

The Divorced Dad

...a financial basket case



Post Divorce Recovery Strategies

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Disclaimers

This article is not financial advice. You need to consider the risks and benefits of any investment strategy either on your own or, as we strongly recommend, with the assistance of a licensed financial planner.

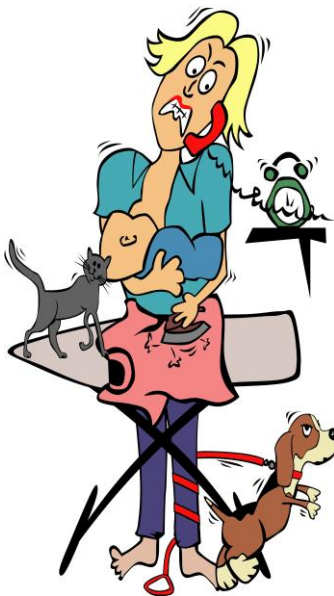
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Introduction

If we were to run a competition for divorced Dads, with the winner being the one who made the most financial mistakes during divorce, the field would be enormous and the stakes high.

Very sad, but true. Most Dads make mistake after mistake with financial settlements and they *need help*. (*Email your horror story and I will think of a prize for the worst!*)



This article is written specifically for divorced Dads and the many challenges they face in their post divorce recovery. The Mums, or stay-at-home Dads, have very different *but equally significant challenges* which are not covered in this article. There is no bias, simply different issues to address at another time. So if you are a divorced Mum, take heart that the intent of this article is to promote the Dad's financial recovery, which will improve his mental health and allow him to be the best Dad he can.

Please email me if you are interested in the "Divorced Mum" strategies!

Regrettably, I can't patch up the differences underpinning the demise of a marriage, but what I can do is make sure that the loving Dad is afforded every opportunity to recover to the best possible outcome financially. There are a significant number of strategies you can use which will marginalise the downside, make your recovery as fast as possible and ensure that you can continue to provide for your children in the best possible way.

How do I know this? I run a successful accountancy practice, am a tax specialist, a financial planner with a major passion for tax-effective investment and a Doctorate dedicated to the power of self-managed superannuation. Moreover, I am also a divorced Dad and loving father of two beautiful children...

The strategies I cover in the following pages are widely applicable, but ideally targets divorced Dads who:

- Are aged 40-55.
- Are left with 25-40% of assets.
- Have children average age of 8.
- Have limited custody of their children.
- Have a higher income and are paying child maintenance.
- Are renting or have a big mortgage.

Let's look at a common scenario and the mistakes that a 'typical Dad' makes:

Sadly, a marriage ends. The Mum receives 65% of the asset base which normally includes the family home. The father typically receives a cash settlement which carries an income tax liability, as do his other assets such as a rental property or shares or non-assessable superannuation.

This settlement earns interest in the bank, upon which tax is payable and he also loses after-tax income to maintenance payments. The Mum, on the other hand, retains a greater asset position, keeps the family home which continues to increase in value without tax or maintenance implications, receives tax-free child maintenance from the Dad and mostly tax-free Centrelink benefits (usually).

In an attempt to start again, the Dad will usually buy a house to live in. Typically, house prices have increased during the protracted separation process, the deposit saved for the purchase comes from heavily taxed income, and he is up for stamp duty and all the associated costs of buying a new residence.

Now the Dad is really being stretched financially. He is facing new mortgage payments which he has to work harder to meet, paying more taxes on his extra income, making child and possibly

spouse maintenance payments and paying for a whole new suite of costs associated with living separately. He is now in a viscous circle he will always struggle to escape.

The family law court is less than accommodating to this predicament. Whether right or wrong, it's just the way it is for the time being.

Some divorce lawyers aren't able to act in the best interest of their clients if they aren't across the intricacies of the tax / financial system; it's not their area of expertise. (This obviously doesn't include your lawyer if they have been prudent enough to give you a copy of this article!)

