Estate and Retirement Planning For Divorce

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When a divorcing couple has significant assets, various opportunities for tax and financial planning arise. The income tax and pre-divorce agreement strategies were discussed in the article sent yesterday entitled "Income Tax Planning For Marital Breakup". Today's article focuses on the transfer tax and retirement planning issues associated with the dissolution of marriages.

Divorce decrees and agreements

Planning for a dissolution of a marriage raises a number of complicated issues. There is more involved than just signing a standard form document to dissolve a marriage. The following issues should all be closely considered.

Creditor issues. 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, the creditor's rights are normally not restricted. For example, assume a couple had co-signed a note and the divorce decree assigned liability to the husband. If the husband declares bankruptcy after the divorce, the ex-wife might still be responsible for the debt. 2

Money problems are often a central cause of divorce. Several issues arise when a divorcing spouse is in financial trouble. 3

(1) If the property transfer occurring as a consequence of the divorce is deemed to hinder, delay, or defraud creditors, the transfer could be rescinded as a "fraudulent transfer."

(2) If there is the possibility of bankruptcy for an ex-spouse, the other spouse would be well advised to obtain the advice of bankruptcy counsel. 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 dischargable in bankruptcy. 4 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 (i.e., the recipient of the alimony is taxable). 5

Retirement plans. ERISA generally provides that the retirement benefit of a qualified retirement plan cannot be assigned. An exception is provided for assignments incident to a divorce. 6 In order to pass a portion of an ERISA retirement benefit to an ex-spouse, the divorce decree must satisfy the requirements of Section 414(p). Beginning on 1/1/02, Section 457 deferred compensation plans for governmental and non-profit employees are subject to the qualified domestic relation order rules. 7 Federal law does not require a qualified domestic relations order for a divorced-based IRA transfer.

Transfers in contemplation of divorce. Divorce is not usually a surprise. As a result, many clients attempt to reduce the potential claims of a divorcing spouse by employing some of the following techniques.

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Clients may hide assets to minimize the allocation of marital assets on divorce. This approach is extremely dangerous because the divorcing spouse may be required to provide statements about assets under penalties of perjury.

Some planners have advised their clients to move assets off-shore. Some have questioned whether the use of such off-shore trusts will provide better divorce protection than a U.S.-based spendthrift trust. This is perhaps true, but review *Reichers v. Reichers*, 8 in which the court recognized it had no jurisdiction over off-shore trust assets and did not require the movement of the off-shore trust assets back to the U.S. Instead, the court took into account the off-shore assets in awarding Dr. Reichers' U.S. property to Mrs. Reichers.

If justifiable for other purposes, consider moving assets into vehicles that restrict a spouse's ability to access underlying assets. For example, it might be possible to move assets into a family limited partnership that has both estate planning and asset protection benefits. Recapitalization of a family company and the passage of the company's voting control to entities (e.g., trusts) outside the client's control may also make sense.

It may be wise to exchange assets for another right that limits the benefit to an ex-spouse. For example, a client could sell a piece of real estate for a private annuity payable over the client's lifetime. As a further example, a client might transfer the residence into a qualified residential trust, retaining a limited term of years, with the remainder passing to heirs.

Making gifts of important family assets might also make sense. For example, annual exclusion gifts could be used to give a family farm to descendants. The spouse could even be asked to agree to split the gift. (This concept is discussed below.)

To minimize fraudulent conveyance issues, any transfer in contemplation of divorce should be made as far in advance of the divorce as possible. In addition, if the transferor receives no consideration for the transfer, a divorcing spouse may have a right to rescind the transaction.

Life insurance. Many divorce decrees require the wealthier spouse to maintain a life insurance policy to fund any alimony or child support obligations that remain at the insured's death. The policy may be handled in various ways:

To deduct the insurance premiums as alimony, the insured should consider having the ex-spouse be both owner and irrevocable beneficiary of the policy. 9

If the policy has a significant cash value and the couple is no longer married, the transfer to the ex-spouse may be a taxable gift for gift tax purposes (discussed further below). Moreover, if the insured dies within three years, the death benefit would be pulled back into the insured's estate. 10 To avoid these concerns, the client could have a new policy issued with the spouse as the applicant, owner, and beneficiary.

If the insured retains any incidents of ownership in the policy, it will be included in the insured's taxable estate. 11 State law may provide that any applicable estate taxes from the policy must be paid from the insurance proceeds, effectively reducing the benefits to the ex-spouse and children. 12 The divorce settlement should provide a clear statement as to whether any estate taxes on the policy proceeds are to be paid from the insured's assets or the policy proceeds.

