

Divorce and life insurance

In brief

INTRODUCTION

- In a divorce, property is divided between the spouses. In addition, a divorce decree may require that one spouse pay alimony (also known as maintenance) and/or child support.
- Generally, all assets of the spouses, whether individual, joint, or community, are subject to division, with the starting point being a 50/50 division of their property. In most states, however, property received as a gift or inheritance can generally be excluded from this pool of assets.
- An agreement signed before marriage, known as a prenuptial, antenuptial, or premarital agreement, may override the starting point of a 50/50 division of assets. In addition, in some states, a marital agreement (one signed during the marriage) may impact how assets are divided.
- Life insurance often plays a key role in a divorce.
 - Life insurance can help equalize property distribution. A divorce decree could require that one former spouse own life insurance insuring the life of the other former spouse; in this case, insurable interest exists.
 - Life insurance can be used to protect the loss of alimony payments. A divorce decree could require that an insured former spouse name the other former spouse as the beneficiary of life insurance that's owned by the insured. Alternatively, a divorce decree could require that the insured former spouse pay the premiums on life insurance owned by the other former spouse.
 - Life insurance can be used to protect the loss of child support payments. A divorce decree could require that the children or a trust for the benefit of the children be named as beneficiaries of life insurance.

POLICY CONSIDERATIONS

A divorce decree should specify who is to be the owner, beneficiary, and payor of a life insurance policy.

Ownership

- If the divorce decree is already final, simply comply with the decree.
- If the divorce decree is not yet final, consider:
 - Who should be the owner? Possibilities include the insured, the former spouse, or a trust.
 - Will there be a change of ownership upon a future event, such as remarriage or a beneficiary reaching the age of majority?
 - Will there be any restrictions on access to the policy cash (loans, dividends in cash, full surrender, partial surrender, exercise of settlement options, etc.)?

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- Insurance companies are generally allowed to release information regarding a policy only to the policy owner. If the policy owner has consented in writing to the release of information to a former spouse, the insurance company will be able to provide policy information to the former spouse.

Premium payments

- Consider who will pay premiums. Should proof of payment be provided to a former spouse?
- A divorce decree can require that one former spouse pay the premiums on a policy owned by the other spouse. As long as the payor is not required to pay premiums after the policy owner's death, this payment is treated as alimony. Internal Revenue Code (I.R.C.) § 71(b)(1)(D) and Treasury Regulation (Treas. Reg.) § 1.71-1T, Q&A 6.
- For divorces finalized before December 31, 2018, the payment of alimony is income tax deductible, and the receipt of alimony is income taxable. Also, the fact that the divorce decree requires one former spouse to pay a third party on behalf of the other former spouse does not prevent the payment from being treated as alimony, as long as all other alimony qualifications are met. I.R.C. §§ 71 and 215; Treas. Reg. § 1.71-1T.
- For divorces finalized on or after January 1, 2019, the payment of alimony is no longer deductible, and the receipt of alimony is tax-free.

Example: Former spouse, A, owns a policy; the identity of the insured is irrelevant. The divorce decree requires that former spouse, B, pay the annual premium of \$5,000 on this policy. Assuming that all alimony qualifications are met, the \$5,000 paid by B to A is alimony. If the divorce decree was finalized before December 31, 2018, the payment is income tax deductible to B and taxable income to A. If finalized on or after January 1, 2019, there is no tax effect.

Beneficiary designations

- Consider who will be beneficiary.
 - If the beneficiary designation simply reads, "children until majority," what happens when one child reaches majority and another has not yet?
 - Does the minor have to be named as beneficiary of entire policy?
 - If children are to be beneficiaries, consider having the divorce decree include "children or a trust for their benefit" in order to create the opportunity for flexible planning.
 - Will the beneficiary designation be irrevocable? If not, should proof of the designation be provided to the former spouse?
- The divorce decree may address who should be the beneficiary of any policies. There are a number of possible named beneficiaries, including, but not limited to, the former spouse, the children, or a trust for the former spouse and/or children, or a combination. The divorce decree may also require that the designation be irrevocable.
- The insurance company generally will pay a death benefit only to the person listed as the beneficiary on the insurance company's records, regardless of the policy owner's intent to name a different beneficiary and regardless of the divorce decree. However, state law may revoke a spousal beneficiary designation upon divorce. For this reason, questions regarding appropriate insurance beneficiary terms for any agreement dividing assets acquired before, during, or after the marriage should be discussed with the policy owner's personal attorney who will be familiar with the applicable laws in the state in which the agreement is drafted.
- As a best practice, estate planning should be revisited during and after the divorce. It is important that beneficiary designations be updated to ensure the policy owner's intent is fulfilled.

POLICY OWNED BY AN IRREVOCABLE TRUST

- If a policy is owned by an irrevocable trust at the time of the divorce, this policy generally should not be subject to the division since it is not owned by either spouse (that is, remains owned by the trust).
- Similarly, the beneficiary designation of a policy in an irrevocable trust at the time of the divorce should not be the subject of a divorce decree.
- Nonetheless, a divorce decree could require that one or both former spouses continue to pay premiums on a life insurance policy owned by an irrevocable trust.
- Often, an irrevocable trust provides that a spouse who is a trustee or trust beneficiary will cease being so upon becoming a former spouse. If the trust document does not address the divorce situation, then state law might provide a course of action to obtain these results.