Any divorce lawyer who doesn't instruct his client to seek separate tax / financial advice before accepting a settlement and to have a plan for post-settlement should be racked with the guilt of a significant omission in service. Dads simply cope much better with a perceived 'lousy' settlement if they have a plan for going forward. This makes the arduous settlement process much smoother for everyone.

Regrettably, by the time most divorced Dads make it into our office it's too late. Deals are done and no allowance has been made for tax or capital gains tax on asset splits, and certainly no plan for recovery put in place. This frustrates the living daylights out of me. The Dad feels financially devastated, bereft of faith and directionless; all of which are major contributors to alcohol abuse, depression, violence, self harm and other scourges.

So what is the upshot here? In a nutshell, the divorced Dad has lost the greater part of his asset base, owes tax on the remainder and has a very depressed position from which to recover.

But, there are ways forward.

Having been through a difficult divorce myself, I now have the ambition of guiding every recently divorced or separated Dad into a new sense of purpose, empowering them with the tools of financial recovery and re-instilling the confidence to once again set forth on the road to a fulfilling and rewarding life.

Here's the plan...

Getting Over It

Invariably you feel like they've 'won the battle', you've 'lost the lot' and now you're back to zero. Or worse still, beyond zero as you've had to borrow against your business or other assets (or from friends and family to pay out a spouse) and yes, you have done the right thing in accepting the non-assessable superannuation as well.

It's shattering on multiple fronts and the process seemed decidedly unfair, but whether or not it is fair or unfair is irrelevant; it's just how it is.

Invariably at this point you will have so much to process emotionally, spiritually and practically. Singularly, the most productive and empowering approach you can take at this point is to 'get over it' and start the process of recovering from ground zero.

'Getting over it' is as important for your financial recovery as it is for your mental health. No-one wants to be or know a victim, and being that victim only erodes your own finite life, not to mention the lousy attitude you reflect on your kids as a role model.

The best way to move on financially is to latch on to a strategy that you believe in and can commit to; to get going again, picking up what pieces may remain and making a start. You're not alone and there are many avenues for support and guidance. Make an appointment to see someone like myself, get some direction and get going. There are always ways forward.

Let me keep it simple. There are two "suggested" roads to recovery in this article (there are many others).

1. If you are aged less than fifty, look to buying a home.
2. If you are over fifty, look to superannuation (and rent or pay interest only on a home).

In both cases we also consider a raft of other tax effective investing strategies regardless of your age or circumstances, but these are covered in my other books.

What is the primary objective from here?

1. To structure a protected wealth recovery strategy by using all available tax allowances, concessions and deductions.
2. To accelerate the funding of the recovery program through the leveraging (when appropriate) all permissible tax allowances, concessions and deductions.

The following extracts are from two chapters of my book “**Tax Effective Investing**” (*available for free at www.ciatax.com.au*). These chapters alone are particularly useful in getting my points across.

Get a House

When marriages break down for whatever reason and there are children involved, it is usually, but not always, the case that the Dad moves out. As a result, the departing spouse faces significant costs to establish a new home.

They begin paying child maintenance and, in some cases, spouse maintenance. It is only after these payments that they can then fund their own costs of independent living including rent, electricity, water, gas, etc. But here is my point - it's all in after tax dollars. In this respect, the taxation system is really working against you.

The inevitable asset split usually favours the child-rearing parent (and rightfully so), and the asset growth that the child-rearing parent enjoys is usually *tax free* given that it's most likely to be the family home. In most cases, the Dad is left with a smaller capital base (which appreciates at a proportionally lower amount), and, even then, any increase on that smaller capital base *is taxed*.

The good news is that there are lateral ways to address this asset and tax imbalance.

Superannuation (discussed next) is another very powerful avenue as it is taxed on a concessional basis (just 15%) with the implication being that when you reach the age of sixty (and retire) the proceeds to you are tax-free.

In all cases, building equity is important.

Banks love equity and will readily lend against it, affording you wealth-building opportunities along the way. Buying a home is important, but paying for a home in after-tax dollars post age fifty is not the optimal approach. As compelling as it may seem, you would have a hard time convincing me of its merits when there are much better options available.

