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Stock market's wild ride can make divorce allocations a bit tricky

Following more than a year of stock market euphoria, 2018 served as a harsh reminder of the concept of market volatility.

In divorce cases, litigants have the option to take their case to trial or reach a settlement. When litigants opt for the latter, their rights and obligations concerning issues of property allocation, spousal and child support and the like are outlined in a marital settlement agreement.

The Illinois Marriage and Dissolution of Marriage Act vests courts with the discretion to value assets and liabilities for purposes of property division as of the date of trial, or such other date as agreed upon by the parties or order by the court. 750 ILCS 5/503(f).

Generally speaking, when litigants reach a settlement of their case, they use the date of divorce or one very close thereto as a valuation date.

Allocating market gains and losses

For better or worse, the value of investment, retirement and other assets consisting of securities is subject to change with virtually each passing minute.

With investment and retirement asset allocation, the physical transfer of funds generally does not happen within minutes, hours or, in some cases, even days of the finalization of a divorce case.

Thus, where these assets are not split equally between the litigants, it is crucial to account for and allocate market gains and losses in the time period between divorce and the actual allocation.

To divide a qualified retirement plan (e.g. 401(k), 403(b)), the court must enter a qualified domestic relations order directing the plan administrator to effectuate the transfer of funds from the plan participant (employee) to the alternate payee (nonemployee).

With some plans, it can take up to 90 days from the date of divorce to complete the transfer of funds.

To put this time period in perspective relative to the market, on Jan. 17, the Dow Jones Industrial Average closed at 26,115.65. Approximately 30 days later, the Dow Jones closed 24,893.49 — a drop of more than 1,222 points or almost 5 percent.

In the first several days of February alone, the market entered a correction. The market's spiral eventually cooled off as investors experienced lukewarm growth year to date, until early October at least. On Oct. 5, the Dow Jones closed at 26,632. As of the drafting of this article, the average stands at 25,396 — another downward swing of approximately 5 percent.

Where spouses express a percentage division of particular assets, they inherently share in market gains and losses from the effective date of the agreement until the date the assets are divided or transferred. However, in some circumstances there is a specified amount of cash to be paid to a spouse to buy out a specified number of shares of stock from a holding to be retained by the other spouse.

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In those circumstances, it is crucial to include language allocating market gains and losses pro rata so the buyout fairly reflects the real value when the deal is closed. This is true even where a vast majority of market analysts agree timing the market is nearly impossible.

A litigant who is allocated a larger share of a 401(k) wants to be assured that in periods of steady market growth she receives her pro rata share of the gains. Similarly, both will want to absorb only their ratable share of market losses.

In a continuing 401(k) plan where there will be additional contributions by the employee spouse, the contributions, appreciation and income need to be subtracted from the former spouse's share.

Other allocation considerations

Periods of market volatility must also be considered in overall property allocation. As a general proposition, take for example a scenario where a spouse is allocated 100 percent of a 401(k) (and perhaps a reasonable discount applied given that the 401(k) is a qualified asset), while the other spouse is allocated nonmarket assets (e.g. cash or real estate).

A market swing akin to those in February and October could conceptually cost the spouse being allocated the 401(k) tens of thousands of dollars, while the other spouse is conceptually more insulated. Therefore, risks that may be associated with assets a client is to receive need to be considered.

In representing high net worth individuals and distributing multimillion-dollar and diverse estates, it is incumbent on the lawyer to advise their client of scenarios like these where one morning the client may wake up to find their million-dollar asset worth significantly less.

At the same time, however, the inverse holds true, as does the risk. It is important to help make thoughtful decisions about this issue for clients to weigh risks and rewards inherent in the assets they receive.

Tax consequences of asset allocation

In addition, periods of market volatility stand to impact capital gains and losses generated by investment assets. The former can create a tax liability (e.g. where a holding is sold for more than its purchase price), whereas generally speaking the latter results in an asset (e.g. where a stock's sales price is less than its purchase price, thus creating an offset against present or future capital gains).

Section 503(d)(12) of the marriage act directs courts to consider the tax consequences of property division. In marital settlement agreements for high net worth divorce cases, the parties are able to plan how to best deal with holdings that carry positive or negative tax consequences when they are sold.

In these circumstances, it is good practice to consult with financial advisers and accountants when considering asset allocation to ensure that assets and liabilities are being apportioned and allocated as the litigants contemplated, and to avoid an unintended result of one spouse being allocated a vastly disproportionate share of assets with ingrained capital gains or losses.

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