Planning for Divorce from the Perspective of a Tax and Estate Planner

Albert Einstein's Nobel Prize money went to his ex-wife as part of his divorce settlement.[1]

Two previous articles[2] discussed the rights and benefits that accrue to a new spouse and how to limit or eliminate those rights and benefits. While the focus of the two prior articles was on remarriage issues, this article will focus on divorce issues and opportunities from the perspective of a tax and estate planning attorney.

As with any area dealing with the Tax Code, there are a plethora of exceptions, limitations and exclusions that are not discussed in this article and particular client facts can create unanticipated traps. To aid advisors in doing more detailed research, we have provided a number of additional research sources.

DO AS A SIDEBAR: There are lots of interesting divorce statistics, including:

- What is the true divorce rate in America? The most often repeated statistic is that roughly 49% of all first marriages end in divorce. But divorce rates in most demographic groups have been diminishing since the 1970s. However, the divorce rate for Baby Boomers has been rapidly growing.[3]
- The highest percent of divorces occur in the third year of marriage.[4] On average, divorces in second marriages generally occur by the sixth year, while most divorces in first marriages occur by the eighth year.[5]
- Wives initiate over 66% of all divorces.[6]
- "*It has been well documented that women and men who cohabit with their future spouse before first marriage are more likely to divorce than those who do not cohabit with their spouse before first marriage*."[7]
- 8% of newly married adults have been married three times or more.[8]

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1 *Mileva Einstein-Maric*, BIOGRAPHY, http://www.biography.com/people/mileva-einstein-maric-282676 (last visited June 5, 2016).

2 John J. Scroggin, *What Can Go Wrong With Spousal Rights In Remarriage?* Estate Planning Journal (February 2016) and *Limit Unwanted Spousal Asset Rights In Estate Plans*, Estate Planning Journal (April 2016).

3 Susan L. Brown & I-Fen Lin, *The Gray Divorce Revolution: Rising Divorce among Middle-aged and Older Adults, 1990-2010*, 3 (Nat'l Ctr. for Fam. & Marriage Res., Working Paper Series WP-13-03, 2013); Susan Gregory Thomas, *Divorce Late in Life: The Gray Divorcés*, WALL ST. J., (Mar. 3, 2012).

4 TIME, Sept. 25, 2000.

5 *Id.*

6 Margaret Brinig & Douglas W. Allen, '*These Boots Are Made for Walking': Why Most Divorce Filers Are Women*, 2 AM. L & ECON. REV. 126 (2000).

7 CASEY E. COPEN, ET AL., CTR. FOR DISEASE CONTROL, FIRST MARRIAGES IN THE UNITED STATES: DATA FROM THE 2006–2010 NATIONAL SURVEY OF FAMILY GROWTH, NATIONAL HEALTH STATISTICS REPORT NO. 49, 2 (Mar. 22, 2012).

8 Gretchen Livingston, *Four-in-Ten Couples Are Saying "I Do," Again*, PEW RES. CTR. (Nov. 14, 2014), http://www.pewsocialtrends.org/2014/11/14/four-in-ten-couples-are-saying-i-do-again/.

- Women who first had sex in their teens have roughly double the risk of divorce later in life compared to women who had their first unmarried sexual experience in their adult years.[9]
- Over 75% of people who marry partners from an affair get divorced.[10]
- Roughly 20% of adults over age 25 have never been married, up from 9% in 1960.[11]
- According to Swedish researcher Yvonne Aberg, divorce is contagious. She found that as the proportion of divorced office workers increased, the chance of divorce by the remaining married office workers also increased. The more single people in the office, the greater the divorce rate.[12]
- Children of divorced parents are more likely to divorce.[13]

Planning and Negotiation by a Divorcing Client

When divorces occur, there are a number of tax and estate planning considerations that are relevant to the negotiation and planning process. Unfortunately, these issues and opportunities are often ignored or misunderstood. Clients and other advisors often wrongly assume that the divorce attorney understands the tax ramifications of the divorce settlement. The engagement letters of many divorce attorneys specifically disclaim the attorney's responsibility for any tax or estate planning issues involved in the settlement. It is critical to have competent tax and estate planning advisor be an integral part of any settlement negotiations. Moreover, all existing estate planning documents (including beneficiary designations) should be reviewed and redrafted by an estate planning attorney.

Among these issues, traps and opportunities are the following:

<u>Retirement Plans</u>. In managing the divorce negotiations, advisors and clients should understand the rules and distinctive differences in the treatment of various types of retirement plans. Inadvertent mistakes can create significant adverse consequences. A few examples can illustrate the complexity, traps and opportunities:

- If a ERISA defined contribution or defined benefit plan is transferred to an ex-spouse, the recipient spouse can make withdrawals from the account, without having to pay an early withdrawal penalty of 10%.[14] If an IRA account is transferred, the recipient spouse who withdraws the funds before age 59½ may have to pay an early withdrawal penalty of 10%.[15] Thus, if a divorcing couple has both IRA and ERISA retirement plans and one spouse intends to begin taking distributions before age 59½ (e.g., a husband intends to take a year off from work), the withdrawing spouse will be better off receiving the ERISA account.

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9 Anthony Paik, *Adolescent Sexuality and Risk of Marital Dissolution*, 73 J. MARRIAGE & FAM 472 (2011).

10 HOLLY HEIN, *SEXUAL DETOURS: INFIDELITY AND INTIMACY AT THE CROSSROADS (*2000).

11 Wendy Wang & Kim Parker, *Record Share of Americans Have Never Married*, PEW RES. CTR. (Sept. 24, 2014), http://www.pewsocialtrends.org/2014/09/24/record-share-of-americans-have-never-married.

12 Sue Shellenbarger, *Co-Workers Can Wreck a Marriage: At the Office, Divorce Is Contagious*, WALL ST. J., (Nov. 13, 2003, 8:53 AM),available at: http://www.wsj.com/articles/SB106868624044945OO.

