The Financial and Estate Planning Council of Metropolitan Detroit, Inc.

April 2014

30600 Northwestern Hwy., Suite 208, Farmington Hills, MI 48334 • (248) 538-7654 • FAX: (248) 671-0165

President's Message

As I look out my office window today in late March I still see mounds of snow and snowflakes, but I am hopeful that soon, at least by mid-May they will have melted. I am looking forward, as I trust you are, to spring's eventual arrival and the FEPCMD's 8th annual charity event and membership meeting on May 19th.

This year's charity event will feature a golf outing, under the capable leadership of Brad Kreiner. We are looking for golfers: foursomes, twosomes or even singles, as well as hole sponsors. For you racket enthusiasts, we are introducing a tennis tournament this year led by Bernie Kent. I hope you will join us for one of these two sporting activities.

This fun and frolicsome afternoon will be followed directly by our May membership meeting and dinner at the Wabeek Country Club. The dinner meeting will feature Thomas F. Kendziorski, Executive Director of The Arc of Oakland County, this year's selected charity. The Arc of Oakland County is a non-profit advocacy organization serving children and adults with intellectual and developmental disabilities.

Tom will be speaking on: *"Planning a More Secure Future for Persons with Intellectual Impairment"* focusing on governmental financial benefits, Special Needs Trusts, and Guardianship and other Alternatives. It is a topic that will be of interest to all of us filled with information we should know to properly advise our clients on their financial and estate planning needs.

Please mark your calendar for May 19th and join us. We also have two events planned in the fall you won't want to miss. Our September Spouses' Night event on September 23rd will be held at the DIA and will feature an address from Graham Beall, the DIA director, and a tour of some of the galleries.

On November 18th at the Inn of St. John's in Plymouth, we will feature Boston's Natalie Choate, the IRA guru, for a CPE event and our annual dinner and election meeting. Our CPE in the afternoon will feature the use of insurance products with IRA's and lifetime distribution strategies. Natalie's dinner topic will be "IRA's with Hair." Intriguing, no?

If you would like to be involved in planning these or other FEPCMD events, please give me or any of the Board members a call. I would love to learn more about the interests of our members so that we may be more effective in meeting your needs as a financial and estate planning professional.

Teresa Schafer Sullivan, President

Divorce: A Taxing Situation

Renzo A. Cerabino, JD, MBA, CFP®, CLU, CDFA

Denial … Anger … Bargaining … Depression … Acceptance … and Taxes! The emotional impact of a divorce can be a rollercoaster of emotions stemming from years of accrued personal issues and their corresponding impact on the entire family. However at some point, the "acceptance" of the situation sets in and the economic impact surges to the forefront of the divorcing couple's mind. In the first installment of this analysis, we will examine some of the basics surrounding the tax impact of divorce on the marital residence, retirement planning and spousal and child support.

Brenda and Eddie

In order to apply the sometimes dense code sections, let's

Divorce: A Taxing Situation - continued on page 4

WELCOME TO OUR NEW MEMBERS

PATRICIA BOJANIC, CPA
Gordon Advisors
Sponsors: Hannah Thoms and Robert Labe

HOWARD L. MARGOLIS, CFP ®, CTFA
CIG Corp.
Sponsors: Molly Wilson, Brian Simmons and Steve Moore

MARC R. SCHECHTER, CLU
Schechter Wealth
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FINANCIAL AND ESTATE PLANNING COUNCIL OF METROPOLITAN DETROIT

8th ANNUAL CHARITY GOLF/TENNIS OUTING

Net Proceeds and Additional Contributions
to Benefit The Arc Oakland County

The Arc. Oakland County
Serving persons with intellectual and developmental disabilities since 1967

Donate
SECURELY ONLINE

MONDAY, MAY 19, 2014

Golf:

Wabeek Country Club
4000 Clubgate Drive,
Bloomfield Hills, MI 48302
http://www.wabeekcc.org/
(248) 855-0700

