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BUSINESS

Your Money 2017 | Monthly financial makeover

Divorce, big tax bill complicate finances

'HELP!' | Kirsten Flack is settling in as a single mother but has debts and few assets. She lacks an emergency fund and wants budgeting advice.

Kirsten Flack returned to work after her divorce, and now works hard to balance her work life and being a single mom of two. (Dean Rutz / The Seattle Times)

By George Erb
Special to The Seattle Times

For six years Kirsten Flack was a stay-at-home mom on the Eastside with small children and a husband who earned a comfortable income. Then everything came crashing down in divorce.

In the summer of 2012, Flack, now 48, rented a house in Seattle and started over. She resumed her career and became a single parent to her two young children.

It took several years for Flack to reestablish herself. After a while she moved up to a better-paying job, but she had few assets and a five-figure debt to the Internal Revenue Service.

Flack also was determined to become more independent, and that meant taking charge of her finances. Last fall she applied for a free money makeover.

In her application, Flack wrote that she wanted to pay down her debt and learn how to budget, invest and save for the future. Then, at the end of her application, she wrote "Help!!"

The Financial Planning Association of Puget Sound connected Flack with two executives at Comprehensive Wealth Management in Lynnwood. One was Brian Lockett, the firm's vice president and wealth manager; the other was Marc Knauss, a senior adviser.

Together, they poured over Flack's finances.

"The divorce really kind of blew a hole in her financial plan," Knauss said. But he also gave Flack a vote of confidence because of her sense of responsibility. "In a few years she'll be in a good spot," he said.

One attribute in Flack's favor is her work history. After working as a nurse at Swedish Medical Center, she got a job as a Seattle-based patient-services nurse for UCB, a global biopharmaceutical company.

The job pays about $112,500 a year, with the possibility of bonuses. That puts her above King County's projected median household income of $84,897 for 2016, according to the state Office of Financial Management.

Flack also gets $1,750 a month in child support.

Despite her comfortable cash flow, Flack has few assets. Instead of owning a home, she rents in one of Seattle's older neighborhoods for $2,400 a month. She has about $7,000 in various checking and savings accounts.

She also lacks an emergency fund. A personal line of credit had an outstanding balance of about $5,000.

Flack is disciplined when it comes to saving for retirement, and she has contributed regularly to her employers' 401(k) plans. Her Swedish 401(k) account has a balance of about $106,000, while her UCB 401(k) contains about $13,500.

She also signed up for UCB's employee stock purchase plan, which let her buy discounted shares in the company. Shares in her account were worth about $3,700.

One of her more painful financial moments came when she borrowed several thousand dollars from her Swedish 401(k) plan to pay for attorney fees and other expenses associated with the divorce.

Under federal rules, a worker can borrow as much as 50 percent of his or her 401(k) account balance, provided that the loan does not exceed $50,000. The borrower then uses payroll deductions to pay off the loan, with interest. The money goes back into the 401(k) account.

Many workers use their 401(k) accounts as ready sources of credit. About one in five participants have loans against

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those accounts in any given month, according to The National Bureau of Economic Research.

But there's a wrinkle. Borrowers of 401(k) accounts who then leave their employers must pay off the loans in full, usually within 60 to 90 days. After that deadline, outstanding balances are considered withdrawals by the IRS and taxed accordingly. Borrowers younger than 59½ are also hit with a 10 percent penalty for early withdrawal.

Flack still had the loan on her Swedish 401(k) when she left the company for UCB. Swedish notified her about the repayment, but she forgot. Her accountant caught the oversight months later. "I about died," Flack said.

To make matters worse, for a time Flack had too little federal tax withheld on her paychecks, driving up the bill. She currently owes the IRS about $25,000, and she's paying the agency $500 a month.

At Comprehensive Wealth Management, Lockett and Knauss looked for ways to help Flack pay down her debt. They also wanted to come up with a ready source of cash that she could turn to for unexpected expenses.

They urged her to stop buying UCB stock under the company's employee stock purchase plan, in part because they say health stocks are currently overvalued. Then they advised Flack to sell her shares and use the proceeds to pay off her personal line of credit.

Next, Lockett and Knauss recommended reducing Flack's 401(k) contribution to 5 percent from 10 percent. That would free up about $375 a month that she could apply to the IRS debt. Meanwhile, she would still get the company's full matching contribution to her 401(k).

They told her to roll her Swedish 401(k) into her UCB 401(k), creating a combined account worth about $119,500 that she could borrow against in a pinch. The objective was to give Flack access to cash until she can build a separate emergency fund.

"It's a lifeline," Lockett said.

Increasing her monthly IRS payments to $875 from $500 means Flack should be able to retire the debt within three years. At that point, she could use money that was going to the IRS to instead build an emergency fund capable of covering six months' worth of living expenses.

Flack was reassured by what Lockett and Knauss told her. "I was surprised by how simple the solutions and suggestions were," she said.

"It felt like a big weight was lifted off of my shoulders."

Borrowing from 401(k) should be a 'last resort'

Brian Lockett

Advisers at Comprehensive Wealth Management have some advice for workers who are tempted to tap their 401(k) retirement plans for loans: Don't do it.

"A 401(k) is one of the last loan options, in our opinion," said Brian Lockett, the Lynnwood firm's vice president.

Federal regulations let workers borrow as much as 50 percent of their 401(k) account balance up to $50,000. Studies show about one out of five 401(k) accounts have outstanding loans in any given month. In 2013 the average 401(k) loan balance was $9,500.

Borrowing against 401(k) accounts is relatively easy, adding to the temptation. Employees fill out paperwork, get the loans and pay them back with payroll deductions. Default rates on 401(k) loans are extremely low, studies show.

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Employees borrow pretax money and pay off the debt with after-tax money, creating a hidden expense.

"It's a costly loan," Lockett said. "It's a last resort."

— George Erb