THOMSON REUTERS
CHECKPOINT

45 EST. PLAN. 39
Estate Planning
**1
July, 2018
Dealing with Divorce

Elizabeth A. Garlovsky and Carrie A. Harrington [a1]

ADVICE FOR ESTATE PLANNERS DEALING WITH CLIENT DIVORCES

Factor the possibility of divorce into estate plans formulated for married clients, and update those plans accordingly should a divorce occur.

***39** When advising a client who is planning to marry, divorcing, or is divorced, the advisor cannot know whether—or how many times—the client will subsequently be in another of these three situations. The advisor's job, however, is to guide the client through whichever stage of the process he or she is in, and to help avoid unintended consequences of divorce when death occurs before, during, or after. Several unique issues are presented when deciding how to amend or more often entirely revise the estate plan to correspond with the client's new marital status. Practitioners must also be aware of issues arising out of divorce-related documents that may frustrate the client's goals, or, worse, may create significant controversy and land the client in court.

Furthermore, the possibility of statutory changes should be addressed when helping clients implement strategies. As discussed below, the recently enacted Tax Cuts and Jobs Act of 2017 (TCJA), for instance, altered longstanding tax rules governing alimony—which is a reason for revisiting what had been time-tested planning arrangements.

The ‘engaged‘ or ‘almost married‘ client

Before a client marries for the first time or prior to a client's remarriage following death or divorce, a unique planning opportunity exists with the premarital agreement. Often clients with disparate balance sheets are first in line to enter into these agreements (and often prodded by older generation family members as a carrot to remain entitled to future benefits of family wealth), but, any couple can benefit from the goals that can be achieved. Many estate planners draft these agreements or represent clients in a ‘reviewing‘ capacity. It is also a perfect time for the soon-to-be-married to put an estate plan in place. If segregating assets for marital purposes is a goal, then having a plan in place before the marriage provides a vehicle for the spouses to demonstrate their intent to keep their assets separate and reduce the risk of co-mingling or transmutation of property.

General provisions. Premarital agreements are creatures of state law. In general, to be valid and enforceable, the agreement must be in writing and signed voluntarily, without duress, by both parties to the marriage. The agreement becomes effective as of the date of the parties' marriage and is designed to define the parties' rights and responsibilities with respect to financial issues if the parties divorce or when one of them dies. ***40** Tax provisions. Portability between spouses of the exemption amount may be viewed as an ‘asset.‘ Under the TCJA, the exemption amount attributable to a less wealthy spouse becomes more valuable as an ‘asset‘ to the spouse with a taxable estate. More than ever, as a rule, premarital agreements should include a provision that obligates a surviving spouse to file a federal estate tax return

for purposes of making an allowable portability election. A recent Oklahoma Supreme Court case established that an executor has a fiduciary obligation to make the election on behalf of a surviving spouse. The surviving spouse is the only person who can make the election and the only person with an interest in the value of the election. [1]

**2 With income tax planning becoming more relevant than ever, review 'funding' provisions carefully. Payments pursuant to a premarital agreement may be subject to fulfillment with assets that are includable in the payee's income. Alimony provisions also need to be reviewed, if not potentially amended, based on change in the law related to taxability of alimony (as discussed below).

General planning. Premarital agreements are the best way to protect family wealth by establishing rights and responsibilities well in advance of a divorce. Parties can use these agreements to provide a 'bare minimum' to a surviving spouse and then use the estate plan to augment benefits.

The divorcing client

A client may seek advice from his or her advisor before announcing to the spouse that a divorce is desired.

Planning. Clients want to know what their options are and if they should do any planning before telling their spouse. Practitioners must first determine whether they can continue the relationship. If the representation was initially 'joint,' the practitioner may have to terminate the representation immediately, or else inform both spouses of the potential divorce.

Often the client will want to amend fiduciary designations in estate planning documents. Some clients may want to keep a spouse as a fiduciary even after a divorce when it comes to certain decisions. However, many clients will want to cut out their soon to be ex-spouse during and after the divorce. Further, some clients wish to wait until the divorce is final to do a brand-new plan. It is important to remember that while the ex-spouse will usually be cut out of revocable documents upon divorce, state laws governing testamentary documents that deem an opposing spouse to have predeceased for designation purposes generally do not apply prior to the divorce being finalized.

