

Divorce Planning

Overview

Of all the areas of financial planning, divorce planning is probably the most emotionally difficult. Family concerns and sensitive emotional issues come to the forefront and are of primary importance to the parties involved, including the children. The financial issues often are pushed into the background. This is an unfortunate situation because divorce is one of the most common reasons for bankruptcy for one or both of the divorcing spouses.

No matter how amicable the divorce may be, it is highly recommended that both parties hire their own attorneys who specialize in family law and divorce. They should also consider hiring financial planners and tax advisers who are well versed in matters of divorce, if their respective lawyers do not have that expertise or the time to handle the financial and tax issues in addition to the legal aspects of the divorce process.

Financial planning for both spouses is critical and needs to be addressed as soon as possible in the settlement process, long before the divorce is legally finalized. Some financial planning professionals are certified in divorce planning and can assist with the gathering and analysis of financial information about the assets and liabilities. This assistance may prove invaluable in designing an equitable settlement between the parties. A financial planner can also assist in creating long-term cash flow projections of each spouse's finances post-divorce as well as help in developing post-divorce budgets. It needs to be reemphasized that for both spouses, these areas of financial planning should be addressed as early as possible in the divorce planning process.

If at all feasible, the soon-to-be ex-spouses should consider mediation rather than going through the time-consuming, emotionally draining and expensive adversarial proceedings that are adjudicated in court. A mediated divorce settlement generally moves more rapidly through the court system as an "uncontested" divorce, consequently incurring fewer potential legal fees than a contested divorce.

Description

Once one or both partners to the marriage determine that irreconcilable differences or other circumstances exist that make termination of the marriage inevitable, the divorce planning process needs to be initiated.

In divorce, the main issues that need to be resolved include:

- ◆ **The family house** – whether one spouse will remain in the home or it will be sold needs to be determined.
- ◆ **Assets and liabilities** – all of the assets need to be identified and valued; the current balances of all liabilities need to be ascertained and identified as either joint, husband's, or wife's liability.
- ◆ **Property settlement** - the equitable division of property needs to be determined and agreed upon.
- ◆ **Child custody** - joint custody or sole custody with one parent will be determined; visitation schedules will be worked out and finalized in the form of a detailed "possession order" that also becomes a part of the divorce decree.
- ◆ **Child support** – amounts and duration of payments as well as which parent will be paying need to be determined.
- ◆ **Alimony** – if alimony is to be paid by one divorcing spouse to the other, the amount and duration of payments need to be negotiated.
- ◆ **Post-divorce sources of income and expenses** – need to be analyzed and projected for each spouse and budgets need to be developed; critical if one of the spouses has stayed at home to take care of the children, is currently not employed outside of the home, has not been the one in charge of family finances, and/or will have to go back to work during or after the divorce.
- ◆ **Insurance coverages** – life, disability, and health insurance policies need to be analyzed to ensure there is continuous coverage throughout the divorce process and afterwards; potential beneficiary designations and ownership changes need to be determined and implemented.
- ◆ **Estate planning documents** – need to be changed accordingly to reflect the divorced status of the spouses.

Tax planning issues in all of the above areas need to be analyzed and resolved. There also are numerous issues regarding tax return and IRS form filings that require resolution.

The decision of what will be done with the family house is an emotional one that also requires looking at the financial considerations involved. If one spouse remains in the home, the spouse who will leave needs to find another place to live that is within his or her post-divorce budget. It needs to be determined if the spouse who will remain in the home can truly afford to do so. A financial planner can help develop a post-divorce budget and cash flow projection to see whether or not remaining in the house is economically possible. The other alternative is to sell the house and both parties find replacement residences which each can financially afford.

The division of property between the spouses can be one of the most difficult issues to resolve in the divorce process. The ultimate negotiated division of the assets will be documented in detail in the property settlement portion of the divorce decree.

The first step is to identify and value all of the assets. Some assets are easier to value than others, like bank accounts, brokerage accounts, stocks, bonds and mutual funds, since current account statements or current stock, bond, or mutual fund prices are readily obtainable. However, hiring a valuation expert may be

necessary for assets that are difficult to value, such as a small business, investment real estate, artwork, or a defined benefit retirement plan.

If an asset is indivisible (e.g., a car, the house, etc.), one spouse may get the entire asset and the other spouse is "compensated" by getting other asset(s) of equal or similar value. The condition of an asset needs to be evaluated when determining value. For example, the house or a car may be in need of major repairs that need to be taken into account in the valuation process.