13 NICHOLAS H. WOLFINGER, UNDERSTANDING THE DIVORCE CYCLE: THE CHILDREN OF DIVORCE IN THEIR OWN MARRIAGES (2005).

14 I.R.C. §72(t)(2) (2016).

15 I.R.C. §72(t)(3) (2016).

- ERISA retirement plan accounts are generally exempt from the claims of most creditors.[16] Original IRA owners[17] have a federal bankruptcy exemption of up to $1.0 million plus the full value of IRAs which received rollovers of ERISA plans.[18] A number of states[19] also provide creditor protection for IRAs. As a result, divorcing clients in financial difficulty should do their best to retain their own retirement assets upon a divorce and try to obtain rights to their spouse's retirement assets.

- In Merchant v. Corder,[20] the Fourth Circuit Court of Appeals ruled that a change in beneficiary designation to an ERISA retirement plan prior to the issuance of a final judgment of divorce was invalid. Because the ex-spouse had not agreed to the relinquishment of her rights to the plan at the time of the change and there was not a qualified domestic relations order (QDRO), when the former husband died the ex-spouse received the entire retirement fund.

- In Hartley v. Commissioner,[21] the Tax Court ruled that when a family court required the plan participant to withdrawal funds from his ERISA retirement plan to pay for alimony, the 10% early withdrawal penalty applied because the payment was made to the plan participant and not an alternative payee as required by I.R.C. §72(t)(2)(C). Moreover, a QDRO was never prepared.[22]

- In Schultz v. Schultz,[23] an Iowa court ruled that when a divorce decree did not include any waiver of a spouse's IRA account and the spouse never removed the ex-spouse as a named beneficiary, the ex-spouse was entitled to the IRA assets upon the death of the account owner, even when the IRA account holder had remarried.[24]

- ERISA generally provides that the retirement benefit of a qualified retirement plan cannot be assigned.[25] The statute provides an exception for assignments incident to a divorce.[26] In order to pass a portion of an ERISA retirement benefit to an ex-spouse, the divorce decree must

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16 29 U.S.C. § 1056(d)(1); 26 U.S.C. § 403(b); Patterson v. Shumate, 504 US 753 (1992).

17 Inherited IRAs do not have similar protections. See: Clark v. Rameker, 134 S. Ct. 2242 (2014) where the US Supreme Court unanimously ruled that an inherited IRA did not have the bankruptcy protection of an ERISA retirement account or a taxpayer's own IRA. State statutes may offer some partial protections for IRAs and other retirement benefits. See: Ed Morrow, *50 State Exemption Chart on IRAs, Non-ERISA 403(b) Plans & Roth Variants*, ASSET PROTECTION PLAN. NEWSLETTER (LISI), no. 256, Aug. 7, 2014.

18 11 U.S.C. § 522(n). The benefit may be limited if rollover IRAs are comingled with a non-rollover IRA.

19 See the IRA State Exemption Chart at http://moranknobel.com/retirement.htm

20 No. 98-2128, 1999 WL 486590 (4th Cir. July 12, 1999) (unpublished opinion).

21 104 T.C.M. (CCH) 553 (2012).

22 Similarly, see: Bougas v. Commissioner, T.C. Memo 2003-194.

23 591 N.W.2d 212 (Iowa 1999).

24 See the excellent article by Leslie A. Shaner, *When Clients Fail to Change Beneficiary Designations*, FAM. L. MAG. (Dec. 10, 2013), http://www.familylawyermagazine.com/articles/beneficiary-designations. *See also* UNIF. PROB. CODE § 2-804 (UNIF. LAW COMM'N 2014).

25 I.R.C. § 401(a)(13) (2016).

26 The Pension Benefit Guaranty Corporation has issued a helpful booklet on divorce and Qualified Domestic Relations Orders. The booklet includes sample forms and a checklist. Copies can be found at www.pbgc.gov/publications/

satisfy the requirements of I.R.C. §414(p).[27] Federal law does not require a qualified domestic relations order for a divorced-based IRA transfer.[28] In Hendon v. E.I. Dupont Nemours & Co.,[29] the Sixth Circuit Court of Appeals ruled that even when a divorce decree and martial dissolution agreement provided that a divorced spouse waived rights to the other spouse's ERISA retirement plan, the ex-spouse was still entitled to the qualified plan assets upon the death of the plan participant. The Court ruled that the waiver was not in compliance with the requirements of ERISA.

- Assume a husband is a participant in a defined benefit plan. Based upon his health and family history, the husband believes he will live longer than the mortality tables indicate. By retaining all of the defined benefit account and giving other assets to his wife, the husband might retain a greater financial benefit then actuarially calculated by the plan administrator.

Creditor Issues. Financial problems are often a root cause of divorce. As a result there may be numerous creditor related issues in the divorce process.

If there is the possibility of bankruptcy for an ex-spouse, then the non-bankrupting spouse is well advised to obtain the advice of bankruptcy counsel before the settlement is finalized. While a property settlement may be deemed a preference or fraudulent transfer, it is less likely that a support obligation to a spouse and children would be overturned. Moreover, payments for alimony, maintenance and support are not dischargeable in bankruptcy.[30] Therefore, one method of protecting a divorcing spouse of a financially distressed party may be to treat the payment as alimony and support—albeit at a potential tax cost to the recipient ex-spouse.[31]

Many clients mistakenly believe that because the divorce decree or settlement requires one spouse to pay marital debts, creditors cannot seek recovery from the other spouse. Because the creditor is not a party to the contest, it is normally not restricted in its rights. For example, assume a couple has co-signed a line of credit note, and the divorce decree assigned the liability to the husband. If the husband declares bankruptcy after the divorce, the ex-wife might still be responsible for the debt.

Occasionally, a client will consider a friendly divorce as a means of protecting assets from the creditor claims of one of the spouses. The Massachusetts Federal District Court decision of U.S., vs, Baker[32] offers an excellent example of the problems that can result from such a fraudulent conveyance.

Net After-Tax Value. The basis of assets transferred as a result of divorce should be an important part of the divorce negotiating process. However, courts may be reluctant to get embroiled in

27 For more information on QDROs, see: Emily W. Mcburney, *QDRO Basics for Estate Planners With Divorcing Clients*, Estate Planning Journal (October 2012).

28 26 USCA § 408(d)(6) (2015).

29 No. 96-6233, 1998 WL 199824 (6th Cir. Apr. 13, 1998).

30 *See* 11 U.S.C. § 523(a)(5), 727, 1141(d)(2), 1228(c)(2), 1328(a)(2) (2016).