Review premarital/postmarital agreements. A client's obligations under a premarital or postmarital agreement must be reviewed. The client should comprehend the risks and advantages as well as the obligations upon divorce and death.

Gather documentary evidence. If divorce is on the horizon for an individual client, it is important to review the client file and any prior notes or asset schedules. This can provide evidence of asset ownership to show which spouse originally owned an asset as well as the basis of the property. Files should also be reviewed for asset schedules obtained when planning was done or other evidence of original asset ownership. Handwritten notes or information provided by the client may not be definitive, but it can be a starting point for negotiations and determining ownership. When divorce is contemplated, begin to gather the written evidence to show the character of the property and the intent behind the transaction.

Review beneficiary designations. Beneficiary designations can be difficult to challenge, and it is important to ensure that the beneficiary designations are accurate at each phase of the marriage and divorce.

**3 *Qualified plans.* Nonqualified plans, such as IRAs, carry no restrictions regarding beneficiary changes. The client needs spousal consent to remove his or her spouse as the designated beneficiary under ERISA-qualified plans.

The U.S. Supreme Court has held that a retirement plan properly pays proceeds of the plan to a deceased employee's former spouse where the employee failed to change the beneficiary after the divorce. [2] In that case, the employee designated his first spouse as his beneficiary while they were still married. They divorced, and the employee later died

while married to his second spouse. The second spouse claimed the money from the plan, but her claim was denied due to the beneficiary designation still naming the first spouse.

The second spouse's claim was denied notwithstanding the existence of a waiver of rights to the plan by the first spouse in her divorce decree with the now deceased employee. Unfortunately, the waiver was not enough to defeat the beneficiary designation. The documents governing the pension plan specifically provided that the employee could change the beneficiary only by signing a new form. As a result, the second spouse got nothing. ***41** *Examine life insurance beneficiary designations.* If a divorce settlement agreement requires that life insurance be kept in place for the benefit of a former spouse, child, or other beneficiary, state law may give preference with respect to the proceeds.

Non-marital property. Steps should be taken to protect non-marital property from commingling. This can be achieved by:

1 Re-registering assets in the name of a separate revocable trust.

2 Removing the other spouse's designation as agent under a power of attorney.

3 Removing any other potential signs that may cause a third party to believe that the opposing spouse has an ownership interest in the property.

Ideally this kind of separation has already existed in the marriage, but if spouses have added one another to the title on certain property, one may try to argue that it is marital property.

With respect to trusts established by a third party for the client's benefit, be careful not to let trust distributions follow a pattern that could give rise to an expectation of entitlement with respect to either income or principal distributions. This could cause a judge in divorce proceedings to include such distributions as income in calculating the ultimate settlement breakdown.

A recent Massachusetts Supreme Court case examined the issue of whether one spouse's interest in a discretionary trust established for a group of people was subject to division as part of the parties' marital estate. The Trial Court awarded the wife 60% of the husband's interest in the present value of a trust created by the husband's family during their marriage and the appellate court affirmed. Upon review by the Massachusetts Supreme Court, the ruling was reversed based on a finding that the husband's interest in the trust was 'so speculative as to constitute nothing more than an expectancy.' [3]

****4** *Fraudulent conveyances.* During the divorce proceedings, or possibly even before proceedings commence, conveyances of marital property away from the marital estate may be overturned and can create problems with the court. It is therefore prudent to consult the applicable state Uniform Fraudulent Transfer Act or Uniform Fraudulent Conveyances Act. Furthermore, always check with the client's matrimonial attorney before advising a client to transfer assets while a divorce is in progress.

Asset registration. The client should look for situations where he or she made spousal transfers exclusively for asset protection purposes. Many states recognize that transfers of marital property between spouses, incident to tax planning, generally are not completed with the intent of making a gift.

Drafting issues. Changing the terms of a will or trust during divorce proceedings can be problematic. Review state law regarding a spouse's forced share at death. Further, if there are minor children, the surviving spouse will likely be custodian for any assets directed to the minor children.

