LITIGATION CONSULTING

COVID-19 and Divorce: Dealing with Financial Uncertainty in Marital "Portfolios" (Part II of II)

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The COVID-19 pandemic has had a profound impact on virtually every aspect of peoples' lives, and marital dissolution is no exception. Market and asset volatility, and the resulting economic uncertainty, creates significant challenges for professionals assisting their clients in determining equitable distribution and spousal support.

In Part I of this two-part series, we suggested an alternative approach to equitable distribution calculations and an approach to asset management throughout a divorce proceeding that promotes value retention in the marital estate rather than immediate liquidation upon the division of property. Part II presents practical tools—based on our experience providing litigation support services during the pandemic—for financial professionals to consider as they grapple with these issues.

Day 365 and Counting

After a year of uncertainty—and, in many cases, misinformation—many people are anxious about their financial futures. Add the layer of stress associated with the divorce process and it is easy to understand why those going through it are turning to financial professionals for guidance. Typical questions we hear:

1. Will I have enough money to live on now and through retirement? When will I get my check?
2. How much is the business worth?
3. I can't pay that much and live; can they do that?
4. Will I be able to stay in my house?

COVID-19 has prompted additional questions:

1. Will I get the value of my investment account at the date of filing even if it has gone down?
2. Will business revenue return to pre-pandemic levels and what does that mean from an income standpoint?
3. COVID-19 has decimated our livelihood. Can we still rely on historical financial information?
4. Is my spouse using COVID-19 as an excuse to devalue assets or reduce income/salary, affecting the ability to provide support?

Three Guiding Concepts Still Hold True

In Part I, we identified three concepts family law professionals should embrace and consider. It is timely to revisit these concepts based on our experience.

1. **Update information frequently.** If a couple's date of filing was before or during the "height" of the pandemic,[1] it is important for the parties to obtain statements and other supporting documents to determine asset performance as well as the impact of post-filing events on the marital estate—e.g., Paycheck Protection Program (PPP) loans, tax credits, etc. For a detailed discussion of the importance of valuation dates we recommend reading Karolina Calhoun's article posted on LinkedIn, "The Importance of Valuation Date in Divorce."[2] The article provides information related to specific jurisdictions, and highlights the importance of valuation date selection and its impact on equitable division of assets. Depending on the date the parties separate their assets, passive and active forces may have a short- or long-term impact on the stability of these assets in the future.
2. **Understand the volatility of asset classes.** Part I addressed the stock market and real estate volatility. Six months later, historical data has given us an indication of potential trends. With positive news on the government vaccination program, industries and geographic regions feeling the harshest financial

1 Jim Hitchner and his staff have prepared a timeline of significant events, including the pandemic's effect on the U.S. stock market. The timeline, with footnotes, is available at https://www.bvresources.com/covid-19-resources.

2 https://www.linkedin.com/pulse/importance-valuation-date-divorce-karolina-calhoun-cpa-abv-cff/?articleId=6697587722611228672

impacts are seeing light at the end of the tunnel (although they may emerge from the tunnel into a new business environment characterized by increased online communication, global supply chains, and changes in purchasers and purchasing patterns). Coupled with this is the emergence and impact of government stimulus programs, including childcare tax credits, earned income tax credits, unemployment benefit taxation, PPP, economic injury disaster loans (EIDL), debt forbearance, individual stimulus checks, and rent moratoriums. Knowing when these and other programs come to an end—as well as any potential rollbacks of tax reductions and other changes made by the Tax Cuts and Jobs Act—will have an impact on decision-making.

3. **Research industry and economic implications.** That same historical data and related trends have revealed certain "winners and losers" in the equity and housing markets. New industries and business concepts have developed, shaped by suppliers and competition. The pandemic has also affected the location of assets and the type of work people do (generally benefiting smaller urban areas, such as Austin, Jacksonville, and Phoenix) as well as negatively impacting certain industries, such as travel and hospitality, food and beverage distribution and service, and sports and entertainment. Understanding the industry you are analyzing and the location of the couple and their assets is more important than ever, given the potentially dramatic differences. For example, it is not unreasonable to assume that a hotel in New York City is not performing as well as other hotels in less populated regions with outdoor activities, even though they are in the same industry.

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Tools to Consider

COVID-19 Considerations Questionnaire (Exhibit 1)

This questionnaire is not an all-encompassing tool; it should be adjusted based on the specific facts and circumstances of a case. Its purpose is to identify historical information regarding income, expenses, assets, and liabilities and compare it to data from the current COVID-19 period (e.g., 2020). Then, using research on the local economy and the spouses' jobs or businesses, professionals can gather information to assess the potential magnitude and likelihood (i.e., permanent versus temporary) of COVID-19 impacting the couple's financial portfolio.