11:15 AM REGISTRATION /11:45 AM: BOX LUNCH/
SHOTGUN START 12:00 PM

18 HOLES OF GOLF WITH A CART/DRIVING RANGE
WARM-UP/UNLIMITED COURSE BEVERAGES

4-PERSON SCRAMBLE (INCLUDES DINNER)
$150 PER GOLFER
(SINGLE GOLFERS ARE WELCOME)

$600 PER FOURSOME

$700 FOR A FOURSOME AND A HOLE SPONSOR

$150 HOLE SPONSOR ONLY

Tennis:

Detroit Tennis and Squash Club
31031 Drake Road
Farmington Hills, MI 48331
http://www.detroittennis.com/
(248) 661-2300

$100 TENNIS AND DINNER
(includes court time and beverages)
Showers and Lockers Available

1:00 PM Warm Up
2:00PM Round Robin Doubles Tournament
(individual sign up - no teams)

5:30 PM COCKTAILS
6:30 PM MEETING & GUEST SPEAKER
7:30 PM DINNER
($60.00 COCKTAILS & DINNER ONLY)

Log onto our website by May 12 to make your reservation and pay with VISA or Master Card. www.metrodetroitfepc.org

OR PLEASE MAIL YOUR RESERVATION AND CHECK BY MAY 12 TO: FEPCMD • 30600 Northwestern Hwy-#208 • Farmington Hills, MI 48334 Phone: (248) 538-7654 • Fax: (248) 671-0165

Golf Registration:

GROUP NAME:________________________ GROUP CONTACT INFO:________________________

PLAYER #1 ________________________
PLAYER #2 ________________________
PLAYER #3 ________________________
PLAYER #4 ________________________

☐YES I WANT TO SPONSOR A HOLE ☐ PAYMENT ENCLOSED:____________

Tennis Registration:

Name:________________________ Contact Info:________________________

☐PAYMENT ENCLOSED:____________

FINANCIAL AND ESTATE PLANNING COUNCIL OF METROPOLITAN DETROIT

MEMBER MEETING PRECEDED BY THE 8th ANNUAL GOLF & TENNIS OUTING

(Please refer to the additional Golf & Tennis Outing Notice)

MONDAY, MAY 19, 2014

Wabeek Country Club
4000 Clubgate Drive, Bloomfield Hills, MI 48302

Thomas F. Kendziorski, JD
Representing The Arc of Oakland County

"Planning A More Secure Future for Persons with Intellectual Impairment"

Presentation Highlights: Governmental financial benefits, special needs trusts and guardianship and the alternatives

The Arc of Oakland County is a non-profit advocacy organization serving children and adults with intellectual and developmental disabilities. Over the past 32 years, Thomas F. Kendziorski has served The Arc as a staff attorney and since 1992 in the capacity as its Executive Director. During that time he has authored thirty issues of The Arc Michigan's annual Income Tax Guide, and the revised 4th edition of its "Planning A More Secure Future", a booklet on wills, trusts, estate planning, governmental financial benefits, along with instruction on guardianship and the alternatives. For twelve years, Mr. Kendziorski was a visiting lecturer for the Department of Special Education at Eastern Michigan University, teaching a graduate course on special education law and public policy. He also served eight years as the parliamentarian for The Arc of the United States.

Mr. Kendziorski knows first-hand the requirements and concerns of families having a member with special needs; he has three brothers with an intellectual impairment and serves as legal guardian for each. He is a member of both the Michigan and Federal District Court bar, receiving his law degree in 1982 from Cooley Law School in Lansing. He earned a bachelor's in political science from Michigan State University in 1979. He is a Vietnam veteran and retired at the rank of Rear Admiral (lower half) in 2010 from the U.S. Navy (reserve component) after 38 years of service. Tom has run seven Chicago Marathons and six consecutive Brooksie's Way half-marathons – raising over $175,000 for The Arc.

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- U.S. Trust

AGENDA:		
	5:30 p.m.	Complimentary Cocktails
	6:30 p.m.	Presentation
	7:30 p.m.	Dinner

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Log onto our website by May 12, 2014 to make your reservation and pay with VISA or Master Card.
www.metrodetroitfepc.org

RESERVATIONS RECEIVED AFTER MAY 12 WILL COST $85.00 PER PERSON.