If a client does not have a revocable trust, consider whether it is appropriate to establish one as part of the estate plan. Assets in a revocable trust generally are not subject to the applicable state law spousal forced share. However, depending

on the timing of the creation of the trust or other planning documentation, the transfer to a revocable trust may be considered a fraudulent transfer.

Consider whether decanting or merging can be used to amend unfavorable terms before a divorce is finalized. This should not be done without consultation with the divorce attorney. Also, consider any fiduciary obligation that the client may have. For example, consider the situation of an irrevocable gift trust of which the husband was the grantor and the wife was the trustee. The wife's family gifted shares of a family limited partnership to the trust. During the divorce proceedings the wife discovered that the trust stated that in the event of divorce, the wife was deemed to be deceased for all purposes of the trust, in which event an unsophisticated brother of the husband would become the trustee. Of course, the wife's family should have taken a closer look at the trust before gifting the property, but the wife may still be able to take active steps to amend these provisions before the divorce is final.

During divorce negotiations, a spouse would be wise to consider any irrevocable trusts and their value to the opposing spouse. Consider including the opposing spouse's resignation as trustee of an irrevocable trust among the items being negotiated.

Transfer tax issues. Several transfer tax issues should be considered when advising a divorcing spouse. ***42** *Gift tax marital deduction.* A married individual can transfer gifts to his or her spouse tax-free, even in the year of divorce, provided that the gifts are made before the dissolution of marriage and neither spouse remarries during the year.[4] A client may want to consider this as part of the divorce negotiations to allow a gift to be made to a soon-to-be ex-spouse without worrying about the tax implications.

****5** *Split gifts.* The IRS allows gifts to be split in the year of divorce, provided that the gifts are made before the cessation of marriage and neither party remarries during the year.[5] Again, this may be considered as part of the divorce negotiations, especially if the spouses had a habit of making split gifts throughout the marriage.

Post-divorce transfers. Certain transfers among former spouses after the divorce will not be considered taxable gifts if such transfers meet the requirements. If a transfer occurs incident to the divorce, and pursuant to a written agreement entered into before the end of the marriage, the transfer will not be a gift so long as the divorce occurs within a three-year period beginning on the date one year before such agreement is entered into (regardless of whether the divorce decree approves the agreement) and either of the following is satisfied:

1 The transfer is between former spouses in settlement of marital or property rights.

2 The transfer serves to provide a reasonable allowance for support of children of the (former) marriage.[6]

Income tax consequences. For income tax purposes, transfers between spouses are tax-free regardless of any gain or loss.[7] Property transfers between former spouses incident to divorce will also qualify for this gift tax marital deduction.[8] However, to show that a transfer is incident to divorce, it must occur within (1) one year after the cessation of marriage or (2) six years after the end of the marriage, if the transfer is made pursuant to the terms of a divorce or separation instrument. These transfers will be treated as gifts for income tax purposes and, therefore, the transferee spouse will take the transferor spouse's carryover basis. The divorcing couple should specifically identify the assets to be transferred in the divorce agreement in order to qualify for this treatment.

Before the enactment of the TCJA, alimony payments were deductible to the payor and includable in the payee spouse's income.[9] However, under the new law, with respect to agreements entered after 12/31/2018, the deductibility and includability provisions expire.

Alimony trusts. Because alimony payments are fraught with bad feelings, one possible solution is an alimony trust. Alimony trusts provide for a consistent income stream, assuring steady payments to the payee regardless of problems the obligor may encounter during the payment period. Further, the trust serves to lessen concerns regarding the payee spouse's potential creditors and the payee spouse's ability to manage and administer the funds because a trustee is managing the assets and expending funds for the payee spouse's needs and support. Furthermore:

1 An alimony trust can appoint a third party to administer the payments and therefore reduce contention between the parties.

**6 2 Payments to the trust are not deductible under Section 71 but after 12/31/2018, that will no longer be a factor. If, however, a lump-sum transfer to a trust occurs and is made pursuant to Section 2516, the payor spouse will not have to worry about the deductibility of the payments.