State divorce laws attempt to split the property both fairly and finally so the ex-spouses can, in theory, go on to live their separate lives and not have to be involved with continued joint ownership of property. Although divorce laws vary from state to state, each state's divorce laws generally attempt to reach an "equitable" (but not necessarily equal) division of the property. Community property states have somewhat different laws, though commonly divide marital assets (i.e., assets acquired during the marriage) in half. Each spouse's separate property (e.g., acquired before the marriage, inheritances, or gifts from third parties) is considered that spouse's property for purposes of the divorce. However, "commingling" rules in a community property state may cause some or all of the separate property assets to be presumed to be community property. Due to the complexity and differences from state to state of the community property and "commingling" rules, details of these are beyond the scope of this article.

Division of retirement plan assets needs to be looked at closely due to the tax treatment of distributions from these assets. For example, having one spouse receive all of the retirement accounts in the property settlement may cause a significant tax cost to that spouse. Withdrawals from retirement accounts are typically taxed as ordinary income; plus withdrawals prior to age 59 ½ are likely subject to a 10% premature distribution penalty if the withdrawals don't qualify for one of the exceptions.

If certain employer-sponsored retirement plans are to be divided between the spouses or transferred to the non-participant spouse, a "qualified domestic relations order" (QDRO) will be issued by the court. A QDRO clearly states the amount of the participant spouse's benefits that the plan administrator must pay to an "alternate payee," normally the former spouse and/or child. IRC section 414(p). QDROs permit qualified retirement plan benefits to be used to fulfill property division, child support, and alimony obligations associated with the divorce.

A QDRO is not needed for the division or transfer of individual retirement accounts between the spouses. These accounts are treated the same as other property under the divorce property division rules that allow for assets to be transferred without the recognition of gain or loss.

Defined benefit pension plans are more difficult to divide because such plans pay out a benefit at a future point in time. If such an asset is subject to the divorce property settlement, a present value calculation of the future benefit stream needs to be calculated. Then, a lump sum will be paid from other assets to the non-participant spouse for the value of the plan benefit it is agreed he/she is entitled to. The alternative is for the non-participant spouse to receive the benefit payments directly when the participant spouse receives the plan benefit pay-out in the future. However, this is less common than the present value lump sum option previously discussed.

The current balances of liabilities need to be ascertained and identified as either joint, husband's, or wife's liability. Whether these are going to be paid off or assumed by one of the parties needs to be negotiated and becomes part of the divorce decree.

The issue of child custody may be one of the most emotional and contested parts of the divorce process. Most states require joint custody based upon the belief it is in the best interest of the children unless there is a compelling reason (e.g., child abuse, drug abuse by one parent) for granting sole custody to one parent over the other. Child custody and visitation schedules will be finalized in the form of a detailed "possession order" that is part of the divorce decree.

The amount of child support to be paid and which parent will be obligated to pay it is part of the divorce decree. The child support amount guidelines vary from state to state. Federal law mandates that child support payments be made by wage assignment. That way, the child support amount is automatically withheld from the wages of the parent responsible for payment. Many states have a program whereby the withheld child support amounts go into a special account so it is recorded every month and ensures the children get the funds they need.

Today, divorce settlements generally do not provide for spousal support in the form of alimony. It is in the discretion of the court to award alimony and it is normally granted only where a divorced spouse is unable to support themselves. If the court does award alimony, it is generally a temporary support measure until the spouse is able to obtain the skills necessary to find gainful employment.

Financial planners can assist both spouses in projecting post-divorce income and expenses and help them to develop budgets for their separate lives after divorce. They can also help educate the spouses on financial matters and how to deal with them during the divorce process and after. This is especially critical for the spouse who may not have been involved in the management of the family's finances during the marriage.

An ex-spouse who is eligible to collect Social Security may qualify for a higher retirement benefit by claiming benefits on the ex-spouse's earnings record instead of their own if certain requirements are met:

- ◆ The marriage lasted ten years or more;
- ◆ The couple has been divorced more than two years ago;
- ◆ The claiming ex-spouse has not remarried; and,
- ◆ The claiming spouse is age 62 or older.