If the ex-spouse is the owner of the policy, he or she will direct the ultimate disposition of the death proceeds. Instead, the insured could place the policy in an irrevocable life insurance trust and give the ex-spouse a beneficial interest until the spouse has died, married, or cohabited. At that time, the benefits of the trust could pass free of transfer taxes to other heirs (e.g., the children from the first marriage). If the policy is owned by an irrevocable insurance trust, the insured will lose the alimony deduction for the payment of insurance premiums, but as the grantor of the trust, the insured can also direct the ultimate disposition of the death proceeds. Properly created, the policy is also excluded from the insured's taxable estate.

If the divorce decree provides that the an insurance policy will revert to the insured on the satisfaction of the divorce obligations it was designed to fund, this reversionary interest 13 may result in the husband having to include the policy in his taxable estate, even when the spouse is the irrevocable beneficiary. 14 However, the decedent's estate may qualify for a deduction for the amount of the proceeds, even if they exceed the remaining alimony or support obligations of the deceased ex-spouse. 15 In many cases it would be better to just let the policy lapse, or have the ex-spouse's will provide for transfer of the policy into a trust for the benefit of joint descendants.

Prior planning documents. If divorce is anticipated, the client should discuss with his or her estate planner the possibility and benefit of executing a new will in contemplation of the divorce. The impact of the divorce on the couple's existing estate planning (especially for their respective descendants) should be considered as a part of the divorce process. Leaving the decision to the inflexibility of statutory law is not generally the best solution. For example, in Georgia, the divorce results in the ex-spouse being treated as a predeceased heir of the maker of the will. 16

However, the attempt to disinherit a future ex-wife may be problematic if the client dies before the divorce is finalized. First, state law may limit the ability of a decedent to disinherit family members when death occurs soon after the will is executed. Second, the state may have a statute providing statutory rights to a surviving spouse, notwithstanding the terms of the decedent's will. One way to avoid the application of such "probate-driven" restrictions might be to make the same dispositions, but use a funded living trust as the dispositional vehicle.

If a divórce or separation has occurred and the resulting agreement places financial obligations on the client, the will should reflect that the terms of the agreement must be carried out. Drafters should be careful to provide that any bequests to an ex-spouse are in satisfaction of the decedent's legal 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.

Many clients have drafted powers of attorney to provide for the handling of medical and property issues on incapacity. Such powers of attorney are not normally revoked by divorce or legal separation. In many cases, the clients do not focus on revising these important documents during or after divorce. Having an ex-spouse or a divorcing spouse in charge of medical and property decisions is probably not advisable. The client should be strongly encouraged on the first vestiges of divorce to change his or her powers of attorney. Alternatively, the document may provide that if divorce or legal separation proceedings are initiated, the spouse's right to serve as power holder immediately terminates and the next named successor is automatically appointed.

Transfer tax consequences of divorce

Some unique gift, estate, and generation-skipping transfer tax issues surround divorce or separation. The following issues should be taken into account.

Property transfers and gift taxes. Property settlements must be reviewed in light of the possible imposition of a gift tax. Section 2523 provides for an unlimited marital deduction for transfers between spouses. However, transfers after divorce do not fall into this exception.

Section 2516 provides some gift tax protection for property settlements entered into after a divorce is finalized. The section provides that transfers for settlement of property rights, or child support are exempt from gift tax if:

> The parties enter into a written agreement. The agreement does not need to be approved by any court.
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> The transfers are payments of cash or property in settlement of spousal martial rights and a "reasonable allowance" of support rights of an "issue of the marriage" who is a minor. 17 Unfortunately neither the Code nor regulations define "reasonable allowance." Any payments that exceed this ambiguous amount are not protected by Section 2516. Support payments (e.g., while in college) for children who have reached majority are not protected by Section 2516. While Section 2516(2) provides for support of "issue of the marriage during minority," Reg. 25.2516-2 restricts the language to minor children of the marriage. Black's Law Dictionary provides that issue means "all persons who have descended from a common ancestor." The regulation's language would appear to be an attempt to provide a greater restriction than the one provided for in the Code. Transfers for other purposes (e.g., requiring a spouse to fund education costs of a stepson) are not excluded from gift tax. However, it is not clear whether payments for tuition costs for a stepchild might be treated as nontaxable gifts under Section 2503(e). Placing such language in a marital agreement might mean that the payment was not a gift, but rather was consideration for the release of marital rights.
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> The agreement must be entered into within a period beginning two years before the divorce and one year after the divorce. The agreement, but not the transfer of assets, must occur during this three-year period. 18 The IRS may require that the modifications of the agreement also occur within these time frames. 19 Note that a pre-nuptial agreement entered into more than two years before the divorce would not qualify. In addition, if one of the parties voluntarily increases the benefits to an ex-spouse after the period has run, Section 2516 does not apply, and the change may be treated as a taxable gift.