3 The payor can benefit from a ‘known quantity‘ payment to the trust and reduce anxiety of unpredictable future income for both parties.

4 The trust can also ‘insure‘ against a spendthrift payee.

5 Once an alimony trust is funded, the trust relieves the payor spouse of future tax obligations when trust income is paid to the payee spouse. The payee is taxed on distributed income, and the trust is taxed on undistributed income.

6 To be effective, the trust should be irrevocable. However, the trust provisions can provide that upon termination of the grantor's support obligation pursuant to the divorce documents, the trust principal will revert to the grantor.

7 This reversion interest might normally cause the trust to be a grantor trust for income tax purposes. Section 682 treats an alimony trust like a non-grantor trust. Therefore, the beneficiary spouse is taxed on the income distributed and the trust pays income taxes on any excess income that is not distributed.

Death of a party during the divorce proceedings. What happens when a husband or wife dies before the divorce becomes final? The short answer is that they are still married, and the divorce can potentially *43 be viewed as a non-factor. The concept of the ‘termination‘ of a divorce due to death is called abatement. Although the divorce is ‘over,‘ the issues between the parties are not necessarily eliminated. Frequently surviving spouses will find that the fight continues; only the parties may change. Do not forget that the client's existing documents, if he or she has any, will still apply. Only the final decree can affect the existing plan.

Not all states recognize abatement of divorce proceedings upon death. Therefore, it is imperative to check local law. For example, some states will allow the proceedings to continue to determine division of property.

If a client is facing impending death during a divorce proceeding, the advisor should consider whether it is prudent to ask for an immediate judgment on the divorce and to hold everything thing else on reserve to avoid abatement.

The divorced client

Once a divorce becomes final, a client may want to revise his or her estate plan.

Planning. When planning for a divorced client, it is important to request and review a client's existing estate planning documents, in addition to documents relating to the divorce decree. Because it is often difficult to get a divorced client to focus on what may appear to be cumbersome legal fees, the advisor should make sure the client understands the effects of the client's existing documents if the client makes no changes.

Check local law to determine if any statutes govern the effect of divorce on testamentary and power-of-attorney documents. Many states treat the divorced spouse as predeceasing the testator, grantor, or principal once the divorce judgment is entered. Often, powers of attorney do not name a successor after the spouse. In such case, the principal will no longer have a valid power of attorney.

****7** This automatic removal of an ex-spouse pursuant to statute, however, will often not apply to land trusts; voting trusts; trust deeds or mortgages; liquidation trusts; escrow; instruments under which a nominee, custodian for property, or paying or receiving agent is appointed; or Totten trusts.

Review the divorce decree. Before a new plan can be drafted, the advisor must closely examine a previously entered divorce decree and marital settlement agreement to ensure alignment with the client's estate plan. Additionally, there may be documents other than the marital settlement agreement, such as promissory notes or partnership agreements, that are important to understand.

The advisor should become familiar with all financial obligations, during life or upon death, that a client may have pursuant to the divorce decree. These provisions may include alimony, child support, education obligations, setting up trusts for children, maintaining or establishing life insurance policies and trusts, and requirements on how property will pass at death. These provisions should be considered each time a client makes changes to his or her estate plan especially if he or she marries again and has more children. Further, confirm that the client has fulfilled any immediate obligations under the marital settlement agreement—such as transferring accounts or real estate, ***44** turning over trusteeship of trusts, or establishing new trusts.

Drafting considerations. Divorce obligations typically supersede any contrary provisions in the estate plan. An ex-spouse may have to bring suit in probate or chancery court to effect the provisions of a divorce decree in the event the plan does not fulfill obligations under a divorce decree.

It is best practices to incorporate specific provisions of the divorce decree and marital settlement agreement, or if an acknowledgment that the decree and agreement exist are sufficient. Here is sample language:

> It is my intention that the provisions of this Will shall satisfy my obligations, if any, pursuant to the terms of a Marital Settlement Agreement (the 'Marital Settlement Agreement') executed on DATE, by and between myself and my former husband/wife, NAME. To the extent the provisions of this Will are construed to provide less than I am obligated to provide for NAME under the Marital Settlement Agreement, the terms of the Marital Settlement Agreement shall control.

