ESTATE PLANNING

My client got divorced

CAPITAL GROUP®

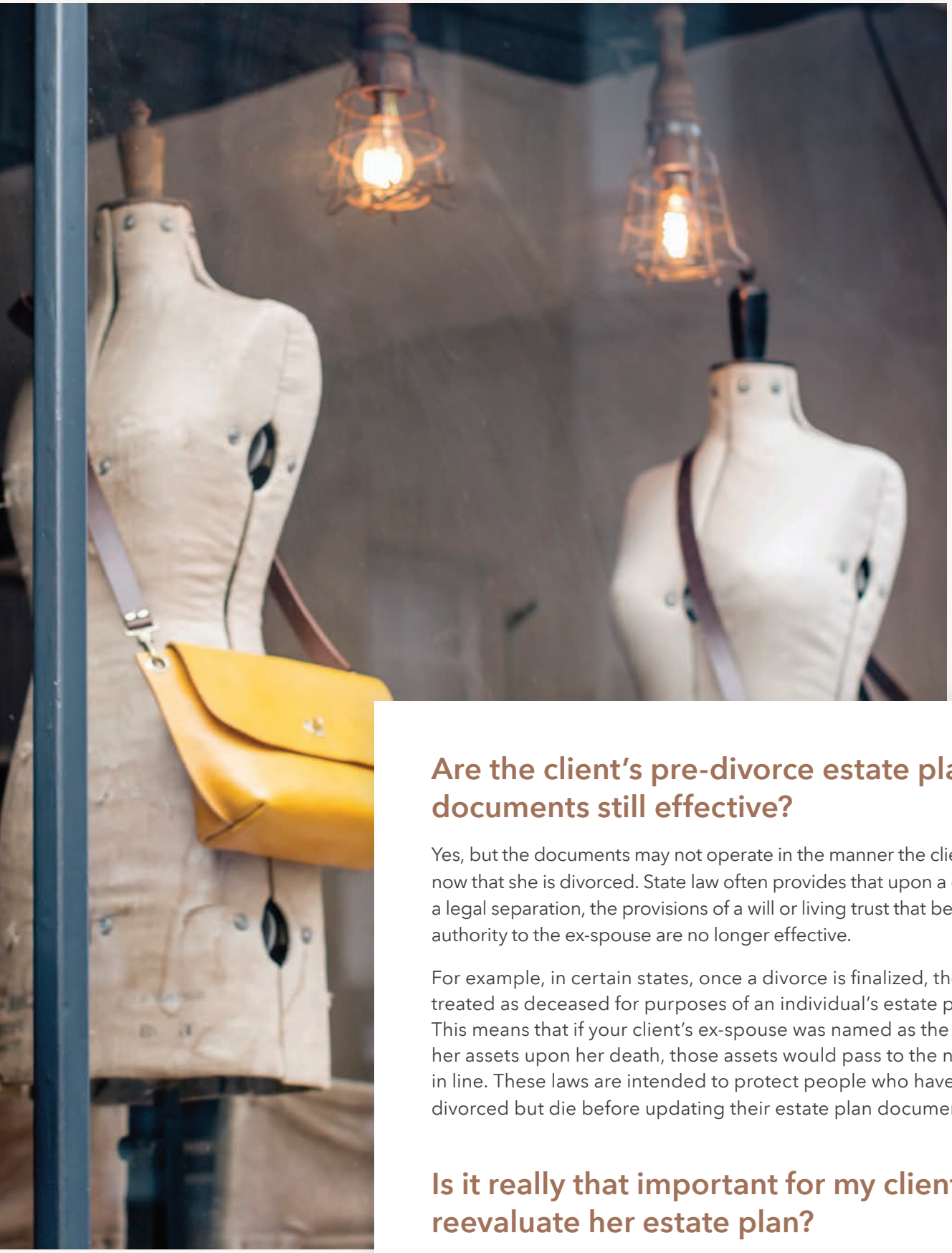
Guiding newly divorced clients through the estate planning essentials

How can I help my client?

