PLANNING FOR RETIREMENT:
THE IMPACT OF DIVORCE

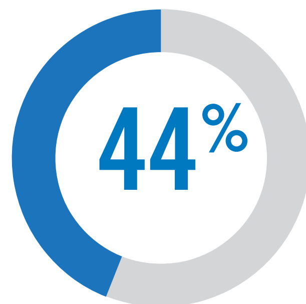
Divorce has long created financial challenges for many American households, not only in managing their day-to-day finances but also in preparing to reach their long-term financial goals. Now, for the first time, the Center for Retirement Research at Boston College has calculated how much divorce impacts retirement readiness.[1] It finds that while half of all American households are at risk of not being able to maintain their pre-retirement standard of living after they stop working, that risk is 7 percentage points higher for households where at least one person has been through a divorce.

Unfortunately, the outlook isn't likely to get much brighter in the near future. Due to changes in federal tax law brought about by the Tax Cuts and Jobs Act of 2017,[2] the financial challenges facing divorced Americans could become even more daunting. The good news? With careful planning, many divorced individuals will find opportunities to help improve their retirement readiness.

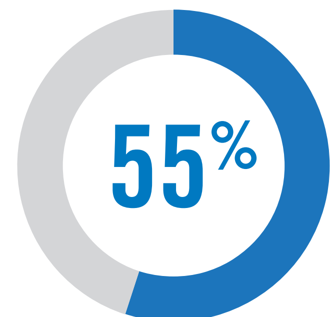
RESEARCH FINDINGS:
DIVORCE SUBSTANTIALLY IMPACTS RETIREMENT READINESS

In 2006, the Center for Retirement Research (CRR) at Boston College developed the National Retirement Risk Index (NRRI) to measure the percentage of working-age households at risk of being unable to maintain their pre-retirement standard of living after they stop working. Today, the index shows, half of American households are at risk of being unable to maintain their standard of living in retirement. The numbers are even worse for households led by people between the ages of 30 and 39, however, where the percentage increases to 56 percent. And now, based on the CRR's latest research, we know that the risk to retirement readiness is worse than average for households that have been through a divorce, too—7 percentage points worse, on average. The CRR also finds that divorce has a greater impact on couples who have remarried than individuals who remain single after the divorce.

These findings are important in part because the impact of divorce on American society is so broad. Data from the Survey of Consumer Finances, which is used in calculating the NRRI, indicate that:



Of all households contain at least one person who was previously divorced



That figure jumps for households headed by someone 50 to 59 years old

Notably, low- and middle-income households experience higher-than-average incidences of divorce, too.

Given that over half of American households approaching retirement have experienced divorce, it is important to understand how divorce impacts retirement readiness today, and how that might change in the future.

THE IMPACT OF DIVORCE: TODAY

As research by the CRR and others indicates, the negative impact of divorce on retirement readiness is significant.[3] While people benefit from economies of scale when married—sharing fundamental expenses such as housing and utilities—they typically face higher living costs per person after they divorce unless they "downsize" their expenses. Those higher living costs can impact their ability to save for retirement.

Getting divorced when nearing retirement can be especially challenging. It's also increasingly common; the divorce rate for those 50 and older doubled between 1990 and 2010.[4] Individuals who divorce at older ages do not have as much time to make up for assets lost to their spouse in a divorce. And if they had been serving as family caretakers, they may not have the experience needed to secure a full-time job—a job that could generate the income needed to offset the financial impact of divorce.

Meanwhile, the way assets are divided in a divorce also can present challenges. While each person going through a divorce often gets to keep any property they brought into their marriage, assets acquired during the marriage are typically split between the two spouses. Sometimes they're not split evenly, or are liquidated altogether. Recent research has found that in roughly half of divorces involving liquid retirement assets, such as money in an IRA or 401(k) account, all the retirement assets went to one spouse, leaving the other with none.[5] This can happen when, for example, a spouse chooses to forgo his or her share in an IRA in exchange for receiving all of the equity in the couple's house.