OR PLEASE MAIL YOUR RESERVATION AND CHECK BY MAY 12, 2014 TO: **COST: $60.00 PER PERSON**
FEPCMD ● 30600 Northwestern Hwy-#208 ● Farmington Hills, MI 48334
Phone: (248) 538-7654 ● Fax: (248) 671-0165
MEMBER NAME: ______________________ **GUEST NAME:** ______________________

TOTAL ENCLOSED: ______________________
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embark on our journey with the hypothetical divorcing couple, Brenda and Eddie. (Yes, I am a Billy Joel fan. And given the fact that they have "had it already" I don't feel bad about impacting their mythical lives for the next 2,500 words or so.) While I will alter and add facts during this discussion, let's assume that Brenda and Eddie have been married for 15 years and have two children ages 5 and 10. They live in a lovely colonial home in Pennsylvania. Both are 50 years old, gainfully employed and earning equal and high salaries.

Transfers Incident to a Divorce

Before discussing our couple any further, let's begin with the fundamental premise that transfers incident to a divorce are generally exempt from tax. Internal Revenue Code ("IRC") § 1041 (a) states that "[n]o gain or loss shall be recognized on a transfer of property from an individual to (or in trust for the benefit of) … a former spouse, but only if the transfer is incident to the divorce." The definition of "incident to the divorce" is found under IRC § 1041(c) and expanded upon in Treas. Reg § 1.1041-1T. They state that a transfer is incident to a divorce when it occurs within one year after the divorce or the transfer is pursuant to a divorce decree <u>and</u> the transfer occurs not more than six years after the divorce. IRC § 1041(b) treats these transfers as a gift and therefore the transferee takes the transferor's basis.

The Marital Residence

The ongoing ownership of the marital residence (and the associated tax consequences) is often the center of heated negotiation. And that was the case with Brenda and Eddie. Eddie very much wanted to keep the residence but ultimately realized it needed to be sold to provide cash for both of them. In order to give Eddie some time to find a new place as well as to adjust psychologically, they agreed to give Eddie use of the marital residence for 5 years under the divorce decree. After the 5 year period the home would be sold. They both agreed to retain ownership until that time. The house was in fact sold 5 years later for $2,500,000. Eddie promptly (but hot happily) sends Brenda a check for $1,250,000. Let's assume the sales price is all gain.

In the situation of a transfer or sale of the marital residence, IRC § 1041 must be read in conjunction with IRC § 121(a). IRC § 121(a) provides the often discussed exclusion from income of $250,000 of gain for an individual and $500,000 for a married couple. "Gross income shall not include gain from the <u>sale or exchange</u> of property if, during the <u>5-year period ending on the date of the sale or exchange</u>, such property has been owned and used by the taxpayer as <u>the taxpayer's principal residence</u> for periods <u>aggregating 2 years or more</u>." (Emphasis added). IRC § 121(b)(1) then limits this exclusion to $250,000. IRC § 121(b)(2)(A) then expands this amount to $500,000 for those filing joint returns if either spouse or both spouses meets the 121(a) test <u>and neither</u> spouse is deemed ineligible provided there has been only one sale or exchange over the past 2 years under 121(b)(3). If only one spouse meets both the ownership and use requirement, the couple may exclude only up to $250,000 of gain.

In the case of a divorce, IRC §121(d)(3)(A), allows an individual holding a residence transferred incident to a divorce to include the period the spouse or former spouse owned it. In addition, IRC §121(d)(3)(B) provides that a divorced individual is treated as using property as his/her principal residence during any period of ownership while his spouse or former spouse is granted use of the residence under a divorce or separation instrument.

So how does all this play out for Brenda and Eddie in our example? Eddie lived there for the last 5 years so he meets the 2 of the last 5 years test and can exclude $250,000 of the gain under IRC § 121(a). For Brenda, it may initially appear that she is out of luck and must recognize the gain. However as noted above, under IRC §121(d)(3)(B), Brenda is treated as using the property as her principal residence during Eddie's ownership because he was granted use of the residence under a divorce or separation instrument. As a result, she can exclude $250,000 of the gain as well.

