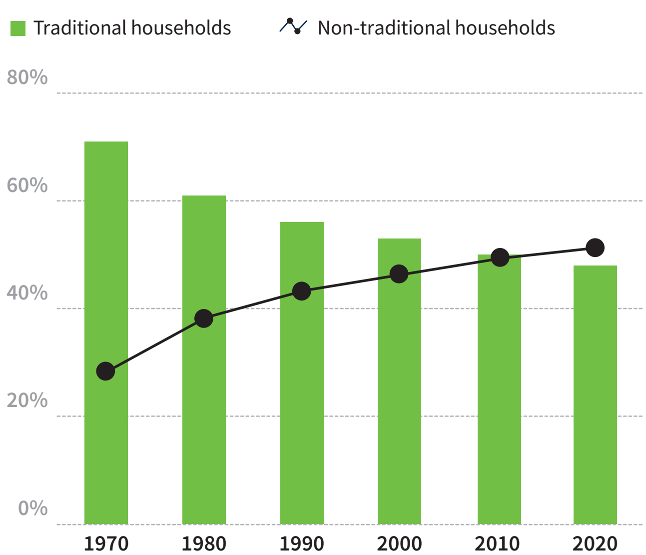
Unique financial planning challenges face growing ranks of non-traditional households

An increasing number of households are headed by divorced and single individuals, or unmarried couples. These "non-traditional" households may face unique financial planning challenges as marital status today plays a prominent role in the rules that apply to financial matters.

According to the U.S. Census Bureau, in 2020 married couples made up 48% of U.S. households, down from 71% in 1970. Over this same time frame, non-traditional households increased from just 29% in 1970 to 53% today.

Traditional households (defined as headed by married couples) are on the decline while non-traditional households are increasing



Traditional and non-traditional households as a percentage of U.S. total population.

Source: U.S. Census Bureau, America's Families & Living Arrangements, November 2022. (The chart above is showing every 10 years. More recent data is available.)

Challenges facing non-traditional households

Non-traditional households include non-married couples and divorced or single individuals. The challenges facing these investors are unique because many rules involving retirement, insurance, income taxes, and estate taxes differ because of marital status. Most often, a traditional married status provides automatic protection in the areas of legal and property rights, medical decision-making, and wealth transfer. But non-traditional households are not entitled to the same provisions. For example, unmarried couples cannot take advantage of unlimited gifts between each other, or the unlimited estate tax marital deduction afforded to spouses. There are also certain tax and retirement-related disadvantages that affect non-married adults.

Single-income households also have specific planning needs. It can be more challenging to save and plan for retirement when it is likely there will be only one income and no other source of support to fall back on. For the single-income household, there may be increased financial risks.

There are many planning strategies, however, that may be used to deal with varying limitations or exclusions associated with the rules governing financial planning vehicles. Investors may want to explore different planning strategies, depending on their household status, and seek out expert advice. These investors should consider working with advisors who are well informed about the unique needs of non-traditional households and are able to provide specific planning guidance. To best identify specific needs and circumstances, it is important to work closely with a financial advisor, tax professional, and estate planning attorney.

Unmarried "partner households" on the rise

Unmarried "partner households" — now totaling 8 million — have risen rapidly over the past decade, the U.S. Census reports. While they may face a range of restrictions and limitations in financial planning, there are numerous strategies available. The following are some specific planning considerations and strategies related to the key financial planning areas of retirement, insurance, income taxes, and estate and wealth transfer.

RETIREMENT

Beneficiary designations are critical. Unmarried partners cannot take advantage of spousal default on retirement plans. A beneficiary designation avoids the probate process that would generally not consider non-married partners as heirs if no will exists.

The lack of Social Security survivor benefits for unmarried partners may have to be factored into income plan projections. Also, many defined-benefit pension plans will not provide automatic benefits to a non-spouse partner.

Limitations on IRA accounts. The opportunity for a spousal beneficiary to transfer ownership of an inherited IRA into their name does not extend to a non-spouse beneficiary. This may prevent a non-spouse beneficiary from delaying or reducing required minimum distributions after the death of the account owner. Additionally, unlike spousal beneficiaries, many non-spouse beneficiaries are not able to "stretch" IRA distributions based on their remaining life expectancy.

INSURANCE

Adequate life insurance is critical. This is important particularly if one partner is financially dependent on the other.

Consideration of an irrevocable life insurance trust (ILIT). This can be helpful since the unlimited marital deduction for estate tax purposes does not apply to an unmarried surviving partner.

Special considerations for health insurance. In some cases, employer-provided health insurance may be taxable if provided to a "non-family" member. Additionally, a partner who loses their job may also need to consider that COBRA benefits are only eligible for "qualified" beneficiaries such as employee's spouse, former spouse, or dependent child.

INCOME TAXES

Income tax issues. There may be income tax filing-related issues such as who gets to claim certain deductions, but there may also be an opportunity to shift taxable assets to the partner in the lower tax bracket.

It may make sense to **establish a separate paper trail** between partners — for example, separate bank accounts to record each partner's "basis" for tax purposes on property.

ESTATE AND WEALTH TRANSFER

No unlimited marital deduction for estate tax purposes. For large estates, planning for liquidity upon the death of the first partner is even more critical.

Gift taxes may apply on transfer of assets. For example, adding a partner to a real estate deed may result in an (unintended) taxable gift, as utilizing a split gift strategy is not available.