Alimony is one area where, at least until now, tax law has been favorable to divorcing couples. Also known as spousal support or spousal maintenance, alimony is paid by the higher-earning spouse to the lower-earning spouse. It provides many divorced individuals with money they need to support themselves. According to the Internal Revenue Service, approximately 414,000 taxpayers paid a total of $10 billion in alimony in 2015,[6] or an average of $24,000—a figure that suggests alimony is most common among wealthier households. While spousal support is gender-neutral by law, women receive 97 percent of alimony payments in the U.S.[7]

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For divorces finalized by the end of 2018, the person paying alimony will be able to deduct that expense from their gross income for federal income tax purposes. The spouse receiving alimony, conversely, must report it as income. Since the lower earner may be in a lower tax bracket, this often results in an aggregate tax savings for the now-divorced couple. In addition, the tax savings for the higher earner may have made it possible for him or her to pay more in alimony than they otherwise could. (Unlike alimony, child support payments are neither deductible to a payer nor deemed income to the payee.)

The tax laws regarding alimony, however, are going to change after 2018.

THE IMPACT OF DIVORCE: 2019 AND BEYOND

In thinking about how divorce will impact retirement readiness in the future, it's important to remember that working-age households are already at greater risk of not being able to maintain their standard of living in retirement than current retirees were when they were working. A variety of factors combine to create greater retirement challenges for working-age households, including longer life expectancies, lower Social Security benefits, and less access to traditional defined benefit pension plans. Soon, divorce may be added to that list.

Here's why: Under the Tax Cut and Jobs Act, people getting divorced in 2019 and beyond who are paying alimony will no longer be able to claim a tax deduction for those payments. In exchange, those receiving alimony will no longer have to report it as income. When this happens, a higher-earning spouse may no longer be able to afford to pay as much alimony as he had in the past, potentially leaving the recipient—usually the ex-wife—in a worse financial position. In fact, both members of a divorcing couple could wind up worse off financially. Complicating the matter even further is that these new alimony rules expire on December 31, 2025, making divorce negotiations, which can be difficult under the best of circumstances, even more challenging.

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PLANNING OPPORTUNITIES

Alimony is not the only area where the new tax law will impact people who get divorced. With so many factors to consider, it is more important than ever for those getting divorced to reassess their financial plans and seize opportunities to stretch their wealth and prepare for retirement. This is especially important for women, who not only may be the lower earner in their marriage (perhaps due to their role as family caretaker), but also may receive lower alimony than they would have under past tax law. With effective planning, they may be able to reduce their tax bill and use the savings to set aside more money for retirement.

Among the key financial issues people may want to consider if they are divorced or contemplating divorce are these:

> **Investments.** After a divorce, individuals sometimes find themselves in a higher or lower income tax bracket. Lower-earning individuals, especially those divorcing after December 31, 2018, and receiving alimony, may find themselves in a very low tax bracket since alimony is no longer reportable as income. If they have taxable income under $51,700 (if filing as head of household) or $38,600 (if filing as single),[8] they also could qualify for a 0 percent tax rate on capital gains, which could make investing more affordable and rewarding. Being in a lower tax bracket also allows an individual to take advantage of lower tax rates when converting a traditional IRA to a Roth IRA, which can be helpful in retirement in several ways. Like a traditional IRA, a Roth IRA can grow tax-free prior to retirement. Unlike a traditional IRA, withdrawals from a Roth IRA are tax-free in retirement, too. Also, because withdrawals from a Roth IRA don't count as taxable income, having higher amounts of retirement income coming from a Roth account could help divorced individuals stay in a lower tax bracket, which in turn could keep their Social Security benefits from becoming taxable. Lower earners may wish to do partial Roth conversions over time, allowing themselves to pay tax at today's current lower rates.

Home ownership. Many individuals, especially custodial parents of school-age children, prefer to keep the marital home when divorcing. Although home ownership decisions should not be based purely on tax implications, home ownership in high-tax states may become less attractive under the new tax law, which caps federal tax deductions for state and local taxes at $10,000 annually. Consider a hypothetical New Jersey mother of two paying $20,000 in annual property taxes and $6,000 in state income taxes. In the past, these yielded a $26,000 federal tax deduction if she itemized her deductions. Under the new tax law, that deduction will be reduced to $10,000. For this person, it may make more financial sense to rent a house, and, rather than itemize her deductions, utilize either the $18,000 standard deduction for a head of household or the $12,000 standard deduction for a single taxpayer. Note that due to the opportunity to convert IRA assets to Roth assets with a reduced tax impact, and the reduced advantages of homeownership, lower-earning spouses may find retirement assets more valuable than a house when marital assets are being split.