Section 2516 does not require that the divorce decree mention the settlement agreement. It can be entered into by the parties independently of the decree, allowing clients to keep their property settlements out of the public records. In addition, if the parties fail to enter into a written agreement, but make the transfers prior to a final decree of divorce becoming effective, the gift tax marital deduction permitted by Section 2523(a) may eliminate any gift tax on the transfer. However, if the parties intend to make post-divorce transfers, they would be foolish not to execute an agreement meeting the requirements of Section 2516.

As noted above, in numerous situations client cannot qualify for Section 2516 protection. However, there has also developed a series of judicial exceptions to the imposition of gift tax on transfers made after the marriage has dissolved. For example, in *Harris*, 20 the Supreme Court ruled that divorce-related transfers founded on a court decree are involuntary and, therefore, are not voluntary taxable transfers. Reg. 20.2053-4 also provides that any obligation imposed by law is a deductible debt of the estate. However, planners must assure that the property transfer provisions of the divorce decree are specifically incorporated into the divorce court's ruling. If the decree merely declares the marriage terminated, but does not approve the property transfer, the IRS could argue that *Harris* is not applicable. Modifications of the original settlement agreement should also be approved by the court.

Property transfers and estate taxes. Divorce attorneys often do not pay sufficient attention to the estate tax implications of divorce decrees. Section 2056 provides for an unlimited marital deduction for death transfers to a spouse, but does not provide any marital deduction for transfers to an ex-spouse. A liability accruing pursuant to a divorce settlement agreement is not necessarily a deductible debt of a deceased's estate. It is important to make sure the divorce documents create an enforceable debt against the estate to generate an estate tax deduction, rather than a taxable transfer.

To be deductible, the obligation must be treated as a deductible debt of the estate. Section 2053(a)(3) provides for the deduction of the decedent's personal obligations to the extent incurred for adequate consideration. If the decedent's obligations are based on a court decree, *Harris* would apply, and the post-death obligations would be deductible. However, if the court did not require the property transfers (e.g., transfers to fund a stepchild's education), *Harris* will not apply and the post-death transfers may not be deductible for estate tax purposes.

If *Harris* is not applicable, the post-death obligations will only be deductible if the decedent's obligations were entered into for "adequate and full consideration." 21

Section 2043(b) provides that transfers satisfying the above gift tax requirements will be treated as an *expense* of the estate. Thus, if former spouses have a written agreement that satisfies Section 2516, testamentary transfers to a former spouse pursuant to the agreement are treated as deductible claims against the estate. It gets

trickier when the property transfer does not fit neatly into Section 2516. For example, Section 2053 provides that a deduction against the estate is permitted only if the claim is "bona fide and for adequate and full consideration in money or money's worth." To the extent that the obligation at the decedent's death exceeds such sum, an estate tax deduction may be denied on the excess.

Even if Section 2516 is not applicable, the IRS 22 and the courts 23 have ruled that the release of support rights and child support obligations will be deemed "adequate consideration." This opens the issue of the equality of the consideration each party gave in the bargain. If the decedent's obligations are larger than the value of what he or she received, the excess may not deductible.

While rights of a spouse and children to support are adequate consideration, transfers in exchange for marital rights to the couple's property are not treated as adequate consideration. Effectively, equitable distribution rights are not vested legal rights in a marriage and therefore cannot be adequate consideration.

Gift splitting. The law permits a spouse to elect to be treated as the donor of a gift, even when the other spouse is the sole transferor. 24 In order for the "gift splitting" to apply, the donor must file a gift tax return, on which the spouse consents to the treatment of the gifts as made one-half by the spouse. 25 The return must be filed by the donor spouse, even if a gift tax return was not otherwise required (e.g., only annual exclusion gifts were made). Gift splitting for any year applies to all gifts and cannot be made on a gift-by-gift basis. If gift splitting is elected, the spouses have joint and several liability for any gift tax that may be due. 26 Because of this rule, consenting spouses should be very careful to assure that the value of the gifts are accurate. If neither spouse has filed a gift tax return for the applicable year, the consent may be filed late, without any adverse tax impact. 27 If a married couple agrees to "gift-splitting," each is treated as though they made the gift for generation-skipping tax purposes also. 28

If gift splitting was anticipated early in the year, divorce before year end will terminate the right to split gifts. For example, assume the wife made $22,000 in gift-split annual exclusion gifts to 15 heirs at the beginning of the year. If divorce occurs before year end and the wife is in a 49% tax bracket, delaying the divorce until after the end of the year could save the wife $80,850 in gift taxes. If gift splitting is not permitted, one-half of the gifts are not covered by the ex- spouse's annual exclusion, and a gift tax may be due from the donor.