Let's look at a few examples to illustrate the points.

An Example:

Buy a home and rent it (rather than living in it). Keep your own rent costs low or even consider sharing a place with a friend or colleague.

By doing this you expose yourself to capital growth which gets you back in the game. Any capital gain here will, unfortunately, be taxed upon sale, so don't sell! This is perfectly fine, because you will use that (unrealised) capital gain to leverage off into your next opportunity.

Alternatively, consider this approach via one of the superannuation investment strategies (described next) and *avoid all tax* on the sale in retirement. Very powerful stuff!

Here's how it works:

\$400,000	House/Unit loan
\$20,000	Interest payable at 5%
\$3,000	Rates, repairs, body corporate, etc
(\$18,000)	Rent received

\$5,000	Cash flow loss
\$1,000	Non cash - Chattel depreciation
\$7,500	Non cash - Building depreciation at 2.5%

\$13,500	Tax loss
\$4,250	Tax refund at 31.5%*

\$750	After tax cash flow loss

**A reminder: in this example we have used a tax rate of 31.5%. (The tax saving rises to \$6,275 for a tax payer on the 2009 top tax bracket).*

Not a bad scenario is it? A minor cash flow loss at worst, or even cash flow positive if you earn in a higher tax bracket. Not a lot to bear and a great platform to operate from.

Where to from here? Buy another property, buy two, buy one through your super. It is all very achievable. The main outtake is 'Do something, don't do nothing'.

If you consider a conservative capital growth rate of 5%, this equates to \$20,000 per annum compounding on your \$400,000 property. History shows that, in the long term, this has been easily achieved in Australia.

A couple of words of warning - Always allow for affordability in your strategy. For example, if interest rates move to higher levels, so too will your loan repayments. Fortunately, if interest rates rise, so too does inflation and rents (usually) with it, unless things get really ugly of course, then were all in trouble. As a rule of thumb, allow for 2-3% above current rates *and* for periods of vacancy, major repairs etc.

The key is to keep your living costs down, and that may be best achieved by actually buying a house. However if you are over fifty, I strongly recommend that you consider interest-only payments, salary sacrificing the extra amount into a safe super option, then paying out the balance of the loan tax-free at sixty-plus retirement.

Always remember that the passage of time that will inflate the property's value. At the age of forty you have a probable twenty-five years left in the work force - plenty of time to reap the rewards of this approach.

Superannuation

Tax-effective investment doesn't get any better than making pre-tax contributions to superannuation. Super contributions are taxed at a lowly 15%. Compare this to the 31.5% tax rate most taxpayers face, meaning that for every \$100 you 'salary sacrifice' into superannuation, you have an immediate saving of \$16.50* in tax.

**A reminder: in this example we have used a tax rate of 31.5%. The tax saving rises to \$31.50 for a tax payer on the 2009 top tax bracket.*

An Example:

Assume you pay tax at the 31.5% tax rate and receive a \$10,000 bonus. You would ordinarily lose \$3,150 in tax. Alternatively, if you declare to have your bonuses paid directly into superannuation, you lose only \$1,500 in tax. That's a big difference of \$1,650. The 'catch', of course, is that you cannot get to this money until you're old enough to retire.

With superannuation, though, the tax-effective savings don't stop at the contributions level, as earnings derived from superannuation funds are only taxed at 10%-15%. After you have retired, it gets even better, as the earnings attract an unbelievable tax rate of zero! Further, the tax paid on a superannuation payout after the age of sixty (and retired) is again zero!

Earnings, too, in superannuation aren't counted as income for child maintenance, something further for you to consider (if appropriate) and discuss with your advisor.

There is simply nothing more tax-effective than superannuation, which is why nearly all accountants and financial planners keep pushing the superannuation barrow.

A general rule with contributions to superannuation is that *before* making additional salary sacrifice payments to superannuation, repay *all* your non-

deductible loans (such as home loans, credit cards, etc) and other expenses prior to the age of fifty. Once beyond the glorious fifty - all super, in nearly all cases.