A special note of caution applies if the marital residence was (a) rental property that became the primary residence, (b) rental property acquired by 1031 exchange that became the primary residence or (c) the primary residence is later transformed into rental property. Those situations can be very complex and outside the scope of this article. However recall that IRC § 1041(b) states that transfers incident to a divorce are treated as gift and that the transferee takes transferor's basis. In the case of the marital residence that means that you take the residence "as is" from a tax perspective. Those receiving the marital residence incident to a divorce should consider the tax impact not only when retaining the marital residence but especially under the above noted circumstances.

Retirement Plans

Let's rejoin Brenda and Eddie (the former king and the queen of the prom) and take a look at their property settlement. As mentioned above they are of equal age and equal high wage earners. In light of this balance they have agreed to split their retirement assets equally. While acknowledging that equal distributions are not always fair distributions, they agree that it works in this case. Brenda worked for a large corporation and was fortunate enough to have accumulated an interest in a pension. The pension was earned completely during the marriage and will pay $10,000 a month when Brenda retires at age 67. Eddie also worked for a large corporation and has amassed $1,000,000 in a 401(k) plan which was also earned completely during the marriage. Eddie accumulated an additional $500,000 in a rollover IRA from a previous employer also earned during the marriage. They understand that these assets are treated differently depending on whether they are covered by Employee Retirement Income Security Act of 1974 (ERISA). Let's discuss each one in turn.

The pension plan is a type of defined benefit account and covered by ERISA. In this arrangement, the employer promises to pay a certain amount (monthly, annually, quarterly) upon retirement. The employee's value is not derived from an account balance but from the formula deriving the benefits. The benefit may be a function of years of service and average salary for example. The actuary working with the plan will calculate the benefit as of the date of the divorce filing. Each spouse is entitled to the court ordered or agreed upon percentage.

So how can Brenda and Eddie share in the pension equally? There are three main ways. First is a present value or cash out method where the non-employee spouse is paid a lump sum settlement from the pension or receives a marital asset of equal value. Second is a deferred division where each spouse is awarded a share of the benefits when paid. Third is known as reserved jurisdiction where the court and the parties agree to revisit the issue. As this method simply defers the issue it is generally the least desirable.

Eddie's 401(k) plan is covered by ERISA, however it is a type of defined contribution plan. In a defined contribution plan, the employer sets up a separate account for each employee which is invested at the direction of the employee. The balance is based on the contributions (from both employer and employee) plus earnings. Stated another way, the cash value is equal to the fair market value of the holdings. Typically, the fair market value is set as of the date of the divorce filing and each spouse is entitled to the court ordered or agreed upon percentage. How can this be split equally? Eddie can simply transfer ½ of the value plus any earnings or losses as of the divorce filings into to a separate account in Brenda's name.

Mechanically, the Retirement Equity Act of 1984 requires that division of ERISA accounts must be done through a qualified domestic relations order ("QDRO"). The requirements of a QDRO are listed in IRC § 414(p)(2). Of particular interest is subsection (B) which provides that a QDRO must include "the amount or percentage of the participant's benefits to be paid by the plan to each such alternate payee, or the manner in which such amount or percentage is to be determined." In order to be "qualified" a QDRO must be approved by the pension plan administrator.

Again, IRC § 1041 governs and provides that the transfer of a spouse's interest in a retirement plan incident to a division of marital property is not a taxable event. The amounts withdrawn from these accounts that are not early distributions are generally subject to tax at ordinary income rates. The interesting questions come into play under IRC § 72(t) which applies a 10-percent additional tax on certain early distributions from qualified retirement plans. Notable exceptions for the purposes of this discussion are those distributions made on or after the date on which the employee attains age 59 1/2 and made to an employee after separation from service after attainment of age 55. In addition, "[a] ny distribution to an alternate payee pursuant to a qualified domestic relations order" are also excluded from the 10% penalty. This means that any distributions made pursuant to a QDRO may avoid the 10% penalty. However note that the amounts are still subject to income tax. Caution should be exercised not to transfer the assets into an Individual Retirement Account ("IRA") account and then try to invoke this exception to the penalty. As noted above, the distribution must be pursuant to a QDRO to avoid the penalty. IRAs are not qualified plans under ERISA so no QDRO is required to transfer the assets.