Advisors should consider preparing new irrevocable life insurance trusts to fund any payment obligations upon death. Life insurance can be a simple way to ensure fulfillment of obligations pursuant to a divorce decree. By placing the policy in a life insurance trust, the grantor can also ensure that the policy proceeds are outside of his or her estate upon his or her death. Further, trusts will allow assets to be protected for the benefit of minor children instead of giving assets outright to an ex-spouse. Be careful not to violate the terms of the decree by changing the beneficiary of a life insurance policy to a trust.

****8** Death of an ex-spouse. Once a judgment for dissolution of marriage is entered, that judgment should set the obligations of each party. Many judgments contain provisions for continuing obligations on behalf of one spouse to the other, or both, which can take various forms.

Life insurance to secure maintenance or child support. Life insurance is a universal planning tool that necessarily becomes an important issue in a divorce. It is important to keep track of how the life insurance will be affected by the divorce

settlement and how local law addresses the rights of divorced individuals to life insurance that is supposed to be secured by a divorce judgment.

Former spouses or children as creditors of the estate in probate court. How do rights of former spouses or children hold up against other creditors when a decedent fails to uphold his or her obligations under a divorce judgment? Often, the injured party, whether it be the surviving former spouse, or a child of the decedent, generally has a valid claim against the estate of the decedent. In some cases, the injured party can have a superior right to the creditors.

Awards for children. Many if not most states provide in their probate statute that certain immediate distributions can be made to a decedent's surviving minor or adult dependent children. These awards may be considered claims of the estate of the decedent and therefore should be considered early in the probate process. One of the first things an executor can and often should do for dependent children (can be minor or adult dependent) is to research the amounts available, if any, without court approval and apply for additional awards with the court if possible. Unfortunately, these awards can also be the basis for direct conflict, albeit unintentionally, between a decedent's children and his or her former spouse. Child awards should be thought through carefully with the input of all affected parties, even when a divorce preceded the death. Families need to find a way to work together even with the bitter taste of the divorce potentially still within recall.

Counsel for the estate must decide how funds to satisfy the awards should be distributed Such award can be payable to the surviving parent or a legal guardian. They also may be required to be placed in an estate for the child if the child is a minor or a dependent adult.

Conflicts of interest can arise between the children and the surviving parent. When minor children are involved, a conflict of interest arises between the surviving former spouse and the minors, especially as the sole heirs of the decedent. Some courts will appoint a guardian ad litem (GAL) to help guide the court and ensure the minors are protected.

Ambiguous marital settlement agreements. Divorces can take a long time, and procuring a settlement between the spouses can be an emotionally taxing while at the same time highly complicated effort that requires input and consensus from multiple parties (e.g., the spouses, their attorneys, mediators, financial advisors, and other family members). From time to time, despite the hard work and substantive input from both sides, something goes wrong after the ink is dry. Perhaps there was an unanticipated contingency or, worse, an ambiguity exists in the final document that but for a death of one of the parties, would otherwise go unnoticed.

****9** When ambiguities exist in a divorce settlement agreement, or, if the decedent dies without fulfilling obligations under the agreement, the surviving former spouse is often left with no alternative other than to turn to the courts. This is of course an unfortunate result as one of the worst things that can happen to a family after the tragic loss of a parent is reliving a ***45** contentious divorce—but this time the parties are not the same. Because the family court will likely no longer maintain jurisdiction over the matter, the issues may be addressed in Probate Court. Probate Court becomes a new forum for the family and, unfortunately, a place where old wounds become fresh again.

There is not a significant amount of research at this point to provide clarity on the myriad issues. However, with divorce rates continuing to hover around 50% of all marriages, problems will continue to unfold as former spouses fail to survive the obligations under their marital settlement agreements. The agreements tend to increase in complexity as do divorces in general. The practitioner should be familiar with common law that addresses some of the issues unfolding when a former spouse sues another's estate over a poorly drafted or easily misinterpreted agreement.