Gift splitting offers several planning opportunities, including the following examples:

20 people

> A divorcing wife has three married children and ten grandchildren. Four grandchildren are married. She has a sizable estate. In the final year of marriage, she can use the gift-splitting provision to make annual exclusion gifts of $440,000 to her family, saving transfer taxes of $90,200 to $107,800 (i.e., half of the gifts ($220,000) multiplied by the lowest transfer tax rate (41%) or the highest rate (49%) in 2003). The marriage would have to remain in place until after the end of the year, and the soon-to-be ex-spouse would have to agree to the gift splitting. Given the significant tax savings, the wife might even consent to make some annual exclusion gifts to his heirs.
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> Assume the same fact pattern, but the divorcing husband has an estate of only $200,000. If the wealthy spouse makes taxable gifts of $1.6 million in addition to the annual exclusion gifts, both spouses' unified tax credits would be used, and up to $392,000 in estate tax savings could occur (i.e., half of the gifts ($800,000) deemed made by the spouse multiplied by the top estate tax rate of 49% in 2003).
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> An entrepreneur wants to begin transferring equity in his family business to children from a prior marriage. He has a pre-nuptial 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 spouse elects gift splitting, the donor spouse can effectively transfer his and his spouse's unified credit amount (with an applicable valuation adjustment of 40%) to a generation-skipping trust, and save up to $816,667 in estate taxes (i.e., $1 million (spouse's unified credit amount) based on a $1,666,667 business interest discounted at a 40% rate and multiplied by the top estate tax rate of 49% in 2003). This in effect uses the poorer spouse's unified credit without any actual transfer by that spouse. The wealthier spouse's will could be modified to provide a trust for the benefit of the ex-spouse or the wealthier spouse could create a life insurance trust that provides a life interest to the ex-spouse, but passes the value at the ex-spouse's death to the wealthier spouse's family.
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> The spouses have been married before and both are wealthy. One spouse has ten potential donees and the other has 20 potential donees. If they both elect gift splitting, each of them can double the other's nontaxable gifts, without any adverse impact to either spouse's estate planning, while saving both families significant estate taxes.

PLANNING TIP

A divorce decree may require that the wealthier spouse fund the college education of the couple's children. Clients should be careful to make the payments in a manner that does not produce a taxable gift. For example, instead of reimbursing an ex-spouse for the cost of tuition, the payment should be made directly to the institution, allowing an unlimited gift tax exclusion under Section 2503(e). Other payments to the child may be covered by the $11,000 annual exclusion.

education or tuition medical

As a part a divorce decree, the couple might also consider pre-funding college costs for children (especially younger children) by using Section 529 Plans. Section 529 (c)(2)(B) permits donors to pre-pay up to five years of annual exclusion gifts to fund a Section 529 plan. However, it is unclear how the advance use of the annual exclusion would apply to the years after the divorce.

Using the unified credit. The unified credit should be viewed as an asset of a couple's divorce estate. For example, assume a wealthy wife is required to make a significant property settlement for the benefit of a less wealthy second husband. She wants the funds to eventually revert to her children from a prior marriage. She could create a lifetime QTIP marital trust during the marriage for the benefit of the soon to be ex-spouse. Properly created, the trust would create no gift taxes. At the ex-husband's death, his unified credit (which he might not otherwise have used in full) benefits her children by reducing the overall transfer taxes. A similar arrangement could be made through a generation-skipping trust and annual exclusion gifts using the couple's combined generation-skipping and annual exclusion exemptions.

In an amicable divorce, clients should also review the possibility of using their unified credit more effectively. For example, a husband and wife could each create unified credit trusts naming the other as beneficiary. These irrevocable trusts could grow tax-free and protect the ex-spouse/beneficiary from creditor claims. To avoid the reciprocal trust doctrine, clients should make sure that the terms of the trusts do not "mirror" each other. 29 If the doctrine applies, both trusts will be ignored for transfer tax purposes.

Marital trusts. Assume a husband and wife are divorcing and the husband wants to provide significant assets to the spouse, but also wants to assure that the assets ultimately flow through to his children and not to a new husband. The husband creates 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 fair market value, and her unified tax credit reduces the overall family's estate tax. The husband makes a timely election to treat the trust as a QTIP trust, 30 eliminating any gift tax on the transfer to the trust.

Divorce trusts. Divorces are seldom amicable. A less wealthy spouse will be concerned that the wealthier spouse will renege on support payments or have future financial problems. One solution may be to create a divorce trust. To ensure future benefits, the trust can be irrevocable. The wealthier spouse transfers property equal to the spousal and children's support rights to the trust. The trust could provide for payments equal to the settlement terms between the divorcing couple. If the trust provides that it reverts to the settler at its termination (i.e., the end of support obligations), then the trust may be includable in the settler's estate. 31 However, assuming the divorce obligations are deductible pursuant to the rules discussed above, there may be an offsetting deduction.