Children and taxes. Although personal exemption deductions have been temporarily eliminated from the federal tax code (they are scheduled to return in 2026), they have been replaced by child tax credits. Tax credits are more valuable than deductions, of course, because they reduce an individual's tax burden on a dollar-for-dollar basis. (By contrast, a deduction is subtracted from gross income, and the ultimate savings is dependent on your tax bracket. For example, someone in, say, the 24 percent tax bracket would realize $240 in tax savings from a $1,000 deduction, but $1,000 in savings from a $1,000 credit.)

THE NEW TAX LAW PROVIDES	
A $2,000 TAX CREDIT	for each dependent child under the age of 17
A $500 TAX CREDIT	for each dependent child 17 or older (A dependent child 17 or older could include a child in college.)

Because the tax credits under the new law may be more valuable than personal exemption deductions under the old law, determining which parent can claim a child post-divorce will be even more important over the next several years.

Private school tuition for grades K-12. Under the new tax law, parents setting aside money for education in a 529 plan can now use up to $10,000 of those funds annually, if they wish, to pay for tuition at a private school for grades kindergarten through 12. Some parents may welcome this flexibility, but in cases of divorce it could put some 529 accounts at greater risk of abuse. For example, a parent-owner of a 529 account could tap it to pay current educational expenses, leaving the child with no money, or less money than planned, when it is time for college. The other parent, who may have contributed to the 529 plan, could then find himself or herself struggling to pay for their child's college education. If 529 plan assets are in place when a divorce occurs, the divorce agreement should be clear on the future use of those assets. Non-owner parents also may want to specify that the parent-owner of the plan share with them, on an annual basis, an official update on the 529 plan account, including current values, from the plan provider.

Social Security. With many people finding it more difficult to save for retirement after a divorce, it's important that they take maximum advantage of the Social Security program. This issue is particularly critical for lower-earning spouses who are planning to divorce and are closing in on 10 years of marriage but haven't quite reached that milestone. Under Social Security law, a person who was married for at least 10 years before divorcing may be eligible for a Social Security spousal benefit or survivor benefit that could exceed their own benefit.

As an example, let's assume that **Susan is 75 years old, and collecting $20,000 annually in Social Security benefits.** She was married for 12 years and then she and her husband divorced 30 years ago. Now, her ex-husband dies while collecting $30,000 annually. Susan's benefit would then **"STEP UP" to a "SURVIVOR BENEFIT" of $30,000**—regardless of whether her ex-husband had remarried or not.

The bottom line: If you're a lower-earning spouse nearing 10 years of marriage, you may want to consider waiting until you reach that milestone before divorcing.

Financial advice. Divorce creates a wide array of financial challenges. In addition to the issues discussed above, some marital assets, depending on the circumstances, may be worth much more going forward for one spouse than for the other. To minimize the financial challenges that divorce presents, anyone who has been divorced or is contemplating it may wish to seek financial advice sooner rather than later.

CONCLUSION

Divorce is a source of financial challenges for millions of Americans and can put them at a greater risk of not being able to maintain their standard of living after retirement. Some provisions of the tax reform bill signed into federal law late last year will likely add to those challenges. Fortunately, divorced individuals can, with careful planning, minimize the negative impact of divorce on their finances and improve their chances of enjoying a financially secure retirement.

[1]Munnell, Alicia, Wenliang Hou, and Geoff Sanzenbacher, Center for Retirement Research at Boston College, "How Does Divorce Effect Retirement Security?," June 2018.

[2]While commonly referred to as the Tax Cuts and Jobs Act of 2017, the act's proper name is "An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018."

[3]Hung, Angela A., and David Knapp, "Impact of Divorce on Retirement Security," working paper.

[4]Brown, Susan L., and I-Fen Lin, "The Gray Divorce Revolution: Rising Divorce Among Middle-Aged and Older Adults, 1990-2010," *The Journals of Gerontology Series B: Psychological Sciences & Social Sciences*, Vol. 67, No. 6, November 2012, pp. 731-741.

[5]Hung, Angela A., and David Knapp, "Impact of Divorce on Retirement Security," working paper, pp. 2-3.

[6]Internal Revenue Service, SOI Tax Stats – Individual Income Tax Returns Publication 1304, Table 1.4, 2015. https://www.irs.gov/statistics/soi-tax-stats-individual-income-tax-returns-publication-1304-complete-report.

[7]2010 census, Census Bureau.

[8]These numbers reflect thresholds for 2018 and are indexed for inflation for 2019 and beyond.

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The National Retirement Risk Index (NRRI), published by the Center for Retirement Research (CRR) at Boston College, measures the percentage of working-age households at risk of being unable to maintain their pre-retirement standard of living during retirement.

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