It's easy to overlook important estate planning matters that need to be addressed after a divorce settlement is reached. As an advisor, you can help your clients by talking through some time-sensitive considerations to help ensure that they're prepared for their new life and financial situation.

Planning for a new chapter

Once a divorce settlement has been reached or a judgment entered, both parties often feel that their work is done. But there's still a lot left to do to ensure that the terms of the settlement or court order are fulfilled, and to reflect the new life and financial situation of your client. As an advisor, you can help your client by raising some important and time-sensitive considerations she should discuss with her estate planning attorney. The questions on the following pages can help guide your conversation.



Are the client's pre-divorce estate plan documents still effective?

Yes, but the documents may not operate in the manner the client intended now that she is divorced. State law often provides that upon a divorce, or even a legal separation, the provisions of a will or living trust that benefit or give authority to the ex-spouse are no longer effective.

For example, in certain states, once a divorce is finalized, the ex-spouse is treated as deceased for purposes of an individual's estate plan documents. This means that if your client's ex-spouse was named as the beneficiary of her assets upon her death, those assets would pass to the next beneficiary in line. These laws are intended to protect people who have been recently divorced but die before updating their estate plan documents.

Is it really that important for my client to reevaluate her estate plan?

Absolutely. Estate planning attorneys generally recommend reviewing estate plans after any big life event, and divorce certainly falls into that category. Also, the divorce settlement may require the client to make certain bequests upon death, and these obligations need to be documented in the client's will or living trust.

What should my client discuss with her estate planning attorney?

Here are some of the more important considerations:

Guardian provisions

If there are minor children, who is appointed as their successor guardian if both your client and her ex-spouse die? If it's a family member or close friend of the ex-spouse (or your client), an alternate appointment may be worth discussing.

For the benefit of the children, it's best that the divorced couple be on the same page regarding successor guardians. If your client appoints her sister, and her ex-spouse appoints his brother, the court will have to choose between the two – or it could even appoint someone different. This will only result in conflict and uncertainty for the children at a very difficult time.

Executor/trustee

Who should be named as executor/successor trustee? This is a situation-specific decision that depends not only on the relationship between the divorced couple but also on other family dynamics.

Your client is choosing who will manage and dispose of her assets when she dies. If her only beneficiaries are her children with her ex-spouse, she may prefer that her ex-spouse serve as the fiduciary since their interests with respect to their children are likely aligned. If the children are minors, distributions from the trust may be made to the ex-spouse acting in the role of the children's guardian.

However, if the divorce is acrimonious or your client doesn't feel comfortable with the ex-spouse handling her assets, she should consider naming someone she and her children are close with or a corporate trustee.

Beneficiary designations

As soon as possible, your client should update the beneficiary designations for her retirement accounts and life insurance policies. Unfortunately, many of the state laws that automatically revoke an ex-spouse's interest under a will or a living trust upon divorce don't operate the same way with beneficiary designations. That means if your client were to die post-divorce but before removing her ex-spouse as beneficiary for her employer-sponsored 401(k), her ex-spouse could walk away with the contents of that account.

Before changing her beneficiary designations to her children, your client should understand the impact of the SECURE Act on inherited IRAs. With the elimination of the "stretch" inherited IRA for most beneficiaries other than spouses, your client may want to consider alternative planning arrangements or donating her retirement assets to charity when she dies.

Prior irrevocable trust planning

Irrevocable trusts generally cannot be changed or nullified. However, many include provisions allowing for certain limited changes, and certain state laws provide similar flexibility.

It's worth consulting an estate planning attorney to better understand how any trusts created during the marriage can be modified to better suit your client's current situation. This may have already been addressed during the divorce negotiations, but because these types of trusts are not considered as "belonging to" either spouse, they are sometimes overlooked. Some of the specific considerations are:

- Should the trustee and successor trustee appointments be changed? If the ex-spouse's brother is acting as the sole trustee of the trust, for example, your client may want to explore naming an additional or different trustee who is more aligned with her, or at least naming a neutral party.
- Can the distribution provisions be adjusted to reflect changes in the family financial situation stemming from the divorce?
- Are there any other provisions in the trust document that may result in conflict down the road?