Planning for divorcing heirs

Many parents recognize that their children's marriages are not stable. Because 49% of marriages end in divorce, a couple with four children can expect (on average) about two divorces within their family. In contemplation of this, clients should consider inheritance vehicles that restrict the ability of a divorced spouse to obtain part of the family money. The following approaches should be considered.

Limiting control. The most important aspect of any asset is its control. This is especially true in the context of an heir's divorce. For example, the last thing most family businesses need is an ex-spouse attempting to gain some control. In many cases, a client's spouse or the spouses of his or her heirs hold interests in a family business or may obtain an interest in a family business as a result of divorce. Buy-sell agreements 32 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 considered unenforceable. Included in those terms should be a long-term buy-out to minimize the cash flow problems for the business. Such terms may also reduce the risk that the spouse would want to receive business interests in the divorce.

Spendthrift trusts. Spendthrift trusts have long been a part of an estate planner's tools. In recent years as clients increasingly express concern about asset protection and spendthrift children, these trusts have become a major part of the estate planning business. Basically a spendthrift trust is any trust that provides for two major restrictions:

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1.It restricts the ability of any trust beneficiary to assign or otherwise transfer his or her interest in the trust. In most states a trust right is freely assigned by the beneficiary (e.g., as collateral for loans or for other personal purposes).

2.It restricts the right of a beneficiary's creditors to demand payment of income or principal to satisfy the beneficiary's obligations.

Such trusts also restrict 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. This is simply good planning. Yet, there are situations where caution is in order. These include:

> The permissible terms of spendthrift trust vary widely from state to state. Several states restrict or prohibit spendthrift trusts. In some states creditors are still free to garnish actual distributions to the beneficiary, but are unable to force distributions in order to garnish them. Some states allow certain creditors (e.g., the government) to pierce a spendthrift trust.
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> In *Dwight v. Dwight,* 33 a Massachusetts appeals court ruled that a 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 seems to indicate that the decision was at least partially based on the existence of the ex-husband's ascertainable standard right to the trust benefits. Had any distributions been up to the absolute and unfettered discretion of the trustee, the ruling might have been different.

What is the best approach? Instead of using ascertainable standards for heirs, give an independent trustee absolute discretionary authority to "spray" benefits among a broad class of beneficiaries (e.g., children and grandchildren).

Discretionary trusts. As discussed above, when clients are concerned about an heir's financial and marital problems, they would be well advised to adopt provisions in their trusts that grant trustees the total discretion to decide when to make distributions to or for the beneficiary's benefit. The result is that the beneficiary has no

vested or attachable rights in the trust for a creditor to make claim against.

If such provisions are adopted, 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 good faith acts. It may also be advisable to place responsive trustees in charge of the heir's trust, so that if the marriage is dissolved, additional benefits (i.e., greater principal distributions) may pass to the heir.

Generation-skipping trusts. Given that 49% of marriages end in divorce, clients should consider using generation-skipping trusts, not only for tax purposes, but also for divorce protection. A generation-skipping trust assures that a divorcing spouse must pierce the limits of the trust rather than making claims against the assets of a soon-to-be ex- spouse.

Garnishment of distributions. Even though a trust may limit the claims of a divorcing spouse against the trust assets, the divorcing spouse might still be able to make a claim against actual distributions made to the beneficiary/ex-spouse. For example, Georgia law [34] provides that, unless the beneficiary of a spendthrift trust is suffering under significant physical or mental disability that impairs the beneficiary's ability to provide for his or her care, an alimony claim can be made against "a distribution to a beneficiary." (Note that a literal reading of the statute would mean that distributions for the benefit of the beneficiary might not be subject to garnishment for alimony.)

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 it. One solution would be to encourage clients who have sizeable assets before marriage or receive sizable inheritances to keep the funds in individual accounts.

Irrevocable trusts. Virtually all irrevocable trusts (and maybe even some revocable trusts), should be drafted 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 he or she 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 will divorce. The documents could provide that all rights and powers of the spouse, including her right to serve as co-trustee, immediately terminate on either legal separation or divorce. Few clients want an ex-spouse to benefit financially from their deaths 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. State statutes may permit the new husband to claim support from the deceased wife's estate, or assets may have been placed in joint name, with the surviving new husband taking survivorship rights. However, if assets are held in unified credit and QTIP trusts, the divorcing spouse will have no property rights to those assets.

Flexible drafting. A key element to planning for the potential divorce of a client or a client's heirs is flexible drafting. [35] Any trust instrument should contemplate the impact on the plan of divorce or marriage of beneficiaries. For example, if a descendant is divorced and the non-descendant parent has custody of minor descendants, the trust should provide for how the ex-spouse is treated.

