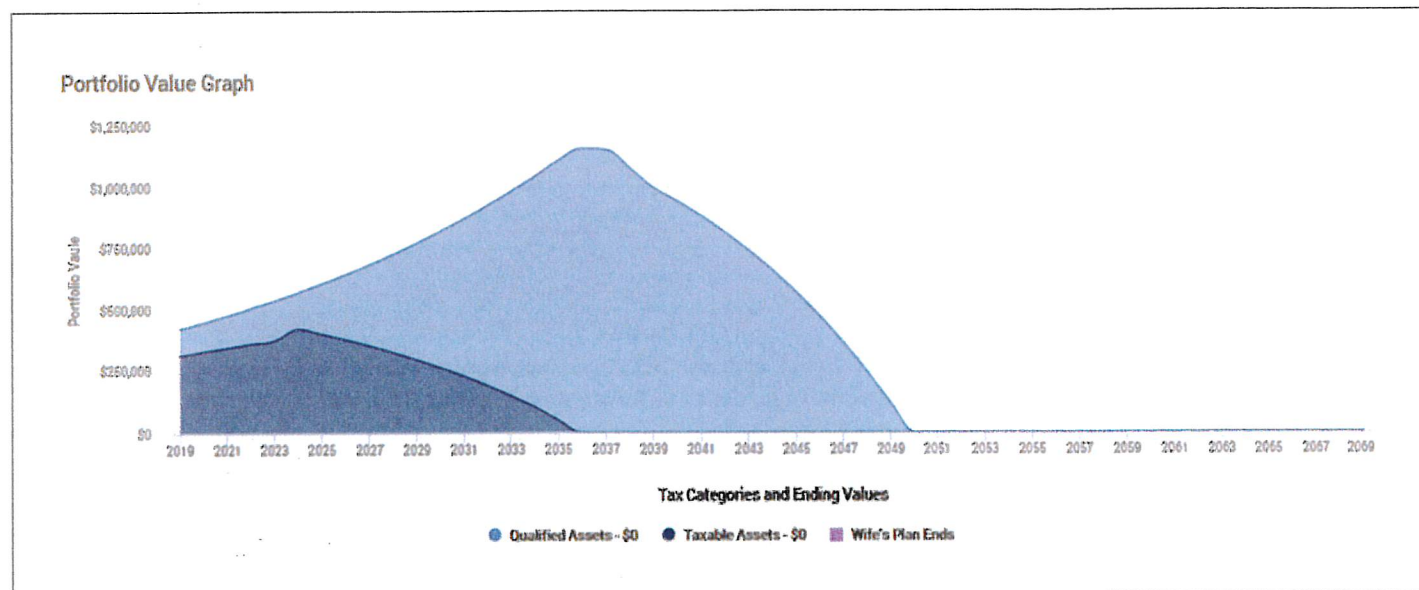
**If you are working  
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and model each. Starting with the stated values, we run the program to see what happens. Like all software, it's garbage in and garbage out. Your assumptions are critical; not just the financial assumptions of her goals, but the internal assumptions of inflation, taxation, and investment returns/risks, etc.

Most sophisticated planning software uses Monte Carlo simulations to analyze the investment returns and risks. Since future returns are random given any hypothetical portfolio but historical returns are known, the variation of returns can be calculated. Monte Carlo simulation allows for the random allocation of returns, given the historic returns and variation (standard deviations), each year for a given lifetime. One thousand lifetimes are projected using assumed incomes from support and earned income, minus living expenses, discretionary expenses, children's education, taxes and so on, along with the assets allocated in the

to the assets. If expenses exceed incomes, the asset income must make up the difference (and possibly the asset itself).

A probability is presented to test if the plan works or doesn't work, based on her keeping the house, \$500,000 in investment assets, spousal support of \$6,000 month for 6 years and child support of \$1,100 for 6 years, and spending \$9,000 per month.





In this case, the current scenario has a 0% probability of working! She would run out of money when she is 65. In addition, most software has a "solve" function to illustrate the variables you may want to vary in order to reach a reasonable probability of success. You are able to lock certain needs that are not negotiable, like base living expenses and time periods for raising kids. But other goals are negotiable, like retirement age. You may find that she can't live the way she wants because some discretionary expenses cannot be covered by anticipated earned income, support or investment income. Or, if you are using investment income to cover near-term expense, retirement may never happen, or be extended beyond her expectations.