31 i.e., the recipient of the alimony is taxable. I.R.C. §§ 61(a)(8), 71(a) (2016).

32 2015 WL 4886081 (D. Mass., August 17, 2015). See: Jay Adkisson on U.S. v. Baker, US District Court finds Divorce Obtained to Fraudulently Transfer Assets, LISI Asset Protection Newsletter #308 (October 6, 2015).

speculative tax consequences of a divorce. For example, in In Re Marriage of Fonstein,[33] the California Supreme Court stated: "*Regardless of the certainty that the tax liability will be incurred if in the future an asset is sold, liquidated or otherwise reduced to cash, the trial court is not required to speculate on or consider such tax consequences in the absence of proof that a taxable event has occurred during the marriage or will occur in connection with the division of the community property*."

While the court may refuse to get involved with tax basis issues, divorce negotiations should take into account the after-tax value (including the cost of satisfying any secured debt) of an asset, not just its fair market value. Assume a spouse has a choice between taking $1.0 million in cash or $1.2 million in stock which has a zero basis. Which is the better option? For tax purposes (assuming an immediate stock sale), the $1.0 million in cash may be a better choice. Why? Assuming a combined state and federal capital gains tax rate of 30%, the $1.2 million in stock carries an inherent tax cost of roughly $360,000, meaning the stock has a true after-tax value of only $840,000.

In general, a pre-death transfer of property secured by a debt that exceeds the asset's tax basis creates a taxable event to the transferor. I.R.C. §1041(e) provides an exception to this rule and a potential trap to the ex-spouse that receives the property. If property is transferred directly (i.e., not through trust) to a spouse or ex-spouse and the property has a liability in excess of its basis, no recognition occurs on the transfer and the recipient spouse takes the transferor spouse's basis.[34] But, if the recipient spouse later transfers the asset during life, the amount by which the secured debt exceeds the tax basis can be taxable to the recipient spouse.

> ***Example*:** Assume a divorcing wife owns a tract of land that has a fair market value of $2.1 million, a basis of $200,000 and secured debt of $1.5 million. The husband receives the property as a part of the divorce and immediately sells it, thinking that he gets to keep the $600,000 in equity. When his CPA asks him about the tax basis in the transaction, the husband responds with "*what's tax basis?*" The recognized taxable gain is $1.9 million. Assuming a state and federal effective income tax rate of 30%, the taxes on the sale are $570,000, leaving the client with $30,000 after payment of the mortgage. Assuming a 6% sales commission, the husband could actually be out of pocket for the sale.

In addition to understanding the market value of the couple's assets, it is important that the advisors know the tax basis of those assets. In determining the assets to be used in the property settlement there are a number of planning opportunities:

- Assume the wife's sale of her assets has a long term capital loss of $300,000. Even though the couple filed a joint income tax return, only the wife is permitted to use the loss after divorce.[35] The property settlement could pass assets with an unrealized gain of $300,000, effectively creating a tax-free sale.

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33 522 P.2d 1169 (Cal. 1976).

34 For a more detailed analysis of this issue, see BORIS BITTKER & LAWRENCE LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS, ¶ 44.6 (2015); I.R.S. P.L.R. 9615026 (Apr. 12, 1996); I.R.S. P.L.R. 8644012 (Jul. 31, 1986); Treas. Reg. § 1.041-1T(d) Q&A 12 (2015).

35 *See* Rev. Rul. 74-175, 1974-1 C.B. 52 (discussing capital losses and net operating losses); Treas. Reg. § 1.170A-10(d)(4)(iii) (2015) (charitable carryovers).

- In the alternative to the foregoing, assume one spouse has assets with a substantial unrealized loss and the owner of the assets is not expected to be able to use the loss if the assets are sold. The loss assets could pass to the other spouse who could sell the assets and use the capital loss to offset gains in their own assets. The tax basis of the transferor spouse carries over to the recipient spouse.[36]

<u>Alimony is Earned Income</u>. I.R.C. §219(f)(1) provides that alimony is considered earned income for IRA purposes. Assume a non-working 51-year-old client is getting divorced. Allocating a portion of any settlement to alimony (e.g., $6,500 per year) would create an income tax deduction for the payer and allow the payee to fund a tax-deductible IRA contribution.[37]

<u>Dependency Deductions</u>. The tax savings from being entitled to the dependency deduction for a couple's children should be a part of the negotiations. Assuming all of the dependency exemption requirements are met,[38] the parents can enter into a written declaration[39] governing which of them will be entitled to the deduction for a dependent child. While the parent in the higher income tax bracket will normally receive the greater tax benefit for the dependency exemption, the phase-out of personal and dependent exemptions for higher income taxpayers should be taken into account in making this decision. Before making a final decision, run the projected tax benefits for each spouse over the years they might be entitled to the deduction.

In some states,[40] the court does not have authority to award the dependency deduction to the non-custodial parent without the custodial parent's approval, giving the custodial parent additional leverage in the negotiations.

The custodial parent is normally the party responsible for filing and paying the "kiddie tax" of an applicable child.[41]

<u>Divorce Trusts</u>. Divorces are seldom amicable. As a result, conflicting perspectives and desires for control can create implacable disagreements. For example, a less wealthy spouse will be concerned that the wealthier spouse will renege on support payments or have future financial problems. The wealthier spouse may not want a former spouse to remarry and still receive benefits or the wealthier spouse may not want to benefit the heirs of the soon-to-be ex-spouse.

One solution may be the creation of a divorce trust. While divorce trusts are not regimented, there are general terms that will normally apply. For example:

- The trust could provide for payments equal to the settlement terms between the divorcing couple.
- The trust must generally be irrevocable to avoid adverse tax consequences and to provide the beneficiary spouse some assurance of payment.

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36 I.R.C. §1041 (2016).

37 Interestingly, I.R.C. §219(f)(7) provides that non-taxable combat pay is also treated as earned income for IRA contribution purposes. Is there a common theme here?

38 I.R.C. § 152(e) (2016).

39 The form's requirements are provided for in Treas. Reg. § 1.152-4(e)(1) (2016).

40 C.f., Georgia: Blanchard v. Blanchard, 401 S.E.2d 714 (Ga., 1991).

41 I.R.C. § 1(g)(5) (2016).

While creative planning may offer new approaches, in most cases, these trusts will generally fall into one of the following approaches. Assume the husband has a higher new worth in the following examples.