Particularly with irrevocable trusts such as dynasty trusts, granting a person a "limited power of appointment" [36] can provide significant flexibility to the planning process. For example, a client creates a lifetime unified credit generation-skipping trust for the benefit of his wife and minor children. He is concerned that the trust has no flexibility to deal with issues that may exist when his children are older (e.g., they develop alcohol or drug problems). While the husband may want to have the trust restrict the wife's ability to make distributions to benefit a new husband, the spouse could be given a limited power of appointment to reconfigure the trust for the benefit of the grantor's descendants at any time before her death. This would add flexibility to the plan.

The trust instrument can provide that a trustee is not legally liable to the trust or beneficiaries for actions taken in good faith. In addition, the trust instrument can indemnify a trustee for suits from beneficiaries and third parties, if the trustee's actions were taken in good faith.

One helpful addition to spendthrift trust provision is a no-contest provision. Although no-contest provisions are outlawed in a few states, they can serve as useful impediment to an heir or creditor who wants to pierce the spendthrift provision of his or her trust. [37] In addition, except in the case of a marital trust, the spendthrift provision can provide that the attempted assignment by a beneficiary of his or her trust benefits would automatically terminate those benefits.

Retirement plans and divorce

Clients should understand the differences in the tax treatment of various retirement plans. Some of these differences are outlined below.

> If a defined contribution or defined benefit plan is transferred to an ex-spouse pursuant to a qualified domestic relations order (QDRO), the recipient spouse can make withdrawals from the account, without having to pay an early withdrawal penalty. [38] If an IRA is transferred, the recipient spouse who withdraws the funds before age 59 1/2, may have to pay an early withdrawal penalty of 10%. Thus, if a divorcing couple has both IRA and ERISA retirement plans and one spouse intends to begin taking distributions before age 59 1/2 (e.g., a husband intends to take a year off from work), the withdrawing spouse will be better off receiving the ERISA account. The parties might even consider swapping retirement

benefits to place the best retirement vehicle in the appropriate ex-spouse's name.

Assume a husband has creditor problems. ERISA plans are not subject to the claims of most creditors. Although some state laws provide protection for IRAs, [39] in order to provide maximum protection, the husband could retain all the benefit of his own ERISA retirement plan and, possibly, even receive a QDRO to obtain the wife's ERISA plan benefits. The wife could receive other assets.

Assume a husband is a participant in a defined benefit plan. Based on 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 would retain a greater financial benefit than actuarially calculated by the plan administrator.

A recent Tax Court ruling, *Bunney* [40] may give a client pause when trying to extract revenge from a spouse in divorce. In *Bunney*, a couple divorced and the wife was entitled to half of the husband's IRA. The husband cashed out the IRA and paid the cash to her. He apparently anticipated that she would be responsible for both the income taxes and the early withdrawal penalty on the $111,600 withdrawal. Instead, the court ruled that all the taxable income went to the husband, and he was responsible for the 10% early withdrawal penalty. This resulted in his paying all of the taxes and penalties, while the wife got $111,600 tax free. To avoid this situation, the husband should have either directed the plan administrator to change the name on the IRA, or make a trustee-to-trustee transfer to the wife's IRA.

In considering whether to receive part of the ERISA benefit of a spouse, the recipient has two choices. The recipient can provide for a current distribution and then roll the funds into an IRA, or the spouse can leave the funds in the ERISA plan and receive benefits in the future. In deciding which option makes the most sense, the following issues should be considered:

Most creditors are unable to access the ERISA plan account assets of participants. IRAs do not generally provide the same creditor protection. [41]

Thus, if the recipient expects to have creditor problems, maintaining an existing ERISA account could provide better asset protection.

The parties should review the plan documents to make sure that current distribution of plan benefits is even permitted.

If the participant is not fully vested in the plan, it may be more beneficial to maintain the existing accounts to obtain full vesting.

The advisor should review the historic rates of return and financial risks in the ERISA plan and compare them to expected returns in an IRA.

If a retirement plan distributes employer securities, the value of the employer stock that is distributed may be taxed at the plan's basis in the stock rather then its current fair market value. [42] If the holding periods are meet, [43] the subsequent sale of the stock receives capital gain benefit. If a retirement plan holds appreciated employer stock, the after-tax benefit of receiving employer stock from the plan should be part of the decision process when deciding which assets an ex-spouse will receive.

If the ERISA plan is maintained by a closely held or family business that will be run by the ex-spouse, the recipient may want to roll the funds into an IRA to gain control over the retirement benefits.

If the plan is a defined benefit plan, the plan administrator must value the benefits to the divorcing spouse. The valuation is made on certain actuarial assumptions, which may not accurately reflect the future value of the benefits. Before making a decision, the client and advisor must understand the underlying assumptions used to calculate the benefits and should hire an actuary to make their own evaluation of the future benefits.

If the assets are rolled over to an IRA, the account owner will have the ultimate responsibility for the fund's management. The advisor should discuss whether the client is able or willing to manage the funds.