As an advisor, I see a lot of resistance from people when considering the idea of contributing more to superannuation. This is because many people don't like managed superannuation funds (usually due to fee structures, poor performance in some cases, and the fees paid to financial planners). For these people, running a self-managed superannuation fund (SMSF) is the right answer.

An Example:

Sometimes it is very difficult to advise someone who is resistant to superannuation investment to put \$200,000 into the XYZ Managed Fund. In these cases, it is much easier to offer an alternative: investing the \$200,000 in their own SMSF, which then buys a small factory (for example), and then rents it back to either the investor's business or someone else's. (Same strategy for residential property, except you cannot rent it back to yourself or an associate)

SMSFs provide investors with the ability to make investment decisions for themselves. As of September 2007, borrowing funds inside your self-managed super is now a reality through the prudent use of easily constructed instalment warrants. An instalment warrant is a form of derivative, and I am well placed to advise on the benefits of using them and SMSFs. These are both something I am particularly passionate about - so passionate, in fact, that my doctoral thesis was about SMSF leveraged investment.

An Example:

Put \$100,000 into their own SMSF, which then borrows a further \$100,000 through an instalment trust structure and buys a small factory (or residential unit, of course not renting it to yourself or an associate) and rents the factory back to either the investor's business or someone else's.

Another Example:

Your SMSF buys farming land and rents it back to you. You plant a tree plantation on it, claiming the tax deductions to do so - other tax deductions include annual expenses such as the rent you're paying to your superannuation fund, insurance, plantation and financing costs - while your plantation grows till you reap the rewards of the "harvest" (have done similar my-self).

As discussed earlier, your own superannuation fund can borrow through an instalment warrant to buy the land. It's almost too good to be true, but it isn't - it's a tax-effective reality!

In Closing...

Divorce is one of the more unsavoury, unproductive and debilitating experiences that anyone can go through, and the financial hardship associated with divorce will be one of the greatest and enduring hurdles that any divorced Dad will face.

There are a significant number of strategies beyond those covered here that will substantially enhance the financial recovery of those affected. And this is fundamental to the overall well-being of the Dad and his ability to father his children as best he can.

It is all very achievable. Here's what you need to do:

1. Get advice first, and get it quickly.
2. Get some housing (or shares etc) equity - simple enough!
3. Leverage the super power of superannuation. Why? Because it's yours, it's protected, has so many tax advantages and it will be instrumental in accelerating your wealth recovery. Superannuation offers fantastic opportunities to recover from divorce:
 - a. Immediate tax-effective returns on your contributions.
 - b. Concessional tax rates on the earnings.
 - c. Tax free status at age sixty (and retired).
 - d. The ability to borrow through instalment warrants (enabling your SMSF to buy a home).

I wish each of you well during testing times and for the years ahead - make a time to see me or any good advisor, go forward and never look back - life's good!

Please feel free to share this article with anyone.

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The Full Book

“Tax Effective Investment” (Free download at www.ciatax.com.au). Covers strategies for:

- Rental properties.
- Buildings depreciation.
- Australian shares/Imputation credits.
- Superannuation.
- Primary production activities.

There are many more tax-effective investments beyond the above list, but these are the key ones which warrant your keen attention. Each one has a dedicated chapter in the book along with practical examples.

The book is reality-based, and written in a pragmatic style to clearly illustrate the benefits of tax-effective investment. Most importantly, though, it shows that whatever the type of investment, it must be a *good* investment. There is absolutely no point to tax-effective investment unless there is a profit (capital growth).

About the Author

Dr. Steven Enticott ‘practices what he preaches’, and has invested (or still invests), in some way shape or form, using every method covered in his book.

Dr. Steven Enticott, a financial planner and tax specialist, is the senior partner of CIA Tax (www.ciatax.com.au). A Fellow Professional Member of The National Institute of Accountants (FPNA) and a Fellow Member of the Tax Institute Australia (FTIA), he holds an Advanced Diploma of Business (Accounting), a Master of Business Administration (MBA), a Diploma of Financial Services (DiPFS), and a Doctorate in Business (DBA-Swinburne University).