INCOME TAX

- There is no gain or loss recognized when transferring property:
 - To a spouse or a trust for the benefit of a spouse. I.R.C. § 1041.
 - To a former spouse or a trust for the benefit of a former spouse where the transfer is incident to divorce. A transfer is incident to divorce if it:
 - Occurs within one year after the termination of the marriage, or
 - Is related to the termination of marriage.
A transfer which occurs more than six years after the termination of the marriage is presumed not related to the termination. I.R.C. §§ 1041(a)(2) and 1041(c); Temporary Treas. Reg. § 1.1041-1T(b), Q&A-7.
 - This non-recognition rule also applies to life insurance, regardless of whether: it is individually or jointly owned; its value is more than, equal to, or less than basis; or there is a policy loan greater than basis. Temporary Treas. Reg. § 1.1041-1T(d), Q&A-11 & 12.
 - The non-recognition rule does not apply, however, if an encumbered asset with a liability more than basis is transferred **to a trust** for the benefit of a spouse or a former spouse. I.R.C. § 1041(e). When life insurance with a loan greater than basis is transferred to a trust, this generally will result in taxable income and a triggering of the "transfer for value" rule. I.R.C. §§ 101 and 1001.
Example: Former spouse, A, owns a policy on A's life. Pursuant to a divorce decree, A is required to transfer ownership of the policy **to a trust** for former spouse, B. The particulars of the policy are: gross value = \$75,000; policy loan = \$50,000; and the policy's basis = \$30,000. The result is A has \$20,000 of taxable income (the loan of \$50,000 less basis of \$30,000). The trust has a new basis of \$50,000. Also, this is a transfer for value; upon A's death, the death benefit less the basis at that time is taxable income, unless an exception exists, such as the trust (transferee) being a partner of the A (the insured).
- The death benefit is income tax free unless a transfer for value occurs. I.R.C. § 101(a). This result does not change if the policy is the subject of a divorce decree.
- If no gain or loss is recognized on the transfer, the transferor's basis carries over to the new owner. The transferor must provide information or records regarding the basis to the new owner. I.R.C. § 1041; Temporary Treas. Reg. § 1.1041-1T(e), Q&A 14. Carry over basis is an exception to the transfer for value rule. I.R.C.

§ 101(a)(2)(A). Additionally, a transfer of a life insurance policy to a former spouse incident to divorce is not a reportable policy sale. I.R.C. § 101(a)(3)(b); Treas. Reg. § 1.101-1(d)(1).

- Many insurance companies will exchange second-to-die policies for two single life policies (one on each former spouse). Often this is done without additional underwriting, but not always. Either way, this does not qualify as a tax-free § 1035 exchange. The owner of the second-to-die policy (e.g., an irrevocable trust) reports any gain as taxable income.

GIFT TAX

- Generally, transfers pursuant to a divorce decree are not gifts because they are for full and adequate consideration. See Revenue Ruling (Rev. Rul.) 68-379, 1968-2 C.B. 414.
- Transfers under certain written property settlement agreements are not gifts for gift tax purposes. I.R.C. § 2516; Treas. Reg. § 25.2516-1.
 - The transfer must be for settlement of marital or property rights, or to provide for support of a minor child of the marriage.
 - The final divorce decree must occur within one year before the property settlement agreement or within two years after the agreement.
 - It is irrelevant whether the agreement is approved by a divorce decree.
- If the policy owner is not the insured, then the owner should also be the beneficiary. Otherwise, if the beneficiary is someone other than the policy owner, then upon the insured's death, the policy owner would be making a gift of the death benefit amount to the beneficiary. If this death benefit is more than the policy owner's annual exclusion amount and lifetime gift tax exemption, the policy owner will owe gift tax.
- A life insurance policy, as well as funds to pay for the premiums, can be transferred to an irrevocable trust. These transfers are considered transfers to the trust beneficiaries. If the trust beneficiaries are the former spouse and/or minor children of the marriage, any portion for amounts falling within I.R.C. § 2516 will not be a gift for gift tax purposes. Any excess will be a gift. Any portion of the transfers for other trust beneficiaries will also be a gift.

ESTATE TAX

- The death benefit of a policy owned by an insured is in the owner's gross estate. I.R.C § 2042.
 - If the divorce decree requires that the policy owner name the former spouse as the beneficiary, then the amount of the death benefit paid to the former spouse is deductible as a debt or claim. Rev. Rul. 76-113, 1976-1 C.B. 276.
 - If the divorce decree requires the policy owner to name the children as the beneficiaries, then the amount paid to the children that is within the state support requirements or is for full and adequate consideration is deductible as a debt or claim. Rev. Rul. 78-379, 1978-2 C.B. 238. Amounts not meeting these requirements are not deductible.
- One former spouse could be required to transfer a policy on his or her life to the other former spouse. If the insured then dies within three years:
 - There is no estate inclusion if it is not treated as a gift under I.R.C § 2516.
 - If the requirements of I.R.C § 2516 are not met, the transfer is treated as a gift to the extent the consideration was below the policy's value; some estate inclusion will result.

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