This forces the uncomfortable conversation that may need to take place: prioritizing expenses. Are cable TV or vacations more important than retiring, or are they worth running out of money at age 58?

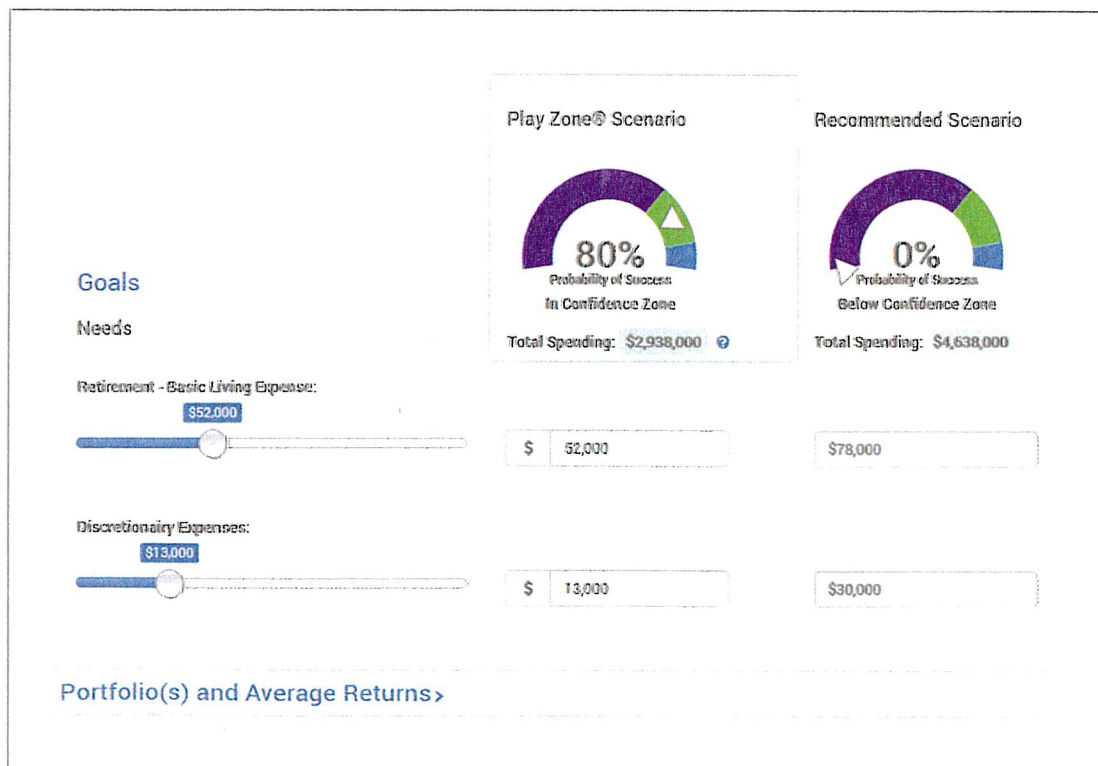
You may determine that the house is too expensive for the wife to keep. If she sells the house and downsizes, adding \$200,000 to her investment accounts and reducing her fixed expense, and also chooses to reduce some of her discretionary spending to \$5,500, and takes on part time work when the kids are out of the house, her probability of success rises to 80% without running out of money for her lifetime.

Only financial modeling will let you know what will work and what will not—and what needs to be done to make it work. You change assets allocated to the wife, various support calculations and earned income assumptions, and review with the legal team. If you are working with one spouse, you're actually providing the lawyer with options on what to negotiate. As counter offers come in, you model those to show the effect on her finances to know if you should accept or counter with an offer that works better for her.

You do the same process for the tax-adjusted values. But you need to be careful to turn off the taxation on distributions from retirement accounts if you accounted for the taxes up front by reducing the asset value for the associated tax liability. This is done on retirement accounts and highly appreciated assets.

If you are working as a neutral, you run each scenario from each party's perspective, varying support payments and asset allocations, attempting to reach a reasonable probability of success for each party. If the divorce is litigated, this analysis is very useful for the court to determine the asset split and support payments, with evidence to support the conclusions.

As the Rolling Stones song says, "You can't always get what you want"—and you might not even get what you need. But until you perform this exercise, how would you know?



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