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White Paper
Divorce and Debt

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Divorce and Debt

What is debt and how is it classified for divorce purposes?

Like property, debt is classified as marital or separate. For more information about these terms, see Property Settlement. In general, both spouses are responsible for any debts incurred during the marriage. It doesn't matter which party actually spent the money. When the property is divided at the time of divorce, it's often the case that the person who gets the asset also gets the responsibility for paying any indebtedness secured by that asset. Even if your spouse agrees to take over the debt, joint obligors on a loan will remain jointly responsible. That is, the creditors can seek payment from either of you.

There are basically four types of debt:

- Secured debt
- Unsecured debt
- Tax debt
- Divorce expense debt

Secured debt

Secured debt gives the lienholder or lender a right to repossess the property in the event of your default on the loan. Some examples of secured debt include mortgages on your real estate, car loans, and boat loans. If a loan stands in the joint names of you and your spouse, you'll need to make it very clear in your separation agreement who will be responsible for making payments on the loan. Otherwise, if one spouse fails to make timely payments, the creditor can pursue the other spouse or (eventually) seek repossession.

Unsecured debt

Unsecured debt does not give the lender the right to repossess any specific property, although there are other remedies at law. Typical examples of unsecured debt include credit cards, personal bank loans or lines of credit, and loans from family and friends. For more information, see Secured versus Unsecured Loans.

Tax debt

If you sign a joint return with your spouse, you're each liable for the tax debt. For three years after the due date for filing your return, the Internal Revenue Service (IRS) can perform a random audit of your joint tax return (although the period may be longer than three years in cases of fraud or failure to file). To avoid potential tax problems in the future, your divorce agreement should spell out what happens if any additional interest, penalties, or taxes are imposed for any prior tax year. Notwithstanding any such

agreement, you should be aware of the so-called innocent spouse rules, which provide certain protections to a taxpayer whose spouse understated the tax due on a joint return. A number of rules and conditions apply. For more information, see Pre-Marriage Tax Debts and the "Injured Spouse" Rules.

Divorce expense debt

Divorce can be expensive, and sometimes a spouse will seek a court order to make the other party subsidize attorney's fees for both sides. This might happen, for instance, when only one spouse works. Since the homemaker-spouse may have no income to pay for a divorce attorney, a judge might order the working spouse to pay.

Sometimes both parties work or have sufficient funds with which to retain attorneys. In these cases, you'll need to spell out who pays for what. For instance, if both parties want the family business, the family home, or a pension to be appraised, you'll have to apportion the costs. The same holds true if you both decide to transfer title to an asset after a divorce.

Debts can also be incurred during the separation period. If luxuries are purchased during this period, courts are likely to assign the debt solely to the party who ran up the debt. In general, debts incurred after the separation date and before the divorce is final are the responsibility of the spouse who incurred them. One exception is family necessities (i.e., food, clothing, shelter, and medical care). These necessities can be paid by the other spouse if the incurring-spouse can't afford to pay.

What are the rules regarding joint credit card debt?

Either signer on a joint credit card can be held responsible for 100 percent of the debt, not just one-half of the debt.

Example(s): Hal and Jane are seeking a divorce. During their marriage, Hal handled the finances and Jane stayed home with the children. During the discovery period of their divorce, Jane learned that Hal ran up over \$30,000 on their joint credit cards to pay for his expensive suits, dinners for friends, recreational pursuits, and the like. Since they live in a community property state, all assets and debts will be divided down the middle. Thus, Jane will be responsible for paying \$15,000 of the debt (from a judge's perspective). However, if Hal fails to keep up with his monthly payments (or, if he decides not to pay any of his \$15,000), the credit card companies can go after Jane for the full \$30,000 because the divorce settlement is not binding on creditors.

During divorce proceedings, several issues can arise regarding credit cards, such as removing a spouse as an authorized signer, and understanding the obligations of joint credit card owners versus single card owners with two authorized signers. For information about these and other topics, see [Credit Cards](#).

Will my former spouse's bankruptcy affect me?