Lack of automatic legal protections and privileges for unmarried couples. Legal documents and asset ownership decisions become even more essential for unmarried couples. These include health care proxy/directives, durable power of attorney, wills, trusts, etc.

Consider a revocable trust. These trusts may provide a "cleaner" method of transferring assets at death. Simple wills may be challenged by other family members during the probate process.

Consider establishing a Domestic Partnership Agreement. This agreement can specify division of assets in the absence of legal divorce proceedings and Qualified Domestic Relations Orders (QDROs) for splitting retirement plan assets.

Divorced and single individuals have unique considerations

The U.S. Census found in 2020 that 36 million households consisted of one person, representing about 28% of all U.S. households. Single individuals often bear the sole responsibility for household finances and savings programs, which may make them more vulnerable to shortfalls without proper planning. There are some strategies that may be useful for divorced and single individuals as they navigate financial planning.

RETIREMENT

Beneficiary planning is important for divorced and single individuals, particularly in cases where there are minor children and guardianship decisions need to be clear.

IRAs and most retirement plans have different rules for unmarried individuals. For example, a non-spouse beneficiary cannot treat an IRA as their own and defer required minimum distributions (RMDs) as spousal beneficiaries may be able to upon the death of the first spouse.

Retirement income planning becomes more important for individuals who do not have a spouse who can "make up the difference" in retirement.

INSURANCE

A sole provider needs adequate life and disability insurance. It is always good to take an inventory of current policies to identify gaps and review beneficiary designations.

Life insurance can also be used within an estate planning strategy to provide an equal inheritance among multiple children or heirs, especially if the estate includes non-liquid assets.

INCOME TAXES

Understanding income tax implications is important especially for newly divorced individuals.

Clients will need to assess the impact of their new filing status and the possible decrease in deductions. Additionally, with the passage of the Tax Cuts and Jobs Act (TCJA), alimony is no longer taxable to the recipient and not deductible to the payor.

Large transactions, such as the sale of a house, may also create tax issues for individuals. Married couples can typically shelter a larger portion of capital gains from taxation upon the sale of a primary residence.

ESTATE AND WEALTH TRANSFER

For divorced and single individuals, there is no unlimited marital deduction. In the case of large estates, **careful consideration is needed for planning for liquidity of assets at death.**

If an individual plans to remarry, they may want to **consider planning strategies involving a Qualified Terminable Interest Property (QTIP) trust** to provide for children from an earlier marriage. The QTIP trust allows each partner to ensure their own assets go to a specific designated beneficiary — typically children from a previous marriage.

As with unmarried couples, it is **important to review legal documents** such as durable power of attorney, health care directives, and guardianship plans for minor children.

The impact of the Defense of Marriage Act ruling

A landmark U.S. Supreme Court decision in 2013 recognized that same-sex married couples have the right to receive certain federal benefits and tax filing considerations that go to all married couples under federal law. The court ruled on June 26, 2013, that the Defense of Marriage Act (DOMA), which prohibited the federal government from recognizing same-sex marriages, was unconstitutional. Additional clarification from the Internal Revenue Service also ensures that these federal laws apply if a couple was legally married in a state that recognizes same-sex marriages, even if they reside in a state that does not acknowledge the marriage.

In a 2015 decision, the Supreme Court ruled that states must allow same-sex couples to marry and they must recognize same-sex marriages from other states.

Key benefits

- Eligibility to receive government benefits available to spouses, such as Social Security
- Ability to use the unlimited marital deduction for gifting and estate planning purposes
- Use of the portability provision, which allows a surviving spouse to utilize a deceased spouse's unused exemption (DSUE) amount to avoid or reduce federal estate taxes upon death
- More choices around IRAs, including contribution to a spousal IRA and the option of transferring ownership of an inherited IRA into one's own name
- Increase in the amount of capital gains exempted on the sale of a primary residence from $250,000 to $500,000
- Certain legal protections such as visitation rights at hospitals and legal divorce proceedings to determine division of assets
- Eligibility to receive employer-provided health benefits on a pretax basis

Important considerations for financial planning

There are a number of areas where married couples may be adversely affected.

Income thresholds for income taxes

Couples where each has relatively high income may be adversely impacted now that they cannot file as single taxpayers. For example, individuals reporting less than $200,000 in income will avoid new taxes associated with health care reform, while the same threshold for married couples is only $250,000.

There are other areas in the tax code where this type of "marriage penalty" still exists, such as the income threshold for the highest marginal tax bracket ($578,125 in taxable income for single filers; $693,750 for married couples filing a joint return).

Utilizing investment losses

Taxpayers can only deduct capital losses in excess of gains against $3,000 of ordinary income. This $3,000 limit applies to both individuals and couples. An unmarried couple could conceivably each utilize their own $3,000 capital loss against their own ordinary income.

IRA eligibility

Unmarried individuals may have more benefits. For example, Roth IRA contributions are limited and not allowed as income exceeds $138,000 for individuals and $218,000 for couples. A couple reporting as unmarried individuals where each earns $120,000 in income would both be eligible to make a Roth IRA contribution. However, in the same situation, those filing a joint return as a married couple would not be able to contribute to a Roth.

Sound planning is the key

Demographics illustrate the transformation of the typical family structure in the United States — a trend that is likely to continue. While non-traditional households face specific challenges, a number of considerations and strategies are available. To understand the range of strategies and the implications for your specific situation, it is helpful to seek expert advice from a professional advisor who is well-informed on these issues.

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