There are special rules for an ex-spouse to qualify for Social Security disability or survivor benefits based upon the ex-spouse's earnings. However, the details of these complex rules are beyond the scope of this article. The Social Security Administration's booklet, "What Every Woman Should Know," is a source of further information which along with other information on divorce and Social Security Benefits can be found at the Social Security Administration's web-site at www.socialsecurity.gov.

Both of the spouses' life, disability, and health insurances need to be re-evaluated. The divorce settlement will specifically address the current insurance policies and what the requirements will be for future coverages. There will be specific provisions in the divorce decree defining who is to maintain such coverage and pay premiums, for how long, and the beneficiaries.

If the divorce settlement requires a spouse to pay alimony and/or child support, adequate life insurance should be carried on that spouse to secure payment of these court-ordered obligations in the event of the payor spouse's death. It also may be determined that proper disability insurance on the payor spouse be maintained to secure payment in the event of disability. The divorce attorney can advise the proper way to structure the life and disability insurance issues in the divorce settlement to ensure coverage is properly

maintained. The financial planner or the tax advisor can make certain the life and disability insurance is properly structured from a tax standpoint.

Health insurance coverage is another critical issue that needs to be addressed in the divorce settlement and will be detailed in the provisions of the divorce decree. No matter which parent they live with, the children's health insurance coverage can be continued under either spouse's coverage until they are adults. A "qualified medical child support order" (QMCSO) is a court order that requires health insurance for the children of the noncustodial parent under that parent's group health plan.

Once the divorce is final, the ex-spouse does not have to carry health insurance coverage on the former spouse unless the divorce decree requires it. If there will be no such provision for continued coverage, the former spouse could choose to get coverage under his or her employer's group health plan. However, if the former spouse has no coverage at work or is not employed, he or she may continue coverage through the ex-spouse's health insurance plan for up to 36 months under the federal COBRA law. This would allow the former spouse time to obtain an individual health insurance policy.

Both spouses should consider consulting an estate planning attorney during the divorce planning process to revise their respective estate planning documents to reflect their soon-to-be changed marital status. Changes to provisions naming an ex-spouse in some legal capacity will probably need to be made in the husband's and wife's Wills, Trusts, Statutory Durable Powers of Attorney, Medical Powers of Attorney, Directives to Physicians, and any other legal documents where the ex-spouse is named. The estate planning attorney should also review life insurance, annuities, and retirement plan beneficiaries and advise as to needed changes.

Tax Implications

As part of the property division in the divorce, the transfer of property from one spouse to the other is tax-free (i.e., no gain or loss is recognized) if the transfer is "incident to a divorce." This holds true even if the divorce decree is final and the parties are legally ex-spouses – as long as the transfer is "incident to the divorce." The transfer of property must occur within one year from the date the marriage ceases, or the transfer must be related to the cessation of the marriage. IRC section 1041. The transferee of the property acquires the same cost basis as the transferor. Consequently, when the transferee ex-spouse sells the property, he/she will recognize gain on the appreciation above the former spouse's basis.

If the property transferred is the primary residence and it is subsequently sold, the transferee spouse is entitled to the \$250,000 exemption from gain recognition for the sale of a residence assuming the other requirements for the exemption are met. See IRS Publication 523, "Selling Your Home," for more details.

Where a QDRO has been used to meet the property division and/or alimony obligations of the retirement plan participant spouse, the alternate payee (i.e., the non-participant ex-spouse) is allowed to treat the payments the same as the plan participant spouse would treat them. The alternate payee will pay tax on the distribution as if it were his or her income. However, he/she is not subject to the 10% early-withdrawal penalty if the distribution is rolled over to an IRA even if the alternate payee is less than age 59½.

Where a QDRO has been used to meet the child support obligations of the retirement plan participant spouse, the amounts paid to the alternate payee child are not taxed to the child but are taxed to the plan participant. Although these payments are not subject to the 10% penalty for early withdrawal, they cannot be rolled over to an IRA.

Child support is not tax deductible by the payer spouse and is not taxable to the recipient spouse. IRC

section 71(c). On the other hand, alimony is tax deductible by the payer spouse and is taxable to the recipient spouse. IRC section 71(a). Under IRC section 71(b)(1), "alimony" is any payment in cash if:

- ◆ The payment is received by the spouse under a divorce or separation instrument.
- ◆ The instrument does not designate the payment as a payment which is not includible in gross income or allowable as a deduction.
- ◆ The payee spouse and the payer spouse are not members of the same household at the time of the payment.
- ◆ There is no liability to make the payment after the payee spouse's death.