Bankruptcy law allows debts between ex-spouses to be wiped out. Therefore, the assets you were promised in your divorce settlement may never materialize. Be aware of this if you're considering the use of a property settlement note (a form of promissory note) to equalize a property division.

Example(s): Assume Nicholas and Sandra wanted to divide their assets 50-50. After assigning the house to one and the pension to the other, Nicholas still owed Sandra \$40,000. Nicholas signed a property settlement note to Sandra, promising to pay her \$40,000 over a five-year period at 7 percent interest. After the divorce, Nicholas filed for bankruptcy and listed the note as one of his debts. The debt was discharged, and Sandra never received her money.

Tip: Alimony and child support can't be discharged in bankruptcy. Therefore, in the above scenario, alimony should have been considered as an alternative to the property settlement note. For more information about property settlement notes, see [Property Settlement](#).

If your ex-spouse files for bankruptcy, other problems may arise for you. While a bankruptcy might wipe out your spouse's obligation to pay marital debt, it doesn't wipe out your own. The creditors can contact collection agencies about you (damaging your credit), or sue you for the full amount of the debt. For more information about bankruptcy, see [Bankruptcy](#).

How do you divide debt at divorce?

Basically, you have five options in allocating your marital debts:

- You and your spouse can sell joint property to raise the cash to pay off your marital debts.
- You can agree to pay most of the debts. In return, you can request a greater share of the marital property or a corresponding increase in alimony.
- Your spouse can agree to pay the bulk of the debts. In exchange, your spouse may get a greater share of the marital property or increase in alimony.
- You and your spouse divide the property and debt equally; that is, each of you gets one-half of the property and each of you agrees to pay one-half of the debt.
- If you're a homemaker with children, your spouse might be ordered to pay the bulk of the debt, pay alimony, and perhaps allow you to keep the house and a portion of other significant assets, such as your spouse's pension.

Because of the threat of bankruptcy and/or damage to your credit report, it might be wise to sell joint assets to pay off debt, or to assume responsibility for the debts yourself.

How can I repair my credit after a divorce?

Credit problems generally stay on your record for seven years, while bankruptcies can remain for up to 10. For more information, see Bankruptcy. There are some steps you can take to repair credit damaged during a divorce:

1. Obtain a copy of your credit report and look for errors. Sometimes, your credit history may be confused with someone else who has a similar name.
2. Meet with a consumer credit counseling representative. A representative can provide you with tools to negotiate with your creditors. He or she can also give you some useful suggestions for paying your bills.
3. Open a secured credit arrangement with your bank. If you deposit a specific sum of cash with a bank (such as \$500), the bank will sometimes provide you with a secured credit card. Making timely payments will help to repair your credit over time.

What questions (relative to debt) should you consider before entering into a divorce settlement agreement?

Before sitting down with an attorney, think about which debts were contracted prior to marriage (separate debt) and which debts were contracted during the marriage (marital debt). With respect to marital debt, consider the following questions:

- If I wish to keep a particular marital asset, will I have sufficient income to keep up with the loan payments?
- Should I liquidate other assets to retire the debt completely (or partially)?
- If my spouse proposes a property settlement agreement, is there any likelihood that he or she would subsequently declare bankruptcy?
- Can I collateralize property settlement notes from my spouse so that bankruptcy will not eliminate his or her obligation to me?
- If, pursuant to our divorce agreement, my ex-spouse assumed responsibility for all credit card debt, what are my legal remedies if he defaults? How can the divorce agreement be enforced?

Disclosures

This material does not constitute the rendering of investment, legal, tax or insurance advice or services. It is intended for informational use only and is not a substitute for investment, legal, tax, and insurance advice.

State, national and international laws vary, as do individual circumstances; so always consult a qualified investment advisor, attorney, CPA, or insurance agent on all investment, legal, tax, or insurance matters.

The effectiveness of any of the strategies described will depend on your individual situation and on a number of other factors. After reviewing your personal situation, we may recommend that you not use any strategy in this document but instead consider various other strategies available through our practice.

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