When interpreting a marital settlement, courts may initially seek to give effect to the parties' intent. The language used in the marital settlement agreement is generally the best indication of the parties' intent. When the terms of the agreement are unambiguous, the parties' intent is determined solely from the language of the instrument. An ambiguity exists when an agreement contains language that is susceptible to more than one reasonable interpretation.

Effect of continuing obligations in divorce settlements in the event of death. Sometimes the divorce does not give the parties a clean break. For financial reasons they may remain connected for extended periods of time. The death of one party after the divorce, while the former spouses are still connected, can cause significant issues for the estate of the decedent, the survivor, and for the children.

Parties' primary residence. Couples commonly divorce without having their residence sold and the proceeds divided. Many factors cause this result, such as an uncooperative real estate market or the desire not to disrupt young children by moving them out of the home.

These may seem like rather common issues and curiously relevant to the topic at hand. It is important to realize that while the parties still own property together, if one of them dies, whether they are divorced yet or not, there is now a 'new' owner of the property—typically the estate of which their children are the heirs or legatees. This may create difficulties for all parties with respect to what might otherwise be a simple residential real estate transaction. Problems arise when the parties both remain on title at the death of just one of them, and frequently the joint title remains by accident. The parties will forget to execute or record the appropriate deed necessary to carry out the property distribution of the divorce settlement agreement. Depending on factors surrounding the residence, there could be a forced sale at an inopportune time and of course additional unnecessary legal fees, court costs, etc. surrounding the sale.

****10** *Other types of obligations.* Former spouses may leave the marriage with contractual obligations to confirm payouts from illiquid marital assets such as businesses, investment real estate, or other unique personal assets. When the obligor dies, the former spouse may not have any superior rights to the continued payments over other creditors, whether personal or business, unless the payments are structured appropriately and secured, for example, with life insurance.

Also, if the payee under such an arrangement dies, similar complications could arise with respect to the continued receipt of the payments unless specifically provided for in the settlement. Even worse, the payments could cause the payee's estate to go into probate and be exposed to the payee's creditors; an unintended result.

Conclusion

Divorce attorneys and estate planning attorneys have more in common than either side may wish to admit. Both are often interacting with clients in a vulnerable position, asking them uncomfortable questions, and wanting to know their beliefs and values regarding money and family relationships. Perhaps most rewarding, the clients have to trust the attorneys with their most personal and private issues.

Too often divorce proceedings consider only what occurs between a couple on divorce but do not consider the further looking future—potential remarriage of a party and the unavoidable death of both parties. While a couple is already in a vulnerable position discussing what happens with property division and child custody, they should consider how their current and future estate planning may be affected.

Estate planning attorneys and divorce attorneys are already planning for worst-case scenarios. When combined, the discussion can be somewhat depressing. However, if divorce decrees are not considered when estate planning, worst case scenarios can become reality. While it may be possible to clean up ambiguous or incomplete provisions in marital settlement agreements before an ex-spouse dies, issues can arise upon one's death. It is best to provide for these issues during life. When dealing with divorced clients, an estate planning attorney should consider all divorce documentation. Such documentation should be reviewed periodically to determine if any circumstances have changed or if they should be considered in estate planning.

Premarital agreements should include a provision that obligates a surviving spouse to file a federal estate tax return for purposes of making an allowable portability election.

In many states, assets in a revocable trust are not subject to the applicable state law spousal forced share.

Many states treat the divorced spouse as predeceasing the testator, grantor, or principal once the divorce judgment is entered.

Footnotes

a1 ELIZABETH A. GARLOVSKY is an estate planning attorney with Lesser Lutrey Pasquesi & Howe, LLP in Lake Forest, Illinois. CARRIE A. HARRINGTON is an attorney in the Trust & Estates Group of Levenfeld Pearlstein, LLC in Chicago, Illinois.

1 In re Estate of Vose, 390 P.3d 238 (Okla. 2017).

2 Kennedy v. DuPont Savings and Investment Plan, 129 S.Ct. 865 (2009).

3 Pfannenstiehl v. Pfannenstiehl 475 Mass. 105 (2016).

4 Section 2523(a).

5 Section 2513.

6 Section 2516.

7 Section 1041(a).

8 Section 1041.

9 Section 71.