Many tax planning issues are involved when classifying payments as either "child support" or "alimony" — income shifting from a high tax rate spouse to a low tax rate spouse, avoiding alimony being reclassified as a property settlement, and alimony recapture rules. Because these are complicated tax areas, it is recommended that a financial planner specializing in divorce and/or a tax advisor be consulted if these are areas beyond the divorce attorney's areas of expertise.

Child custody may result in significant tax benefits for the custodial parent. The taxpayer must have custody of the child for a greater portion of the year to qualify as the "custodial parent." IRC section 152(e). In addition, if the custodial parent taxpayer pays greater than half of the cost of maintaining the home, he/she can file his/her tax return as "head of household" (lower tax liability than "single" filing status), claim the exemption deduction for the child, and may be able to claim the dependent care credit.

The custodial parent is normally entitled to claim the exemption deduction for the child which also allows them to claim other tax credits related to the child. However, the custodial parent can allow the noncustodial parent to claim the exemption deduction for the child by executing IRS Form 8332 "Release/Revocation of Release of Claim to Exemption for Child by Custodial Parent." IRC section 152(e)(2). Even if the noncustodial parent claims the exemption deduction for the child, the custodial parent can still file as "head of household" if they have custody of the child for more than half the year and pay more than half the cost of maintaining the home.

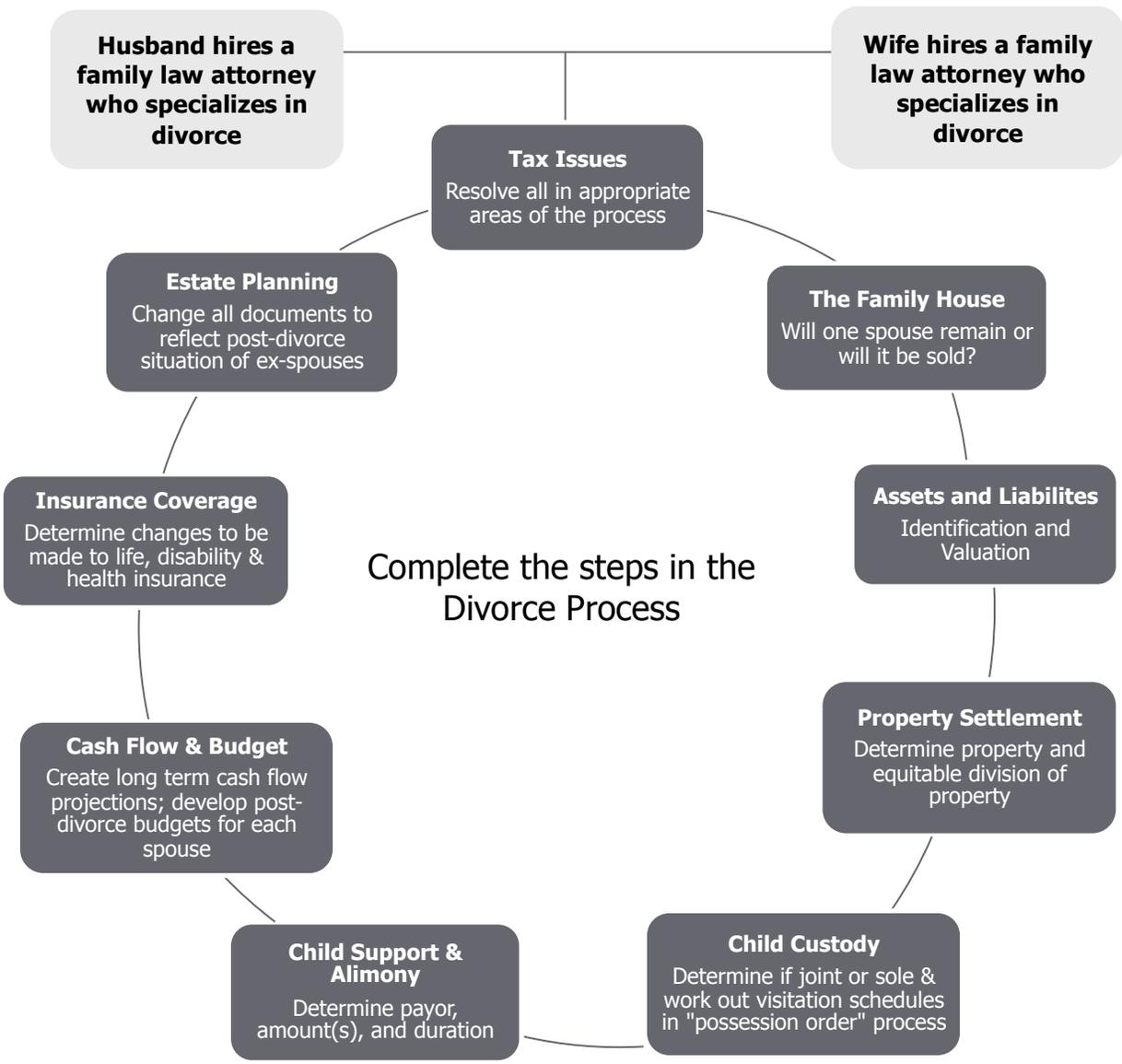
In the case of two or more children, from a tax planning standpoint it may make sense for the parents to specify in the divorce decree that they each have custody of at least one of the children. Then, both parents would each be entitled to claim the exemption deduction, file as "head of household," and may be able to claim the tax credits related to the child they have custody of as long as they meet the requirements of being the "custodial parent" as mentioned above.