The IRA holder may also be tempted to make early withdrawals from the IRA. If the recipient spouse has tended to be a spendthrift, leaving the money in the ERISA plan may protect the recipient from both bad spending habits and the lack of financial savvy.

Improper beneficiary designation changes have created huge problems in divorce cases. [44] For example:

In *Merchant v. Corder*, [45] the Fourth Circuit ruled that a change in beneficiary designation to a retirement plan prior to the issuance of a final judgment of divorce was invalid. Because the ex-spouse had not agreed to relinquish her rights to the plan at the time of the change and there was no qualified domestic relations order, the ex-spouse received all of the retirement fund when the deceased husband died. because prior to the invalid change, wife was benc (I think)

In *Samaroo v. Samaroo*, [46] the Third Circuit held that even when a QDRO exists, the rights of an ex-spouse may terminate on the death of the plan participant before retirement. The failure of the QDRO to name the ex-spouse as a survivor beneficiary at the participant's death resulted in the termination of all of the ex-spouse's rights in the plan.

In *Hendon v. E.I Dupont de Nemours and Co.*, [47] the Sixth Circuit ruled that even when a divorce decree and marital dissolution agreement provided that a divorced spouse waived his rights to a ERISA retirement plan, the ex-spouse was still entitled to the qualified plan assets on the

death of the account participant. The court ruled that the waiver was not in compliance with the requirements of ERISA.

In *Schultz v. Schultz*, 48 the Supreme Court of Iowa 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 on the death of the account owner, even when the account holder had remarried.

In *Egelhoff v. Egelhoff ex rel. Breiner*, 49 the Supreme Court ruled that a Washington statute that purported to terminate a divorced spouse's rights in a retirement plan did not apply to ERISA plans. The state statute was not allowed to preempt the federal rules.

What is the solution? There are a number of actions that clients and their advisors should take, including:

Clients should make sure to obtain properly drafted QDROs when plan assets are to be passed to an ex-spouse. These orders should be completed by lawyers with a working knowledge of the related tax issues and statutory requirements.

If qualified plan assets are not passing to an ex-spouse, a new beneficiary designation should be prepared and filed with the plan administrator immediately after the divorce decree becomes final. If the soon-to-be ex-spouse agrees to sign a waiver, the change can be made prior to the divorce being finalized.

The courts have consistently ruled that pre-nuptial agreements, in which couples relinquish their rights to their partner's retirement accounts, do not apply to ERISA retirement plans. 50 Therefore, any spouse who has entered into a pre-nuptial agreement that relinquishes such rights, needs to sign an additional waiver after the marriage to relinquish such benefits. In the event of divorce, the early waiver of spousal benefits can provide significant negotiation benefits to the plan participant.

Conclusion

Divorce may not be inevitable, but it certainly has a strong probability of affecting any family of significant size. Discussing the difficult planning and drafting issues surrounding divorce may not be comfortable for the client or the advisor, but it is essential if a client and the client's family are to be protected properly.

PARTIAL CHECKLIST OF ACTIONS AS A RESULT OF DIVORCE

Change beneficiary designations on:

ERISA qualified plans (*ONLY* after the divorce is finalized, or with signed spousal approval before divorce).

IRAs.

Deferred compensation plans.

Stock option plans.

Life insurance policies.

Complete any title transfers on assets (preferably before the divorce is finalized), Such as:

Residence ownership.

Other real estate ownership.

Automobiles.

Stock or equity rights in a business or investment.

Life insurance (e.g., ex-spouse owns policy).

Redo all estate planning documents (to the extent an ex-spouse is named), including:

Will (especially if revoked by divorce).

Revocable trusts.

Medical or healthcare power of attorney.

General power of attorney.

Decide whether to maintain any irrevocable insurance trusts that name spouse as beneficiary.

Create any required funding arrangements under the divorce decree (e.g., new trust).

Enter a modification for any employee benefit cafeteria plan (permitted under the Code).

Make changes in personal or employer-based insurance coverages that names ex- spouse (perhaps obtain a refund) including:

Life insurance.

Health insurance.

Long-term care insurance.

Disability insurance.

Property and casualty (e.g., auto, home, umbrella).

Terminate joint liabilities, for example:

Credit cards.

Lines of credit.

Guarantees of ex-spouse's liabilities (e.g., business interest).

Mortgages (may not be permitted).

Utilities.

Change of address for (notice to post office and notice to each party), for example:

IRS (i.e., tax returns and audits) Form 8822.

Employers.

Credit mailings.

Driver's license.

Passport.

Terminate joint accounts (and change direct deposits) or permitted access by an ex-spouse, for example:

Banking (i.e., checking, savings, etc.).

Brokerage.

Safety deposit boxes.