Lifetime QTIP. The husband can create a lifetime QTIP trust for the wife, with the provision that the trust rolls over to a trust for his descendants at her death. The assets remain available to benefit the wife for life. At her death the basis in the assets step-up to their fair market value and her available estate exemption can reduce the family's overall estate tax. The husband should make a timely election to treat the trust as a QTIP trust eliminating any gift tax on the transfer to the trust. However, the client should be aware that the wife must receive all income generated by the trust and the trust cannot terminate before the wife's death.

Bypass Trust. But what if the donor spouse wants the trust to cease providing benefits to the soon-to-be ex-spouse before her death (e.g., after a stated number of years or when she remarries)? In that case, the donor spouse may effectively be forced into using some form of a lifetime Bypass trust because the rules governing QTIP Trusts would not permit such an early termination before the beneficiary/spouse's death. There are at least two major downsides to this decision compared to a QTIP trust. First, upon the termination of the trust benefits to the ex-spouse, there is no step-up in the basis for the trust assets. Second, the trust will be covered by the grantor spouse's transfer tax exemption rather than the former spouse's exemption. However, with the high federal transfer tax exemption and only Connecticut having a gift tax, this concern will not be a pertinent part of most clients' decisions.

Reversionary Trust. The grantor of the trust may want the assets of the trust to revert to the grantor upon certain prescribed events (e.g., death or remarriage of the former wife), particularly if there are no children from the marriage who could be named as remaindermen. If the trust provides that it reverts to the settler at its termination (i.e., the end of support obligations), then the trust will normally be includable in the settler's estate.[42] However, assuming the trust is satisfying a deductible divorce obligation, there may be an offsetting estate deduction. With the larger federal transfer exemptions creating fewer taxable estates, reversionary trusts may become more acceptable from an estate tax perspective.

Charitable Remainder Trust. One creative solution in divorce/second marriage negotiations is to have the wealthier spouse create a charitable remainder trust (CRT) that names the spouse (or soon to be ex-spouse) as lifetime beneficiary. The grantor of the trust obtains a current income tax deduction equal to not less than ten percent of the value of the contributed assets. The sale of an appreciated asset contributed to the trust would not generally create current taxable income to the trust or grantor. The grantor could retain a lifetime income interest from the trust after the death of the ex-spouse. Finally, the grantor spouse could retain the right to change the charitable remainderman during the grantor's life.

The ex-spouse receives an income stream for life in lieu of direct ownership of assets. For a financially challenged spouse, this might be a good choice for at least part of the benefits they receive as a result of the divorce.

42 See: I.R.C. § 2036 (2016).

The CRT for the spouse can also contain a provision that terminates the CRT upon the remarriage of the spouse,[43] a contest of the grantor's Will or upon other contingencies.[44] The contingency is not taken into account in calculating the value of the charitable remainder interest and the resulting charitable deduction.[45] Normally, the existence of a contingency that could result in potential termination of the interest would void the estate tax marital deduction.[46] However, Code section 2056(b)(8) provides an exception to the terminable interest rule *"If the surviving spouse of the decedent is the only beneficiary of a qualified charitable remainder trust who is not a charitable beneficiary nor an ESOP beneficiary…"*

<u>Divorce and Charitable Remainder Trusts</u>. Many married clients have created CRTs that have a lifetime payouts for the lives of the two spouses. The IRS has permitted a division of the CRT if they get divorced.[47] In lieu of a division of an existing CRT, the clients might provide that one of them renounces all of their rights to the CRT as a part of the negotiated divorce terms. This renunciation might create a charitable deduction to the disclaiming party because the present value of what the charity will receive may have increased. If they file a joint return in the year of the renunciation (e.g., they remain married until the following year), the non-disclaiming spouse could receive an indirect tax benefit from the renunciation.

<u>Life Insurance</u>. As a part of divorce settlements one or both spouses may be required to maintain life insurance on their life for the benefit of an ex-spouse and/or children.

If the insured former spouse wants to deduct the insurance premiums as alimony, the insured should consider having the ex-spouse be both owner and irrevocable beneficiary of the policy.[48] However, many divorced clients have a rather adverse reaction to an ex-spouse benefiting from their death.

If the insured dies within three years of the transfer of an existing life insurance policy, the death benefit could be pulled back into the insured's taxable estate.[49] In <u>Smoot v. Smoot</u>,[50] life insurance proceeds paid to a former wife from a policy owned by the decedent were taxable in the insured former husband's taxable estate. As a result the former wife was required to contribute to the estate taxes due on the taxable estate.[51] The case illustrates two problems with divorce related life insurance. First, the ex-spouse will not be happy about the diminution of any insurance proceeds by applicable state or federal estate taxes. Second, if the insurance death payment is made directly to the former spouse, the executor of the estate may have a hard time getting funds out of the former spouse to cover the ex-spouse's portion of the estate taxes.

43 See Priv. Ltr. Rul. 9829017.

44 I.R.C. § 664(f) (2016).

45 For more information see: Marc D. Hoffman, *Helmsley Will - Interesting Qualified Contingency and Other Provisions*, STEVE LEIMBERG'S CHARITABLE PLAN. NEWSL. no 128 (Sep. 18, 2007).

46 I.R.C. § 2056(b)(1) and (b)(7).

47 I.R.S. P.L.R. 200824022 (Jun. 13, 2008); Rev. Rul. 2008-41, 2008-2 C.B. 170.

48 *See* Rev. Rul. 70-218, 1970-1 C.B. 19.

49 I.R.C. § 2035 (2016).

50 *Smoot v. Smoot*, No. 2:13-cv-00040 (S.D. Ga. Mar. 31, 2015)

51 *See* I.R.C. § 2206 (2016).

Drafting: Divorce agreements should clearly state whether the former spouse is responsible for any applicable portion of any state or federal estate taxes on the insurance proceeds. Moreover, the insured's Will may specifically provide that the insurance recipient is required to pay any applicable taxes in order to avoid having the taxes reduce the residuary estate.

