Chapter 12

SPECIAL CIRCUMSTANCES

INTRODUCTION

Because no two people are alike, it is safe to assume that no two financial planning situations are alike. We all handle our finances differently, even if we have the same job, make the same money, and have the same number of children. Financial planning is an inherently personal process and planners must make sure that they communicate this to the person or people sitting at the table. Every situation is unique.

Of course, some situations are more unique than others. Not every financial plan will be constructed around a husband, a wife, and two and a half children. According to the 2008-2010 U.S. Census Bureau American Community Survey (ACS), 49.1% of all American households consisted of married, opposite-sex partners. That leaves a great deal of households that are not typical. Consider the following types of atypical households:

* one person households, such as widows or divorcees;
* unmarried partner households; or
* same-sex households.

Each type of household comes with very different issues. The planner must be prepared to elicit, with a great deal of poise and tact, the information needed to complete an accurate financial picture and be able to create the necessary projections. This is often a very complicated task. Some clients will be more than willing to divulge every nugget about their life, financial and otherwise. Others will play it close to the vest and may not be willing to discuss matters that do not have a dollar sign attached to them.

DIVORCE PLANNING

Nothing stirs up a financially stable marriage more than divorce. It is painfully clear that two individuals in separate households cannot live as cheaply as one married couple. All too often the financial aspects of a divorce are worked out between the soon-to-be ex-spouses or, worse yet, themselves and their attorneys, without the assistance of a qualified financial advisor during the divorce process. Financial planners are all too often brought in only after the fact, even though they can play a valuable role in:

1. assisting the client in identifying financial goals – this focus will often lead to a less messy financial separation;

2. structuring property settlements;

3. negotiating the proper amount of alimony or child support;

4. ensuring that the right assets are transferred in the most tax efficient manner; and

5. helping the client deal with financial burdens that he or she may never have handled before.

Like widows, divorcees are often on their own for the first time in their adult life. The financial pressures often seem overwhelming, especially if your client feels like their ex got the better end of the deal.

If a divorce is inevitable, there are certain financial actions that should start immediately. The following should be done in consultation with an attorney, if one will be retained:

* establish bank, brokerage, and other financial accounts in the client’s own name;
* obtain new credit cards and establish the client’s own credit rating, especially if the ex-spouse was not too good with money
* change the beneficiary designations for retirement plans and life insurance; and
* make any necessary adjustments to estate planning documents such as wills and powers of attorney.

One of the biggest decisions that should be made in a divorce is what happens with the house. Obviously, one of the two spouses will be out the door. In certain cases, it may make sense for both to leave.

Although the dominant factor influencing the decision to stay in- or leave- the home may be emotional, the financial considerations need to be addressed quickly. Can the client afford to stay in the marital home? If so, for how long before a downsizing of the financial burdens of a house must be reduced? Planners may need to deal with feelings of entitlement or unwillingness to trade-down. Too often after a divorce the former marital house becomes a burden instead of a home.

If not done as part of the divorce planning, before or while negotiations are underway, a new budget for the newly or soon-to-be divorced client, with a cash flow projection, should reveal whether the house is affordable or not. Be sure to consider all sources of income and expenditures and tactfully challenge the client’s estimates. If this is not the first time through the budgeting process for the client, it is likely to be the first time going through a divorce.

Close attention needs to be paid to the division of retirement assets. Next to the house, retirement assets typically hold the most value, but also come with a cost – a potentially large tax cost. Even if assets are divided equally, one spouse may end up in a much better financial situation than the other.

*Example*: Al and Dorothy Palmer are divorcing after 15 years of marriage. They are both 40 years old and have amassed $500,000 in a joint savings account and $500,000 in Al’s IRA. They do not own any other assets, see no need to hire an attorney, and agree to divide their assets in half. For simplicity, Al suggests that Dorothy takes the savings account and he will keep the IRA. Although Al’s suggestion does divide the assets in half in total, he is leaving himself without any current assets. Since he is under age 59½, he is unable to tap his IRA without penalty – and he would need to pay income taxes on top of that.

Many divorces are settled with regular periodic payments being required from one of the former spouses to the other spouse. The structure of these payments will determine whether they are classified as alimony or not. Alimony is deductible by the payer and taxable to the recipient. On the other hand, property settlements and child support are not deductible by the payer and are not taxable to the recipient.

Payments will qualify as alimony only if all of the following requirements are met:

1. Payments must be made in cash.

2. Payments must be received by or on behalf of a spouse under a divorce or separation agreement.

3. The spouses must not be members of the same household at the time payments are made.

4. The parties must not identify the payments in the agreement as not being alimony for federal tax purposes.

5. Payments must terminate no later than at the death of the recipient and there must be no liability to make any payment (in cash or property) as a substitute for such payments.