With respect to the transfer of IRA's, while many companies have their own forms a court order can be used to transfer the funds. In general there are two methods of division. One is to simply change the owners name on the IRA account. This works when 100% of the IRA is being transferred. The other is a trustee-to-trustee transfer. In this method the IRA owner directs the IRA trustee to transfer the IRA assets to the trustee of the new or existing IRA set up in the name of the recipient spouse. Therefore, Brenda can simply open her own IRA and direct the trustee to transfer her half.

Note that the Unemployment Compensation Amendment of 1992 ("UCA") requires a 20% mandatory withholding on an eligible rollover distribution that the participant does not elect to have paid to another retirement plan in a direct rollover. However, the UCA does not apply in the case of IRAs and so they are not subject to the 20% mandatory withholding tax that applies to distributions from qualified retirement plans.

The most challenging part of retirement plans can be the relative “value” to each spouse. While these accounts are tax deferred they are subject to the above discussed penalties and so can be of less value depending on the age of the recipient spouse. Consider the case of a 35 year old spouse who opts to receive all of the retirement account but does not receive any cash in the settlement. Unless s/he has ample income the “value” of these account may be limited as s/he cannot access them without penalty for 24 ½ years. Careful evaluation of the marital assets is necessary to access the true value to the parties. Thankfully, Brenda and Eddie get along very well and have equal assets.

Spousal and Child Support

(NOTE: This article references Pennsylvania law)

When Brenda and Eddie both accepted that they were going to split, they decided they would drive around with the car top down and the radio on and discuss the child and spousal and support situation.

With regard to child support, they agreed to apply the statewide guidelines under 23 Pa.C.S.A. § 4322(a). Section (b) provides for a rebuttable presumption, in any judicial or expedited process, that the amount of the award which would result from the application of such guideline is the correct amount of support to be awarded. A written finding or specific finding on the record that the application of the guideline would be unjust or inappropriate in a particular case shall be sufficient to rebut the presumption in that case, provided that the finding is based upon criteria established by the Supreme Court by general rule. The amount and the obligor’s share are determined under 231 Pa. Code Rule 1910.16-3 and 16-4. The amount available for support generally begins with Gross Income Per 1040, then adding back voluntary deductions (e.g.. 401(k)) and less taxes paid. There may be other adjustments such as non cash pass through income or non taxable cash income. As a result of the potential complexity Brenda and Eddie defer to the court for this calculation and agree to accept the outcome.

From a tax perspective, child support payments are neither deductible by the payer nor taxable to the payee. In contrast, IRC § 71 provides that gross income includes amounts received as alimony or separate maintenance payments. However, payments are deductible by the payor. Therefore, all things being equal the payor prefers payments to be considered alimony and the recipient child support. Things are nearly never equal and so discussions around the effective tax rates of the payor and the recipient abound.

In the case of Brenda and Eddie, they had a detailed conversation around spousal support. While they decided to split amicably, Brenda thought that nobody looked any finer or was more of a hit at the parkway diner than she could be after the divorce. In short Brenda thought she would like to sow some wild oats. For that to occur, Brenda feels she needs a sports car and an extensive travel budget. Although somewhat taken aback, Eddie understands and is willing to be supportive. They agree to a front loaded alimony structure to provide for three years of fun and travel. Eddie agrees to pay spousal support as follows: Year 1: $100,000, Year 2: $85,000 and Year 3: $10,000.

The IRS knows all too well that it is in the payor’s best interest to pay spousal support as quickly as possible to realize the deductions as quickly as possible. As a result, the IRS has developed a formula under IRC § 71(f) to determine when there is excess front-loading of alimony payments thereby disallowing the deduction. In general, if there are excess alimony payments (a) the payor spouse shall include the amount of such excess payments in gross income for the payor spouse’s taxable year beginning in the 3rd post-separation year, and (b) the payee spouse shall be allowed a deduction in computing adjusted gross income for the amount of such excess payments for the payee’s taxable year beginning in the 3rd post-separation year.