If the former spouse is the owner of the policy, the ex-spouse will direct the ultimate disposition of the death proceeds. Instead, the insured could place a policy in an irrevocable life insurance trust (ILIT) and give the ex-spouse a beneficial interest until the spouse has died, married or cohabitated,[52] at which time the benefits of the trust could pass free of transfer taxes[53] to other heirs (e.g., the children from the first marriage). If the policy is owned by an ILIT, the insured will lose the alimony deduction for the payment of insurance premiums, but as the creator of the trust, the insured can also direct the ultimate disposition of the death proceeds. If the ILIT is properly created and operated, the policy may be excluded from the insured's taxable estate.

If the divorce decree provides that the insurance policy will revert to the insured upon the satisfaction of the divorce obligations it was designed to fund, then this reversionary interest[54] may result in the insured former spouse having to include the policy in the taxable estate, even when the non-insured ex-spouse is the irrevocable beneficiary.[55] However, the decedent's estate may qualify for an estate tax deduction for the amount of the proceeds.[56] In many cases it will be better to have the settlement agreement provide for transfer of the policy into a trust for the benefit of any joint descendants.

Assume a former spouse obtained a life insurance policy on the ex-spouse. Does the insured ex-spouse have an obligation to cooperate with the former spouse to retain the policy? In a Kansas Supreme Court decision,[57] the court ruled that a husband had no obligation to help the ex-spouse maintain a life insurance policy on his life. The case largely turned on Kansas Statutes Annotated § 40-453(a), which provides that an insurable interest ceases when an insured requests the insurer to terminate or non-renew the policy applicable to such person's life. The Court noted: "*we hold a court order requiring a child support obligor to cooperate with a child support obligee's efforts to obtain insurance on the life of an obligor is against public policy, as expressed by the Kansas Legislature in K.S.A. 40-453(a). . . .*"

Drafting: In drafting the divorce settlement agreement, specifically provide that any ex-spouse who is insured by the other spouse must cooperate in maintaining the coverage. The responsibilities for paying the insurance premiums should also be spelled out.

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52 Determining cohabitation can be intrusive and conflict laden.

53 On transfers of an existing life insurance policy to the ILIT, the insured/owner must survive the transfer by three years for the policy to be outside the insured/owner's taxable estate.

54 I.R.C. § 2042(2) (2016).

55 Rev. Rul. 76-113, 1976-1 C.B. 276; *Estate of Kahanic v. Comm'r,* 103 T.C.M. (CCH) 1434 (2012); Louis A. Mezzullo, *Using Life Insurance to Satisfy Support Obligations in a Divorce*, 38 EST., GIFTS & TR. J. 329 (November 2013).

56 Rev. Rul. 76-113. 1976-1 C.B. 276; *see also* I.R.C. § 2053(a)(4) (2016).

57 *In re* Marriage of Hall, 286 P.3d 210 (Kan. 2012); *see also* Howard M. Zaritsky, Marriage of Hall*: Ex-Husband Cannot Be Made to Cooperate with Ex-Wife's Attempt to Maintain Life Insurance Policy on His Life*, EST. PLAN. NEWS. (LISI), no. 2012, Oct. 15, 2012.

Like retirement accounts, divorcing couples need to review their life insurance beneficiary designations and make changes as a result of the divorce. Normally, an unchanged beneficiary designation will trump waivers contained in the divorce settlement agreement.[58]

Gifting and Divorce. The couple's transfer tax exemptions and annual exclusions should be viewed as a tradable asset. The unused transfer tax exemption of a less wealthy spouse can be a valuable asset to the wealthier spouse. Assume a husband wants to begin transferring equity in his family business to children from a prior marriage. He has a prenuptial agreement that restricts the rights of the current spouse. The appraiser has provided a discount in value of 40% for the minority interest he will transfer in the business. If the spouses elect gift-splitting, the donor spouse can effectively transfer his and his wife's transfer tax exemptions (with an applicable valuation adjustment of 40%) to a generation-skipping trust and could obtain an transfer tax savings of up to $3,633,333.[59] There are multiple ways to make the trade-off including:

- The husband could modify his Will to provide a more generous trust for the benefit of the soon-to-be former wife,[60] or
- The husband could create an ILIT or a non-insurance trust with other assets that provides a life interest to the ex-spouse, but which passes the trust assets to the husband's family at the ex-wife's death (or other triggering event such as her remarriage), or
- The husband might provide a larger property settlement to a soon-to-be ex-wife. "*In return for saving me $3.6 million in transfer taxes, I will agree to increase the property settlement by $2.0 million.*"

The annual exclusion[61] of $14,000 (2016 exclusion) per donee per year can also be a valuable resource. Both spouses have been married before and both are wealthy. One spouse has 10 potential donees and the other has 20 potential donees. Using gift splitting, each of them can double the non-taxable annual exclusion of the other, without any adverse impact to either spouse's estate planning, while saving both families significant estate taxes. But pay attention to the Reciprocal Trust Doctrine.[62]

> ***Drafting***: Make sure there is a document in which each spouse agrees to sign a gift tax return for the year in which they consent to gift-splitting.

In an amicable divorce, clients should also review the possibility of using their transfer tax exemptions more effectively. For example, assume a husband and wife could each create Bypass/Exemption trusts naming the other as beneficiary. These irrevocable trusts could grow estate tax-free and protect the ex-spouse/beneficiary from creditor claims. Clients should make sure that the terms of the trusts do not "mirror" each other to avoid application of the reciprocal

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58 EDWARD G. (WOODY) CONNETTE, ET AL., LAWYERS MUTUAL, DEAD BUT NOT DONE: THE OUTDATED DESIGNATION OF BENEfiCIARY, *available at* http://files.lm2014.gethifi.com/Dead_not_Done.pdf (last visited June 1, 2016).

59 i.e., $5,450,000 (spouse's 2016 gift exemption), discounted at 40% ($9,050,000 in transferred value), multiplied by the top estate tax rate of 40%.

60 Although the wife will normally prefer an irrevocable transfer and current benefits.

61 I.R.C. §2503(b) (2016). The exclusion increases periodically in increments of $1,000 for cost of living adjustments.

62 *See* Cheryl L. Hader, *Planning to Avoid the Reciprocal Trust Doctrine*, 26 EST.PLAN. 358 (Oct. 1999); Paul E. Van Horn, *Reciprocal Trusts Revisited*, 19 PRAC. TAX LAW. 39 (Summer 2005).

trust doctrine.[63] If the doctrine applies, both trusts will be ignored for transfer tax purposes.