6. The spouses must not file a joint return with each other.[[1]](#endnote-1)

Child support is not treated like alimony for federal income tax purposes. Payments which otherwise qualify as alimony but are reduced upon the happening of an event involving a child will not be treated as alimony.[[2]](#endnote-2)

In order to allow for the transfer of one spouse’s defined contribution retirement plan (e.g., 401(k)) to the other spouse in a divorce, a court may issue a Qualified Domestic Relations Order or QDRO, for short.

It is more difficult to split employer-sponsored defined benefit plans, usually known as company pension plans, since these types of plans typically pay only in the future. If this asset is being evaluated as part of a property settlement, a present value is usually calculated and paid in a lump sum to the other spouse from other assets. Less frequently, it is paid out only when (and if) the employee receives the benefit in the future.

One very important consideration is health insurance, especially if the planner is dealing with a non-working ex-spouse. Once the spouses are no longer married, there is no requirement for the ex-spouse to continue carrying coverage for the former spouse unless the divorce decree says otherwise. If the ex-spouse does cut off the other spouse, all is not lost. Divorce is a qualifying event for COBRA purposes and up to 36 months of coverage may be purchased by the other spouse. Obviously, the children’s’ health insurance must be considered as well.

An ex-spouse may qualify for higher Social Security benefits after a divorce. Provided the marriage lasted at least 10 years and the divorce occurred more than two years ago, a divorced spouse may claim benefits based upon his or her ex-spouse’s earnings record. This does not impact the benefits the other ex-spouse will receive. When filing for benefits, an astute worker from the Social Security Administration should ask about prior marriages and check to see how benefits may change if this rule applies.

NONTRADITIONAL RELATIONSHIPS

More households than ever fall outside the traditional opposite-sex, married couple relationship. The most commonly encountered nontraditional relationships are opposite-sex unmarried couples and same-sex partners.

As states began to legalize same-sex marriage in the early part of the twenty-first century, an inevitable conflict arose with the federal Defense of Marriage Act (DOMA), which broadly prohibited the federal government from recognizing the legality of same-sex marriage even when such marriages were permissible under state law. The legal requirements for marriage has always been governed by state law, and DOMA created circumstances in which same-sex couples saw their marriages recognized by some states while being ignored by other states and the federal government. This lead to tremendous practical difficulties with things like filing tax returns. Same–sex couples would often have to prepare multiple versions of their returns for the various jurisdictions in which they had tax reporting obligations, filing as a married couple in some states and filing as single taxpayers in other states and on their federal returns. It also complicated insurance planning.

DOMA was overturned by the United States Supreme Court in the 2013 decision in *Windsor v. U.S*. That decision brought about federal recognition of same-sex marriages, but the situation in the various states is still unclear. A number of states have allowed same-sex marriages through court decisions or legislative enactments, and there is currently extensive litigation about the legality of same-sex marriage pending, including an anticipated Supreme Court ruling later this year.

These changes have given rise to two recent trends. First, with the increasing number of states that recognize same-sex marriages, there are simply more same-sex married couples today than there were several years ago. Many of these couples are older, and have lived together as domestic partners for quite some time. That partnership may or may not have enjoyed legal recognition by tax authorities, employers, and financial institutions. Newly married same-sex couples may be trying to integrate a much more complex array of financial assets and planning goals into a new marriage using tools that had been previously unavailable to them. This may require different planning strategies than might be used for the traditional newlywed couple who may have married when they had few assets.

The second recent development relates to the variation in state recognition of same-sex marriages. These couples may face complex planning problems depending on the state(s) in which they live, work, and own property. What if the couple lives in a state that recognizes same-sex marriage, but one spouse works in a state that does not? What if they were married in a state that recognizes their marriage, but subsequently relocate to state that does not? What if they own—and wish to insure—property in a state that does not recognize their marriage?

These recent changes and continued uncertainty have given rise to several financial insurance planning issues that can have important tax consequences. Planners with same-sex clients who are newly married, or whose marriages are newly recognized by their state, should review these issues to see if there are opportunities to help their clients achieve their planning goals, reduce their tax liability, or protect themselves in the case of a marriage that may be ending.

When it comes to financial planning, how couples use retirement accounts can vary significantly depending on whether they are married or not. Newly married same-sex couples should review their use of qualified retirement plans, particularly if they are older or have significant retirements assets already accumulated. This review should focus on three areas: contributions, Roth conversions, and survivorship options.

***Contributions--*** With regard to contributions, deductions for IRA contributions may change if one spouse is covered by an employer and the other is not. A spousal IRA is one in which a taxpayer’s nonworking spouse is permitted to contribute to an IRA based upon the compensation of the taxpayer. Therefore, in order to fully fund a traditional and spousal IRA, the total compensation received in that year must exceed $11,000 ($5,500 for each spouse). All other rules for traditional IRAs apply to spousal IRAs.