Terminate automatic withdrawals that are no longer appropriate (e.g. to ex- spouse's account or benefit).

Change access codes, for example:

Web-based access (e.g., bank, brokerage).

Credit, debit, and ATM cards.

Frequent flyer accounts.

Email accounts.

Footnotes:

1 See Scroggin, "Salvage Tax Breaks When Planning for Marital Breakup," 69 PTS 324 (December 2002).

2 See Henkel, *Estate Planning and Wealth Preservation: Strategies and Solutions*, (WG&L 1994) section 53.17.

3 *Id.*

4 See 11 U.S.C. sections 523(a)(5), 727, 1141(d)(2), 1228(c)(2) and 1328(a)(2).

5 See Sections 61(a)(8) and 71(a).

6 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/.

7 See Section 414(p).

8 *Reichers v. Reichers*, 178 Misc 2d 170, 679 NYS2d 233, 1998 NY Slip Op 98522, 1998 WL 686662 .

9 See Rev. Rul. 70-218, 1970-1 CB 19.

10 See Section 2035.

11 See Section 2042.

12 But see Section 2206.

13 See Section 2042(2).

14 Rev. Rul. 76-113, 1976-1 CB 276.

15 *Id.* See Section 2053(a)(4).

16 See O.C.G.A. §53-4-49.

17 See Sections 2516(1) and (2).

18 See Ltr. Rul. 7940022.

19 See Rev. Rul. 79-118, 1979-1 CB 315.

20 *Harris*, 39 AFTR 1002, 340 US 106, 95 L Ed 111, 50-2 USTC ¶10786 .

21 See Section 2053(c)(1).

22 Rev. Rul. 71-67, 1971-1 CB 271.

23 *Estate of Kosow*, 75 AFTR 2d 95-1272, 45 F3d 1524, 95-1 USTC ¶60190 and *Estate of Scholl*, 88 TC 1265 .

24 Section 2513.

25 Reg. 25.2513- 2(a).

26 Reg. 25.2513-4.

27 Section 2513(b); Rev. Rul. 80-224, 1980-2 CB 281.

28 Section 2652(a)(2).

29 See Hader, "Planning to Avoid the Reciprocal Trust Doctrine," 26 Est. Plan. 358 (October 1999); Rev. Rul. 86-24, 1985-1 CB 329.

30 Section 2523(f)(4).

31 See Section 2036.

32 See: Zaritsky, *Tax Planning for Family Wealth Transfers: Analysis with Forms*," section 9.05: Retaining Family Ownership Through Buy- Sell Agreements" (WG&L, 2002).

33 *Dwight v. Dwight*, 756 NE2d 17 .

34 O.C.G.A. §53-12-28.

35 See Nelson and Carr, "Drafting to Achieve Maximum Flexibility in the Estate Plan," 25 Est. Plan. 252 (July 1998); Acker, "Every Drafter's Dream: The Flexible Irrevocable Trust" (BNA Tax Memorandum, 1998) p. 295; Keydel and McBryde, "Building Flexibility in Estate Planning Documents," 135 Tr. & Est. 56 (January 1996).

36 Forsberg, "Special Powers of Appointment: The Key to Flexibility in Planning," 28 Est. Plan. 68 (January 2000).

37 See Raithel, "Drafting Estate Planning Provisions to Avoid Litigation," 27 Est. Plan. 55 (February 2000); Ormond, "No Contest Clauses in California Will and Trusts: How Lucky Do You Feel Playing the Wheel of Fortune?," 18 Whittier L. Rev., 613 (1997).

38 Section 72(t)(2)(C).

39 See O.C.G.A. §18-4-22 and *Meehan v. Wallace*, 79 AFTR 2d 97-399, 102 F3d 1209, 20 EBC 2326 . See also 11 U.S.C. 541(c)(2).

40 *Bunney*, 114 TC 259 .

41 Note 39, *supra*.

42 Section 402(e)(4)(A); Notice 98-24, 1998-1 CB 929.

43 See IRS Notice 98-24, 1998-1 CB 929.

44 See Roush, "Beneficiary Designations After Divorce: Will the Ex-Spouse Benefit?" 25 Est. Plan. 5 (June 1998).

45 *Merchant v. Corder*, 182 F3d 908 .

46 *Samaroo v. Samaroo*, 191 F.3d 185 .

47 *Hendon v. E.I Dupont de Nemours and Co.*, 145 F.3d 1331 .

48 *Schultz v. Schultz*, 591 NW2d 212 .

49 *Egelhoff v. Egelhoff ex rel. Breiner*, 532 US 141, 149 L Ed 2d 264, 25 EBC 2089 . See Gary, "State Statue Does Not Revoke Beneficiary Designation After Divorce," 28 Est. Plan. 376 (August 2001).

50 See note 1, *supra*.

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