1. In a related vein, Treas. Reg. §20.2010-3(a)(3) specifies that divorcing a new spouse before that new spouse dies will preserve the surviving spouse's ability to use the DSUE amount from the last prior deceased spouse. Either way, these rules mean that a surviving spouse who did remarry and is likely to survive that new spouse can avoid loss of a portable DSUE amount by acting before the new spouse dies, either via divorce or by making a gift that consumes the portable DSUE amount.

<u>Revocation of Rights in Existing Trusts</u>. Many clients have created existing irrevocable trusts (e.g., an ILIT) in which a soon to be ex-spouse is a Trustee, beneficiary and/or holder of rights over the trust (e.g., a limited power of appointment).

> ***Drafting***: The settlement agreement or the irrevocable trust terms should provide that the former spouse irrevocably renounces all of the spouse's rights, powers and other benefits in any existing trusts upon divorce or legal separation.

<u>Tax Basis Records</u>. There are no federal laws mandating that the transferor spouse provide basis and holding period information to the recipient spouse when a divorce occurs.[64] Although Treasury Regulations[65] require that such information be provided at the time of any transfer, there are no penalties for failing to provide the information.

> ***Drafting***: Any divorce settlement agreement should require that the transferor spouse provide the transferee spouse with sufficient records to support both the basis of the property and its holding period. Without such information, the IRS could challenge the transferee's unsupported tax filings.

<u>Revocation of Benefits Upon Divorce</u>. In most states, a divorce automatically terminates the rights of an ex-spouse under a Will that preceded the divorce. For example, in Georgia, *"[a]ll provisions of a will made prior to a testator's final divorce or the annulment of the testator's marriage in which no provision is made in contemplation of such event shall take effect as if the former spouse had predeceased the testator . . ."* [66] Note that the Will is still valid, but the ex-spouse is deemed to have predeceased the testator.

There is a potential unintended consequence in states which adopt the above approach. Assume there are children of the marriage and the Will provides that the surviving spouse will serve as a Trustee or Co-Trustee for the children's beneficial interests upon the death of the testator. The couple gets divorced and then the husband dies. As a result of the above presumption, the former wife is treated as predeceased "*for all provisions of a will*," The wording would indicate that the

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63 Id.

64 The basis consistency and basis reporting rules contained in the Surface Transportation and Veterans Health Care Choice Improvement Act of 2015 do not apply to lifetime transfers. See I.R.C. §§ 1014(f), 6035 and 6662.

65 Temp. Treas. Reg. § 1.1041-1T, Q&A-14 (2015).

66 GA. CODE ANN. § 53-4-49 (2016).

former wife could not serve as a Trustee for the couple's children.

In many states, the wife is considered to have predeceased the former spouse, but the relatives of the former spouse who are listed in the Will may still have a right of inheritance. Some states also treat the former spouse's relatives as having predeceased.[67] In re Estate of Mower,[68] a couple divorced and the former husband unexpectedly died 16 days later. His Will was not modified before his death. The Will provided for an alternative bequest to the ex-wife's brother and his wife that the Court upheld, even though the divorce had occurred and the former wife was treated as being pre-deceased.

The automatic statutory revocation of rights of a divorced spouse under the other spouse's Will may not apply to other documents. For example, the parties may mistakenly believe that the divorce settlement trumps existing beneficiary designations and fail to change those designations.[69]

The disinheritance of an ex-spouse may only occur when the divorce is finalized. Even if a new Will is drafted to disinherit the soon-to-be ex-spouse during the divorce process, in most states, the spouse still has legal rights against the decedent's estate (e.g., a spousal elective share or community property right) until the divorce is finalized.[70]

Largely because of continual mistakes by divorced residents, at least 23 states have adopted statutes which provide that divorce automatically results in a deemed elimination of beneficiary designations for the benefit of the former spouse.[71] For example, Florida provides that a former spouse is treated as predeceasing the decedent when a divorce occurs.[72] However, a number of Supreme Court decisions[73] have indicated that state statues that automatically rescind rights upon divorce do not apply to ERISA retirement plans and other federally provided benefits because federal law preempts state law with regard to such rights.[74] Therefore, clients are well advised to promptly review and modify all beneficiary designations as a part of their marriage or divorce.

67 C.f., Texas (TEX PB. CODE ANN. § 69(b)), provides: *"If, after making a will, the testator's marriage is dissolved, whether by divorce, annulment, or a declaration that the marriage is void, all provisions in the will, including all fiduciary appointments, shall be read as if the former spouse and each relative of the former spouse who is not a relative of the testator failed to survive the testator, unless the will expressly provides otherwise."* (emphasis added)

68 2016 WL 2647566 (Wash. Ct. App.).

69 C.f., Trueblood v. Roberts, 732 NW2d 368 (2007) where the ex-spouse inherited the life insurance proceeds because the beneficiary designation was not changed after the divorce.

70 See Scroggin, supra note 2.

71 See the excellent article by Leslie A. Shaner, *When Clients Fail to Change Beneficiary Designations*, FAM. L. MAG. (Dec. 10, 2013), http://www.familylawyermagazine.com/articles/beneficiary-designations. *See also* UNIF. PROB. CODE § 2-804 (UNIF. LAW COMM'N 2014)

72 FLA. STAT. § 732.703 (2015); *See* Jeff Baskies, *New Florida Statute Clarifies Impact of Divorce on Non-Probate Assets*, EST. PLAN. NEWS. (LISI), no. 1990, July 23, 2012.

73 *Hillman v. Maretta,* 133 S.Ct. 1943 (2013); *Kennedy v. DuPont Savings and Investment Plan,* 555 U.S. 285 (2009); *Egelhoff v. Egelhoff,* 532 U.S. 141 (2001); *Ridgeway v. Ridgeway* 454 U.S. 46 (1981); *Wissner v. Wissner,* 338 U.S. 655 (1950). A number of state courts have issued similar rulings (*see, e.g., In re Sauer, 32 A.3d 1241* (Pa. 2011)).

74 ERISA § 514(a) (codified at 29 U.S.C. §1144(a) (2012)) provides that ERISA "*shall supersede any and all State laws insofar as they may now or hereafter relate to any [ERISA] employee benefit plan*."