If the working spouse participates in an employer sponsored plan and the married couple files a joint tax return, the spouse is permitted to make a deductible IRA contribution provided their AGI is less than $183,000 for 2015. Once AGI reaches this level, the deduction is reduced as income rises, and is completely phased out at $193,000 of AGI. Note that for married taxpayers who file separate returns, the phase-out begins at $0 of AGI and is fully phased out at $10,000 of AGI.

***Roth conversions--*** The rules for Roth conversions are not significantly different for married and unmarried couples because even for married couples each spouse’s account must remain separate. However, the decision about whether to convert a traditional IRA into a Roth IRA (or other 401(k) plan) depends greatly on what the client’s income level and tax rates are expected to be during retirement. Partners in a same–sex couple ten years ago may have anticipated never being married because of legal restrictions, and made Roth conversion decisions based on that assumption. If that same couple is now married in 2015, they should revisit their assumptions about income levels and tax rates in retirement to see if they still hold true.

This can be particularly important for couples in which one spouse has a significantly higher income than the other. Where a Roth conversion may not have made sense for the low income partner who didn’t expect to be married, it may now be beneficial when that same partner has become a spouse and the household income is significantly higher and expected to remain so through retirement.

***Survivorship options--*** In contrast to non-spouse beneficiaries, a surviving spouse named as the sole beneficiary of a deceased spouse’s IRA (or qualified plan) has various options on how the IRA/plan can be held and when required minimum distributions must be made.

For example, a surviving spouse can roll over the participant spouse’s IRA/plan into the survivor’s own plan and, by doing so, is treated as the plan participant for purposes of determining the “required beginning date” and the “minimum required distribution.” If the surviving spouse is under age 70½, the spouse can postpone distributions until age 70½, thus allowing for a greater period of income tax deferral. (In the case of a spousal rollover of a Roth IRA, the surviving spouse is not required to take distributions during the spouse’s lifetime.) Nonspousal beneficiaries have no ability to roll over an IRA/plan and must start receiving distributions by the end of the year after the participant’s death.

With a spousal rollover, the minimum required distribution during the spouse’s lifetime is based on the joint life expectancy of the spouse and a person ten years younger. This results in smaller distributions, and a longer period of tax-deferred growth within the IRA/plan. Minimum required distributions to a nonspouse beneficiary will be based solely upon the beneficiary’s single life expectancy (unless the plan dictates otherwise, e.g., a lump sum distribution).

If a surviving spouse rolls over an IRA/plan, the spouse can name his own “designated beneficiary.” After the spouse’s death, minimum required distributions will then generally be based upon the designated beneficiary’s life expectancy, extending the tax deferral benefits of the IRA/plan. In the absence of a spousal rollover, minimum required distributions will be based solely upon the original beneficiary’s life expectancy – even after the beneficiary’s death.

Thus, spouses have greater options to obtain the most favorable income tax deferral results in relation to IRAs and qualified plans. In addition, the IRA will qualify for the marital deduction, thus avoiding estate tax.

In a nonspousal relationship, the surviving partner named as the beneficiary of a deceased IRA participant’s plan has no such choices although the Pension Protection Act of 2006 permits non-spouses to do a trustee to trustee transfer of an inherited IRA to the heir’s own IRA and begin taking required minimum distributions over the life expectancy of the heir. The value of the IRA is subject to federal estate tax and, in some states, state estate tax. To the extent that the IRA must be distributed to pay any estate tax, income tax will also be due on the distribution (although an income tax deduction for the estate taxes attributable to the IRA is available under Code section 691(c)).

There are a number of financial planning points to consider when dealing with nontraditional relationships. As more and more states acknowledge same-sex marriage or other forms of same-sex unions, the nature of a same-sex couple’s legal rights regarding financial matters has become muddled. Whereas some states will treat same-sex couples the same as opposite-sex married couples, most states, and the federal tax laws, do not recognize same-sex unions for tax and other legal matters. For example:

* **Federal Law**
* *Federal* *income taxes*. Under current rules, unmarried couples are not permitted to file a joint income tax return. However, as a result of the much-discussed marriage penalty, taxpayers who use the married filing joint status typically will pay more in income taxes than two working taxpayers who each file using a single filing status. Married couples cannot elect to file single; if they do not file using a joint status they are required to file separately – which often produces the worst tax result. So there is at least one positive financial outcome to a nontraditional relationship.
* *Federal gift taxes*. A marital deduction is only available to married couples.[[3]](#endnote-3) Gifts to anyone other than a spouse are subject to the annual gift tax exclusion and lifetime unified credit.
* *Federal* *estate taxes*. A marital deduction is only available to married couples and can result in no estate tax if the entire estate is left to the surviving spouse. Therefore, a married person dying with a taxable estate will pay less estate tax than an unmarried person with the same taxable estate, unless the unmarried couple established bypass trusts. The bypass trusts would prevent a second estate tax upon the death of the second spouse. With proper planning, the difference becomes the timing of the potential estate tax liability. Married couples can delay any estate tax liability until the death of the second spouse while same sex couples would owe any estate tax liability upon the death of the first spouse.
* **State Law**
* *Intestacy rights*. The surviving partner of a nontraditional relationship will often have no rights to a decedent’s property if a will is not in place. When dealing with nontraditional relationships, it is crucial that proper and careful estate planning be performed.
* *Titling of assets*. One common way to protect both parties in a nontraditional relationship is to carefully title assets to ensure that lifetime wishes are carried out. Consider the following:

Joint Tenancy with Right of Survivorship

Pay on Death or Transfer on Death account designations

* *Beneficiary designations*. Partners in nontraditional relationships should review their retirement plan accounts and life insurance to make certain that their partners are named as the primary beneficiaries.
* *Power of attorney*. In order to make sure the world knows the client’s true intentions, have it put in writing. A power of attorney may cover all financial or medical aspects of a person’s life or may be task-specific. It may be written so it could be used immediately or so that it can be used only in the event of incapacitation or other defined event, a springing power of attorney. Since many families have difficulties understanding or accepting nontraditional relationships, this is an important step in making sure that the person the client wants making crucial decisions will be permitted to do so.
* *Social Security*. Couples in nontraditional relationships may or may not be able to rely on Social Security benefits like married couples do. Married spouses are entitled to claim the higher of the benefit determined under their own earnings record or one-half of their spouse’s. Provisions are also in place for higher benefits for surviving spouses. Unmarried individuals must claim benefits on their earnings record alone.
* *Company pensions*. Although company sponsored pensions are becoming increasingly rare to find, they do still exist. Some companies have made adjustments to be more accepting of alternative life arrangements. However, in many cases, a pension is paid for the life of an unmarried employee. Upon the employee’s death, the pension payments cease.

CHANGE OF EMPLOYMENT

No one seems to stay employed in one place very long. Gone are the days when everyone got his first job and stayed with the same company until he retired or died. People now change jobs almost as frequently as they change shoes. Company loyalty does not exist in the same fashion it did decades ago.

Companies share a large portion of the responsibility for this change in attitude toward loyalty. Financial planners will rarely see a client who has a pension that is funded solely by the company. Some portion of the cost of benefits is more frequently passed on to the employee, making it more important for employees to shop around for the best deal for their services.

Financial planners will often be called upon to evaluate:

* the cost or benefit of changing jobs, especially where there is a change in location;
* early retirement packages offered by a company; or
* severance and job assistance packages.

Changing Jobs

The decision to accept a new job with a new employer must be made on several different levels. So much consideration needs to be given to how a job change is going to affect the employee, his or her family, and the potential for advancement, that the financial considerations may not be fully examined. Even worse, only one aspect of the finances – the salary – may be looked at, instead of the entire package.

In order to fully evaluate the financial part of the equation, a planner can assist in reviewing the value of the old job versus the value of the new. Often, this independent look can make the decision that much easier.

In addition to cash compensation or salary, a total compensation package will include some or all of the following:

* Overtime
* Vacation time
* Retirement plan offerings, including eligibility for matching
* Health benefits, including dental and flexible spending arrangements
* Life insurance
* Disability income plans
* Dependent care assistance
* Relocation assistance
* Company car(s)
* Stock bonuses, options, or other ownership programs
* Club dues
* Educational assistance
* Business expense reimbursements

Obviously, this is by no means an all-inclusive list. Each company will have its own summary of benefits – be sure to get the whole picture.

If there is a change in job location, it is imperative to review the state and local tax impact. More municipalities are assessing taxes on their workers, which could eat away at some of the perceived benefit of making a move to a new job.

Early Retirement

Instead of using layoffs to cut the workforce, many companies use an option of early retirement to entice workers to voluntarily leave. These types of package are often offered with little advance notice and generally decisions must be made within a month or two of the offer.

These types of packages must be reviewed very carefully before a recommendation to accept is provided. For example:

* Are medical benefits provided in the package?
* Is the worker in any way barred from seeking employment in the same field with a competitor?
* How much of the employee’s pension is lost (or increased) if the package is accepted?
* If the package is not accepted, does the employee risk being laid off or involuntarily relocated?

Severance Packages

Severance payments are commonly provided to employees who are laid off. Occasionally, such packages are provided with outplacement assistance services. These services may include job training, placement, or financial planning.

CHAPTER ENDNOTES

1. . IRC Sec. 71(b). [↑](#endnote-ref-1)
2. . IRC Sec. 71(c). [↑](#endnote-ref-2)
3. . Couples who are considered married under common law may be eligible to use the marital deduction. [↑](#endnote-ref-3)