Cash Flow Statement (Exhibit 2)

It is not uncommon for spending to have remained stable or even to have increased during the pandemic, even when couples were experiencing financial hardship. This was evident when it came to business owners relying on funding sources other than earnings, such as outstanding accounts receivable, lines of credit, government stimulus programs (e.g., EIDL, PPP), and increased cash flow due to debt forbearance programs. At first blush, a review of bank or credit card statements may show continued cash inflows and outflows comparable to historical periods; however, a closer look at the balance sheet may identify funding apart

Knowing your client's goals and which assets/income align with them will serve as a compass as you navigate the choppy waters ahead.

from traditional operating activities. Exhibit 2 illustrates an actual case in which we identified the source of funds.

Net Worth Method (Exhibit 3)

The statement of cash flows is a powerful tool for analyzing businesses, but for personal financial analysis, one recommendation is to use the net worth method. The IRS website describes this method as follows:

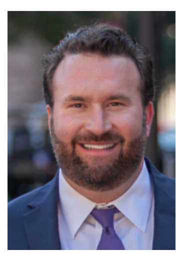
> An investigation utilizing the net worth method of proof differs from a specific item method in that direct comparisons of income, expenses, and credits cannot be made. The net worth method of proof utilizes evidence of income applications such as asset accumulation, liability reduction, expenditures, and other financial data to indirectly establish correct taxable income. An accounting is made showing how funds generated from income were applied by identifying increases to net assets and various expenditures. After making adjustments for exemptions, itemized deductions, nontaxable income, and nondeductible losses, the courts permit the IRS to infer, indirectly, that the remainder is taxable income.[3]

By reviewing the personal balance sheet prior to the pandemic and comparing it to the date of filing and then also to the most recent financial statement, you can determine if there are any significant changes or discrepancies. Be sure to check your state or local jurisdiction to understand which dates to review and whether the date of filing or the date of trial is the most appropriate date for measurement of the current financial status. Residential real estate prices generally have increased during the pandemic, debt payments or student loans could have been deferred, and additional credit cards could have been accumulated, so it may be necessary for each spouse to pull their credit reports to identify and confirm any new activity during COVID-19.

The benefit is not only in reconciling and recognizing disposable income (income minus expenses) as compared to the change in net worth, but also identifying where falsehoods reported on a financial affidavit may exist as it relates to income or expenses. By reviewing liability balances, this type of analysis can identify whether spending was impacted.

Conclusion

As we enter into the next phase of the pandemic, we will be faced with new questions to answer, such as: How long will the market keep reacting like this? When will my business be back to pre-COVID-19 levels? Will the uptick in business continue? Focusing on the fundamentals is important. Communicating the importance of valuation dates, discussing historical trends along with future projections, and monitoring industry information will continue to be pillars of achieving success for our clients. Now more than ever we need to be sure to communicate all components of our analyses (good and bad) as the volatility experienced externally will most likely mirror personal assets. Knowing your client's goals and which assets/income align with them will serve as a compass as you navigate the choppy waters ahead. VE



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3 IRS Internal Revenue Manuals, Section 9.5.9.5, Net Worth Method of Proof, https://www.irs.gov/irm/part9/irm_09-005-009.

Exhibit 1: COVID–19 Considerations—Questionnaire

What was total "income"?	2017	2018	2019	Commentary
Wages				
Dividends				
Capital gains/losses				
Rental income				
Business income				
Retirement distributions				
Other				
List "major" expenses and/or cash outlays:	2017	2018	2019	Commentary
Home				
Medical				
Auto				
Investments				
Education				
Lifestyle				
Vacation				
Health—mental				
Health—physical				
Children				
Education				
Medical				
What assets have you acquired and/or "built"?	2017	2018	2019	Commentary
Home				
Auto				
Jewelry				
Retirement				
Business				
Real estate, land, etc.				
Liquid investments				
Tax assets				
Inheritance				
Deferred compensation				

Exhibit 1: COVID–19 Considerations—Questionnaire (Continued)

What liabilities have you incurred?	2017	2018	2019	Commentary
Home				
Medical				
Auto				
Education				
Lines of credit				
Business				
Credit cards				
Personal loans				
Tax liabilities				
How has COVID-19 impacted the following:	2020	Magnitude ($)	Permanent/ Temporary	Commentary
Wages				
Dividends				
Capital gains/losses				
Rental income				
Business income				
Retirement distributions				
Other				
Has COVID-19 caused any expenses related to the following:	2020	Magnitude ($)	Permanent/ Temporary	Commentary
Home				
Medical				
Auto				
Investments				
Education				
Lifestyle				
Vacation				
Health—mental				
Health—physical				
Children				
Education				
Medical				