IRC § 71(f)(2) defines excess alimony payments as the sum of the overpayments of the first two years of payments. The excess payment of year one is the amount of the alimony or separate maintenance payments paid by the payor spouse during the 1st post-separation year, over (B) the sum of— (i) the average of— (I) the alimony or separate maintenance payments paid by the payor spouse during the 2nd post-separation year, reduced by the excess payments for the 2nd post-separation year, and (II) the alimony or separate maintenance payments paid by the payor spouse during the 3rd post-separation year, plus (ii) $15,000. The second year is defined as the amount of the alimony or separate maintenance payments paid by the payor spouse during the 2nd post-separation year, over (B) the sum of— (i) the amount of the alimony or separate maintenance payments paid by the payor spouse during the 3rd post-separation year, plus (ii) $15,000.

So how does Brenda and Eddie’s solution fare? Applying IRC § 71(f)(2) yields a year 1 recapture of $60,000 and a year 2 recapture of $27,500. As a result Eddie must include $87,500 of the alimony payments in the third year and Brenda will be disallowed a deduction of $87,500 in the third year. Not at all the outcome the parties expected.

Although not the case with Brenda and Eddie, there is sometimes a temptation to try convert child support into deductible spousal support. The IRS is aware of this and has created contingency rules. Under the current rules, if any support amount is reduced upon (a) the happening of a contingency specified in the instrument relating to a child (such as attaining a specified age, marrying, dying, leaving school, or a similar contingency), or (b) at a time which can clearly be associated with a contingency relating to child then IRC § 71(c)(2) provides that an amount equal to the amount of such reduction will be treated as an amount fixed as payable for the support of children of the payor spouse.

Situation (b) above provides two matters for consideration, the six month rule and the multiple reductions rule. Under the six month rule, any reduction will be considered a contingency when payments are to be reduced not more than six months before or after the date the child is to attain the age of 18, 21 or the local age of majority. Under the multiple reductions rule, any reduction will be considered a contingency when payments are reduced on two or more occasions, which occur not more than one year before or after a different child of the payor spouse attains a certain age between the ages of 18 and 24 inclusive. Consequently, if payments are reduced at similar times for two children, the reductions are presumed to be clearly associated with a child.

Conclusion:

The impact of taxes on divorce has far reaching implications when considering settlement proposals and personal post divorce planning. Due to the breadth and scope of this topic, it truly takes a village to fully understand and craft a settlement or plan for one's post divorce future. This involves a full team and a comprehensive plan.

At a minimum, the advisory team should include an attorney, financial professional and an accountant. Other professionals may include the family office, a banker or a trustee. Involving the entire team early will bring the best ideas to bear and also show the client that each is willing to present their ideas and become subject to the review of the other team members. However, I would (as I have in the past) like to present a word of caution. The client will probably look around the room and perform a mental calculation of the fees he or she is being charged before any plan is implemented or any documents are drafted. In order to counteract this objection, the client will need to feel that the advice is cost effective. It is therefore critical for each advisory team member to discuss fee matters with the client and if appropriate set a cap on certain aspects of the planning.

If this occurs, we can be far more confident that Brenda and Eddie will get a divorce as a matter of course and part the closest of friends. In the next installment we shall consider selected pre and post divorce estate planning matters.

Renzo A. Cerabino, JD, MBA, CFP®, CLU, CDFA is a Vice President in First Niagara Bank's Private Client Services Group. He earned his JD and MBA from Villanova University and his bachelor's degree in Industrial and Labor Relations from Cornell University. The opinions expressed are solely those of the author and do not represent the opinions of First Niagara Bank or any of its subsidiaries or affiliates. The opinions contained herein are not intended as tax or legal advice and may not be relied upon in any manner by the reader. The hypothetical situations and their discussed solutions are likewise for discussion purposes only and do not represent actual persons. They are also not intended as tax or legal advice and may not be relied upon in any manner by the reader as actual situations are unique and require professional advice.

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