The IRS has announced[75] that qualified retirement plans which provide that a legal separation automatically terminates a participant's designation of his or her spouse as beneficiary may violate the ERISA spousal death benefit rules. The announcement noted that *"Retirement plans may continue to provide that if participants <u>get a divorce</u>, their designation of their former spouse as plan beneficiary is automatically revoked."* Note that it is the terms of the retirement plan that were in question and when spousal rights are automatically revoked.

<u>New Dispositive Documents</u>. If divorce is anticipated, the client should promptly discuss with an estate planner the benefit of executing a new Will in contemplation of the divorce. The impact of the divorce on the client's existing estate planning should be considered an integral part of the divorce process and should precede the finalization of the divorce process. Leaving the decision to the inflexibility of statutory law is generally not an recommended approach.

> ***Drafting***: If a divorce or separation has occurred and the resulting agreement places financial obligations on the client, any new Will should reflect the terms of the settlement agreement. Drafters should be careful to provide that any bequests to an ex-spouse are in lieu of the decedent's legal divorce obligations. For example, assume the divorce decree provides that a payment of $100,000 be made to an ex-spouse in ten years. The Will says *"If my ex-spouse is alive in ten years, I convey to her $100,000."* As a result, the ex-spouse may receive a double benefit of both the bequest and divorce settlement rights.

<u>Incapacity Documents</u>. Many clients have drafted powers of attorney to provide for the handling of medical and property issues upon incapacity. In many cases, the clients do not focus on revising these important documents during or even after divorce. Having an ex-spouse or a divorcing spouse in charge of your medical and property decisions is probably not advisable.

In many states, a spouse authority to act as decision maker under incapacity documents is revoked when a divorce occurs. However, the effective date of the revocation of authority in incapacity documents varies from state to state For example:

- In Florida,[76] an agent's authority under a Power of Attorney terminates when "*an <u>action is filed for dissolution or annulment</u> of the agent's marriage to the principal or their legal separation*, *unless the Power of Attorney otherwise provides*" and dissolution or annulment of the marriage of the principal revokes the designation of the principals former spouse as a surrogate.
- Georgia law[77] provides: *"... if, after executing an advance directive for health care, the declarant's marriage <u>is dissolved or annulled</u>, such dissolution or annulment shall revoke the designation of the declarant's former spouse as the declarant's health care agent."*

Drafting: Clients should be encouraged upon the first appearance of divorce to update their powers of attorney and medical directives and name successor decision makers. Clients should consider whether to provide that their Medical Directives and Powers of Attorney are terminated immediately upon the filing of a divorce complaint, rather than having the termination be

75 INTERNAL REVENUE SERV., EMPLOYEE PLANS NEWS, 2013-3.
76 FLA. STAT. § 709.2109(2)(b) (2016) (emphasis added)
77 GA. CODE ANN. § 31-32-6(b) (2016). (emphasis added)

effective as of the date of the final divorce decree. Most clients would prefer not to have a soon-to-be ex-spouse decide what pain medicine they should receive upon incapacity.

Drafting: Always name successors to the primary agent named under medical directives and powers of attorney. If the spouse is the only named agent and is automatically removed by applicable state law, there could be no one empowered to serve as agent for the Medical Directive or Power of Attorney.

Planning for Divorce by Family Members

Divorce is a demographic fact which is often ignored in the estate planning process. Every estate plan needs to address the possibility that the client or an heir will face a future divorce. While the discussion may be awkward for the client and advisors, it is an unpleasant prospect which should be directly addressed. Many parents recognize that a child's marriages are not stable. In contemplation of this, clients should consider inheritance vehicles which restrict the ability of a divorced spouse to obtain part of the family assets. Among the approaches which should be considered are:

<u>Limiting Control</u>. The single most important aspect of any asset is its control. This is especially true in the context of the divorce of an heir. For example, the last thing that most family businesses need is a former son-in-law attempting to gain some control over the family business. In many cases, a client's spouse or the spouses of his or her heirs hold interest in a family business or may obtain an interest in a family business as a result of divorce or death of the family member. Even more disastrous can be a situation in which an heir dies and passes the business interest to a spouse, with the spouse later remarrying and passing the business interest to a unknown surviving spouse. Buy–sell agreements[78] should contemplate this possibility and provide a mechanism that allows other family members to buy-out the divorcing spouse on reasonable terms. If the terms are designed to penalize an ex-spouse, they may be unenforceable. Included in those terms should be a long-term payout to minimize the cash flow problems for the business. Such terms may also reduce the risk that a former in-law would want to receive business interests in the divorce.

<u>Spendthrift Trusts</u>. Spendthrift trusts have long been a part of the estate planner's tools. In recent years, as clients increasingly express concerns about asset protection and/or spendthrift children, these trusts have become a major part of the estate planning business. Basically, a spendthrift trust is any trust which provides for two major restrictions. First, it restricts the ability of any trust beneficiary to assign or otherwise transfer his or her interest in the trust. In most states, a beneficiary may freely assign a trust right (e.g., as collateral for loans or for other personal purposes) unless the operative document limits such assignments. Second, a spendthrift trust restricts the right of creditors of a beneficiary to demand trust distributions of income or principal in order to satisfy the obligations of the beneficiary. Such trusts also eliminate the ability of spouses to put pressure on an heir to put assets into a joint name. Virtually every trust should contain a spendthrift provision. It's simply good planning.[79]

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78 See HOWARD M. ZARITSKY, TAX PLANNING FOR FAMILY WEALTH TRANSFERS ¶ 9.05 (5th ed. 2015).

79 This article will not discuss the unique issues of self-settled spendthrift trusts. For more information on that topic, see: ________________________.

But there are cases which should provide some caution.[80] For example:

X The permissible limits of spendthrift trust vary widely from state to state. _____________

X In Dwight v. Dwight,[81] a Massachusetts Appeals Court ruled that a spendthrift trust created by a divorced husband's father could be treated as an increase of the divorced husband's income, allowing the ex-spouse to claim a portion of it as alimony. A narrow reading of the case would seem to indicate that the decision was at least partially based upon the existence of an ascertainable standard for the husband's benefit. Had distributions been in the "*sole, absolute and unfettered discretion*" of an independent trustee, the ruling might have been different.