What else does my client need to do now that her divorce is finalized?

Depending on her situation, a few key administrative tasks may remain:

Complete asset transfers

Ensure that all transfers of property between your client and her ex-spouse, as required under the divorce agreement or judicial decree, are accomplished as soon as possible. This is important because, although there should be no tax consequences (gift, income or otherwise) from transferring assets pursuant to a divorce settlement, this preferential tax treatment could be compromised if the transfer is not made in a timely manner. Depending on your client's state of residency, the court may prevent the transfer of assets until the divorce is finalized. Your client should ensure that these restrictions have been lifted before making any transfer.

For assets that have a formal title – like real estate, bank and investment accounts, and entity interests – the transfer will be accomplished by changing the title to reflect the new owner. For example, if during the marriage the family home was owned jointly by the couple, but under the divorce agreement it goes to your client, the home should be retitled to reflect your client's sole ownership.

Obtain QDROs for retirement assets

Retirement accounts are often subject to the division of assets under a divorce settlement. Because of the special rules around federal retirement benefits, a division of a pension plan or 401(k) under a divorce agreement is not sufficient. Instead, the judge issues a separate order – a qualified domestic relations order (QDRO) – that requires the plan administrator to assign a portion of the benefits to the employee's former spouse. Because of the administrator's involvement, precision is key in drafting that part of the divorce settlement agreement and the accompanying QDRO. Your client or her divorce attorney may want to consult a local attorney who specializes in QDROs before the divorce settlement is finalized.

In certain states, QDROs are not always issued in conjunction with the divorce settlement, so it's essential that your client confirm that QDROs have been obtained for all of the former couple's federal retirement assets.

At-death obligations

If the divorce agreement includes obligations for your client to make bequests in her will or living trust upon death, she'll need to work with her estate planning attorney to update those documents. If similar obligations apply to her ex-spouse, it's a good idea for her attorney to work together with her ex-spouse's attorney to ensure that these obligations are accurately reflected and fully satisfied under the ex-spouse's estate plan documents.

What tax considerations should my client keep in mind?

With the current lifetime exemption from estate taxes so high, relatively few clients need to worry about paying an estate tax. But this could change after the current amount sunsets at the end of 2025.

Your client should, however, consider the marital deduction: Now that the ex-spouse is not the primary beneficiary of her assets upon death, your client no longer gets the benefit of that deduction. (In a typical marital estate plan, estate tax might not need to be paid until the death of the second spouse.)

Accordingly, if your client has substantial assets, she should talk to her estate planning attorney about her potential estate tax liability and the options for mitigating it. Liquidity will also be a concern if estate taxes are due, so it's important to maintain a pool of assets to satisfy any liabilities.

As far as income taxes go, your client will now be filing as a single person, as opposed to filing jointly with her spouse. This may result in a substantial change to her annual income tax bill going forward, for better or worse. Either way, your client should work with her CPA to understand her post-divorce income tax projections.

For divorces finalized in 2019 or after, at the federal level alimony payments are not deductible by the paying spouse and are not considered income of the recipient spouse. For divorces finalized in 2018 or before, the opposite is true: The paying spouse can take a deduction, and the recipient reflects the payment as income on his return.

State tax law around the tax treatment of alimony varies – in certain states, the federal pre-2019 deductibility still stands – so it's important for the client to consult with a CPA who is well versed in her home state's tax laws.

As a reminder, child support payments are not deductible by the payer and are not considered income to the recipient.

Starting the conversation

Though clients nearing the end of a divorce may not be thrilled at the prospect of more to-dos, they'll appreciate your support. Help your client schedule a meeting soon after the settlement is reached so that time-sensitive items are addressed without delay. Then, by talking through the considerations described in this piece, you can help her turn the page and begin a new chapter with confidence and peace of mind.

Looking for more ways to help clients with tax and estate planning? Contact your Capital Group representative.

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