Marital status as of the last day of the tax year determines the couple's tax filing status for that tax year. If there is no final divorce decree or separate maintenance agreement obtained by the last day of the tax year, the couple must file as a married couple. In other words, they can file as either "married filing jointly" or "married filing separately." However, there is an exception where the couple has children and they live apart that they may be able to file as "head of household." See IRS Publication 504, "Divorced or Separated Individuals," for details of the requirements.

Where the divorcing couple is considered still married for tax filing purposes and they file a joint tax return, both husband and wife are jointly and severally liable for any taxes, interest, and penalties due on the joint tax return even if they should later divorce. IRC section 6013(d)(3). This is the case even if the divorce decree should provide otherwise. It is possible to avoid this liability exposure by filing separately or by qualifying for "innocent spouse relief." To claim "innocent spouse relief," the innocent spouse must prove that they had no knowledge of the mistake on the jointly-filed tax return and file IRS Form 8857 "Request

for Innocent Spouse Relief.” Separation of liability relief and equitable relief are two additional ways in which an innocent spouse may be relieved of liability for taxes, interest, and penalties on a joint tax return. However, the details of innocent spouse relief, separation of liability relief, and equitable relief are beyond the scope of this article. See IRS Form 8857, “Request for Innocent Spouse Relief,” and the accompanying instructions (Inst 8857) for more information.

IRS Publication 504, “Divorced or Separated Individuals,” and IRS Publication 555, “Community Property,” are other good sources of tax information on divorce issues.



Both divorce attorneys work as a team with...

Financial planning professional who specializes in divorce

- Assists in identifying & valuing liabilities
- Helps with property division
- Creates cash flow projections & develops budgets

Tax advisor

- Advises on the tax ramifications in all areas of the divorce planning process

Over the course of time...
Each ex-spouse works independently with the financial planning professional, as needed.



Rodney Ferguson, CLU®, ChFC®, Member Agent of The Nautilus Group®, a service of New York Life Insurance Company, Registered Representative offering securities through NYLIFE Securities LLC (Member FINRA/SIPC), a Licensed Insurance Agency, 11701 Borman Drive, Suite 295 - St. Louis, MO 63146 (314) 821-0500, Financial Adviser offering investment advisory services through Eagle Strategies LLC, a Registered Investment Adviser. Ferguson Financial Group is not owned or operated by NYLIFE Securities LLC or its affiliates. Ferguson Financial Group as well as NYLIFE Securities LLC and its affiliates do not provide legal, tax or accounting advice.

This material includes a discussion of one or more tax-related topics. This tax-related discussion was prepared to assist in the promotion or marketing of the transactions or matters addressed in this material. It is not intended (and cannot be used by any taxpayer) for the purpose of avoiding any IRS penalties that may be imposed upon the taxpayer. Taxpayers should always seek and rely on the advice of their own independent tax professionals. Please understand that New York Life Insurance Company, its affiliates and subsidiaries, and agents and employees of any thereof, may not provide legal or tax advice to you.

© 2016 New York Life Insurance Company, all rights reserved. SMRU:456002-A exp: 11.16.2017

California License No.: 0F24494