X _________________

Drafting: Include in any prenuptial or post-nuptial agreement a waiver of any direct or indirect rights or powers over any trust benefits of the other spouse in the event of divorce.[82]

Drafting: Given the high incidence of divorce, lawyers should counsel their clients about the possible alimony and property claims that heirs' divorcing spouses may be able to make and draft the client's estate planning documents in ways designed to minimize those risks. For example:

- Using discretionary trusts with independent trustees in lieu of mandatory payouts or ascertainable standards,
- Making specific statements that it is the client's intent that income and property of the trust are not accessible to an heir's ex-spouse or any creditors and
- Adopting spendthrift trust language.

Caution: In states which do not permit self-settled spendthrift trusts, the use of trusts (e.g., Charitable Remainder Trusts and Grantor Retained Annuity Trusts), created by a grantor and which provide current distribution rights and benefits to the grantor (and with the grantor often serving as a Trustee) may open the grantor's beneficial rights in the trust to the claims of creditors.[83]

Garnishment of Distributions. Even though a trust may limit the claims of a divorcing spouse against the assets of the trust, the divorcing spouse might still be able to make a claim against actual distributions made to the beneficiary/ex-spouse. For example, a Georgia statute provides that, except when the beneficiary of a spendthrift trust is suffering under significant physical or mental disability that impairs the beneficiary's ability to provide for their care, an alimony or child support claim can be made against "*a distribution to a beneficiary*."[84] Note many state statutes do not allow a former spouse to require that the trustee(s) make a distribution from a

80 For an excellent article on this topic, see: Jeff Pennell, *Third Party Trusts in Divorce Is a Beneficiary's Interest Marital Property?* available at: *www.caepc.org/assets/Councils/CentralArizona-AZ/.../**Trusts**%20in%20**Divorce**.pdf* (last visited June 26, 2016)

81 756 N.E.2d 17 (Mass. App. Ct. 2001).

82 For more drafting recommendations, see Pennell, supra note 13.

83 *See*: In Re Mack, 69 B.R. 392 (2001).

84 GA. CODE ANN. § 53-12-28 (2016).

discretionary spendthrift trust.[85]

Discretionary Trusts. As discussed above, when clients are concerned about the financial and marital problems of an heir, they would be well advised to adopt provisions in their trusts which grant trustees the broad discretion to decide when to make distributions to or for the benefit of a beneficiary. The effective result is that the beneficiary has no vested or attachable rights in the trust for a creditor to make claim against.[86]

> ***Drafting***: If the client adopts such provisions, it may be important to provide some additional safeguards for both trustees and beneficiaries, such as giving beneficiaries the right to remove trustees and indemnifying trustees for their good faith acts. It may also be advisable to place responsive trustees in charge of such heir's trust, so that if the marriage is dissolved, additional benefits (i.e., greater principal distributions) may pass to the heir.
>
> ***Drafting***: A key element of a Spendthrift/Discretionary Trust is limiting the rights of a trustee/beneficiary to make decisions on distributions to the beneficiary's own benefit.[87] Either the beneficiary should not be a trustee or they can be a Co-Trustee, with specific language limiting the beneficiary's right to participate in distributions for an heir's own benefit or to satisfy any legal obligations that they might have (e.g., child support).

Jointly Held Accounts. Many couples hold significant assets in joint name (e.g., a brokerage account). As a deemed marital gift, the spouse may have a right to 50% of the account in the event of divorce, even though the spouse may have made no contributions to the joint account. The solution? Encourage clients who have sizeable assets before marriage or who receive sizable inheritances to keep the funds segregated from marital assets in their personal accounts.

Caution: Beware that in the "kitchen-sink" states, segregated inherited assets may still be taken into account in a divorce.[88]

Irrevocable Trusts. Virtually all irrevocable trusts should be drafted (and maybe even some revocable trusts), in contemplation of the possibility that one or more of the beneficiaries may get divorced. For example, assume a client creates an irrevocable life insurance trust. The spouse is named as a beneficiary and co-trustee and is given significant power, such as the right to remove other trustees and a limited power of appointment to reconfigure the trust for the benefit of the couple's joint heirs. The documents should contemplate the possibility that the insured grantor and the beneficiary/spouse are later divorced. The document could provide that all rights and powers of the spouse, including her right to serve as co-trustee, immediately terminate upon either legal separation or divorce. Few clients want an ex-spouse to benefit financially from their death or be able to control the inheritance of their assets.

Similar issues involve planning for surviving spouses. For example, assume a widow remarries and then dies. There could be claims against the deceased spouse's assets by the second husband.

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86 *See*: First Northwestern Trust Co. v. IRS, 622 F.2d 387 (1990).

87 C.f., In the Matter of: Warren and Brenda Bierman, 1998 Bankr. LEXIS 2012.

88 ________________________

Spousal elective share and homestead statutes may permit the new husband to claim support from the deceased wife's estate, or assets may have been directly or indirectly (e.g., payoff of the mortgage on a home that was jointly held) placed in joint name, with the surviving new husband taking survivorship rights. The use of spendthrift Bypass and QTIP trusts in the deceased husband's estate can reduce these potential claims.

Conclusion: Divorce attorneys tend to exclude tax advisors in their settlement negotiations. As a result, unidentified tax and estate planning issues often arise after the divorce. Moreover, recently divorced clients have often had their fill of attorneys and are not particularly eager to talk with an estate planning attorney about potential estate revisions caused by their divorce. The failure to address these issues can be extremely costly.

Checklists:

- See www.scrogginlaw.com for a *Practical Post-Divorce Checklist* for the recently divorced.
- Linda J. Ravdin, *Marital Agreements*, 849-2nd TAX MGMT. (BNA), at Worksheet 8 Client Letter — Post-Execution Checklist to Carry out Terms of Agreement.

Websites: There are some interesting divorce related sites on the Web, including:

- http://www.divorce360.com/content/divorcecalculator.aspx - calculate your chance of divorce
- http://www.alllaw.com/calculators/ChildSupport - for child support calculations
- For state information on marriage and divorce rates see: http://www.pewsocialtrends.org/2009/10/15/marriages-and-divorce-a-50-state-tour/

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