Exhibit 1: COVID–19 Considerations—Questionnaire (Continued)

How have your assets been impacted by COVID-19?	2020	Magnitude ($)	Permanent/ Temporary	Commentary
Home				
Auto				
Jewelry				
Retirement				
Business				
Real estate, land, etc.				
Liquid investments				
Tax assets				
Inheritance				
Deferred compensation				
Have you incurred any liabilities due to COVID-19?	2020	Magnitude ($)	Permanent/ Temporary	Commentary
Home				
Medical				
Auto				
Education				
Lines of credit				
Business				
Credit cards				
Personal loans				
Tax liabilities				

COVID-19 Assessment:

A. Address client concerns by reviewing historical financial assessment along with COVID-19 impact analysis.

B. Quanitfy the "magnitude" and "likelihood" of client concerns.

1. Magnitude—discuss concept of materiality and determine a dollar amount to associate that addresses client concerns, risks, etc.
2. Likelihood—discuss and assess client concerns. Provide support (i.e., economic outlook, projections of retirement needs, etc.) to address concerns and educate client to better assess the likelihood.

EXHIBIT 2: COVID-19—Business Cash Flow

Historical Period—Statement of Cash Flows

	12/31/18	12/31/19	Date of Filing	12/31/20
Cash from Operating Activities				
Net income (adjusted for disallowed tax deductions)	$232,831	$148,106	$155,381	$26,282
Addback depreciation and amortization	22,503	23,834	12,482	–
Change in non-cash current assets	–	–	(122,117)	88,100
Change in other assets	–	–	–	(2,317)
Change in current liabilities	136,137	(136,137)	96,445	(56,792)
Net cash provided by operating activities	**$391,471**	**$35,803**	**$142,191**	**$55,273**
Cash from Investment Activities				
Loans to shareholder	(106,441)	106,441	–	–
Gains/(losses) on sale of property	27,000	–	–	–
Purchase of property, plant, and equipment	(63,059)	–	(22,129)	35,735
Net cash provided by investment activities	**$(142,500)**	**$106,441**	**$(22,129)**	**$35,735**
Cash from Financing Activities				
Change in long-term debt	24,271	(9,804)	(42,207)	108,517
Shareholder distributions	(329,353)	(144,063)	(82,046)	(116,250)
Net cash provided by financing activities	**$(305,082)**	**$(153,867)**	**$(124,253)**	**$(7,733)**
Increase (decrease) in cash from all activities	**$(56,111)**	**$(11,623)**	**$(4,191)**	**$83,275**
Cash balance reported at end of year	36,686	25,063	20,872	104,147
Less cash balance reported at beginning of year	**(92,797)**	**(36,686)**	**(25,063)**	**(20,872)**
Change in reported cash balance	(56,111)	(11,623)	(4,191)	83,275

EXHIBIT 3: COVID–19—Net Worth Method

Date of Separation (Division of Assets): Dec. 31, 2020

	12/31/19	Date of Filing	12/31/20
Assets:			
Checking #1234	$1,000	$5,000	$2,000
Savings #5678	5,000	500	–
Investment account #A123	25,000	20,000	10,000
Investment account #B456	125,000	125,000	100,000
401(k)	200,000	100,000	250,000
Marital home	750,000	750,000	900,000
Mortgage	(450,000)	(440,000)	(400,000)
Automobile	35,000	45,000	20,000
Jewelry	5,000	5,000	5,000
Total	$696,000	$610,500	$887,000
Liabilities:			
Credit card 1	$30,000	$40,000	$40,000
Credit card 2	1,500	15,000	20,000
Auto loan	25,000	20,000	15,000
Student loan	100,000	100,000	95,000
Line of credit	50,000	60,000	70,000
Total	$206,500	$235,000	$240,000
Net Worth	**$489,500**	**$375,500**	**$647,000**
Reconciliation with Change in Net Worth			**$157,500**

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EXHIBIT 3: COVID–19—Net Worth Method (Continued)

Income, as reported*	Annual	Monthly
Husband	$120,000	$10,000
Wife	120,000	10,000
	$240,000	$20,000

Expenses, as reported*		Monthly
Husband		$12,000
Wife		14,000
		$26,000

Disposable Income	Monthly	Annual
Husband	$8,000	$96,000
Wife	$6,000	$72,000
		$168,000
	Unaccounted	
	$(10,500)	

REMOVE PASSIVE GAINS/LOSSES

**As reported refers to amounts reported on a financial affidavit*