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MARITAL SETTLEMENT AGREEMENTS AND SPOUSAL TRUSTS AFTER THE 2017 TAX ACT[1]

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I. INTRODUCTION

Marriage is a relationship with tax implications. Divorce terminates that relationship and can cause significant tax consequences. Tax legislation enacted in 2017 changed some of the tax consequences of marriage and made major changes to the tax consequences of divorce. This article discusses these changes with particular emphasis on the treatment of trusts, both trusts created during marriage and trusts created as part of a marital settlement.[2]

II. MARRIAGE FOR TAX PURPOSES

The existence of a marital relationship for federal tax purposes is determined under the laws of each of the 50 states, the District of Columbia, and the possessions and territories of the United States[3] There is no federal tax law that defines marriage without reference to state law.[4] For federal tax purposes, two individuals are married to each other if their marriage (including a common law marriage)[5] is recognized by the state, possession, or territory of the United States in

2 The tax legislation enacted in 2017 (An Act To Provide for Reconciliation Pursuant to Titles II and V of The Concurrent Resolution on the Budget for Fiscal 2018 (Pub. L. 115-97) is referred to in this article as the "2017 Tax Act").

3 Treas. Reg. §301.7701-18(b)(1). References in this article to "Code" are to the Internal Revenue Code of 1986, as amended, and to "IRC §" are to sections of the Code. References to "Treas. Reg. §" are to sections of the regulations promulgated by the Treasury Department under the Code. For convenience, references in this article to state law include the laws of the District of Columbia and the laws of the possessions and territories of the United States.

4 "The Constitution delegated no authority to the Government of the United States on the subject of marriage and divorce. . . . There is no federal law of domestic relations." United States v. Windsor, 133 S. Ct. 2675 at 2691 (2013). Congress does, however, have the power to regulate the meaning of marriage for the purposes of the application of specific federal statutes such as the Internal Revenue Code in order to further the federal policy those statues are intended to accomplish. For example, 8 U.S.C. §1186a (b)(1) (2006 ed. and Supp. V), a provision of the Immigration and Nationality Act disregards marriages valid under state law but "entered into for the purpose of procuring an alien's admission [to the United States] as an immigrant." Additionally, a definitional provision of the Social Security Act treats individuals as married for purpose of the Social Security Act's income based criteria for determining benefits if they hold themselves out as married to the community in which they live. 42 U.S.C. §1382c (d)(2). No provision of the Internal Revenue Code provides a definition of marriage independent of the definition provided by state law.

5 The term "common law marriage" generally refers to a marriage entered into without a marriage license or ceremony.

which their marriage was entered into even if their marriage is not recognized by the state of their domicile.[6]

If individuals are in a relationship denominated as marriage by a foreign jurisdiction, that relationship will be treated as a marriage for federal tax purposes only if the relationship would be recognized as marriage under the laws of at least one state.[7] A relationship that is not denominated by state law as a marriage will not be treated as a marriage for federal tax purposes even though the rights and obligations conferred and imposed on the parties to the relationship are similar or identical to those conferred and imposed on parties to a marriage.[8]

For most federal income tax purposes, individuals are married to each other for the entire taxable year if they are married to each other on the last day of that year.[9] Individuals who are legally separated from each other on the last day of the year under a decree of divorce or separate maintenance will not be considered married.[10]

Because marriage and divorce are fundamentally matters to be determined under state law, rather than federal law, the Internal Revenue Service (the "IRS") will generally accept the validity of a divorce decree even if its validity is doubtful under the laws of the state within which the couple live.[11] If the divorce decree is later declared invalid by a court of competent jurisdiction, it will follow the later decree.[12]

In Revenue Ruling 76-255[13] and *Boyter v. Commissioner*[14] the IRS indicated that, given the right circumstances, it may raise a challenge to the validity of a divorce even in the absence of

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6 Treas. Reg. §301.7701-18(b)(2); Rev. Rul. 2013-17, 2013-38 IRB 201; Rev. Rul. 58-66, 1958-1 CB 60. The proposed version of Treas. Reg. §301.7701-18(b)(2) contained a broader definition. It provided that two individuals would be treated as married for federal tax purposes "if the marriage would be recognized by any state, possession or territory of the United States." Prop. Treas. Reg. §301.7701-18, Fed. Reg. Vol. 80, No. 205, p. 64378. Comments submitted by the Section of Taxation of the American Bar Association pointed out that this definition was inconsistent with conflict of law rules, which generally would not recognize a marriage as valid if it violates the strong public policy of a state that has the most significant relationship to the spouses at the time of the marriage. The change of language between the proposed version and the final version of the regulations narrows the definition of marriage but does not resolve the issue raised by the Section of Taxation. Under Treas. Reg. §301.7701-18(b)(2), a common law marriage entered into by domiciliaries of a state that does not recognize common law marriages would be valid for tax purposes if entered into in a state that does recognize common law marriages despite the fact that the state within which the taxpayers live treats them as unmarried.

7 Treas. Reg. §301.7701-18(b) (2).

8 Treas. Reg. §301.7701-18(c). The preamble to the final regulations defends the decision to treat partners in registered domestic partnerships and similar relationships as unmarried even when their rights and obligations to each other are the same as those of married individuals by pointing to the difficulty the IRS would have in evaluating state law to determine if a relationship other than one denominated as marriage should be treated as marriage. T.D. 9785 (2016).

9 IRC § 6013 (d) (1).

10 IRC § 6013 (d) (2).

11 G.C.M. 25250, C.B. 1947-2, 32. The spouses who were the subject of the G.C.M. had obtained a Mexican divorce. Although the G.C.M. had concluded that Connecticut, the spouses' domicile, would probably not accept the validity of the divorce, it also concluded that Connecticut would not likely permit the spouses to deny its validity if they had taken steps which indicated their reliance on the validity of the decree. In this case, the husband had relied on the validity of the decree when he entered into a new marriage.

12 Rev. Rul. 67-442, 1967-2 CB 65.

13 Rev. Rul. 76-255, 1976-2 C.B. 40.

14 74 T.C. 989 (1980) remanded 668 F. 2d 382 (4th Cir. 1981).

a court decree declaring its invalidity. Revenue Ruling 76-255 involved a ten year marriage that ended in a divorce in a "foreign jurisdiction." The Ruling assumed that the divorce was valid but that its only purpose was to enable the divorcing individuals to file tax returns as unmarried individuals and that they intended to remarry. They actually remarried within a month after their divorce. The Revenue Ruling declared that the divorce would be a "sham" and would not terminate their marital status for federal income tax purposes.

The sole support for the IRS's conclusion is *Gregory v. Helvering*,[15] a 1935 decision of the Supreme Court involving the tax-free reorganization of a Delaware corporation. This decision is based on a close reading of section 112(g) under an earlier version of the Code, which defined "reorganization" for tax purposes. The Court ultimately held that there had been no reorganization because the Code's requirements for a valid reorganization had not been met.

The Court in *Gregory v. Helvering* did not deprive the taxpayer of the tax benefits of a reorganization because of her motives in arranging for the reorganization, but because it concluded that those motives prevented a reorganization for tax purposes from occurring despite the fact that the reorganization may have been perfectly valid under Delaware state law.

The relevant distinction between determining the validity of a reorganization and marital status for federal tax purposes is that the Code contains its own definition of reorganization while it depends entirely on state law for a definition of marriage and divorce.

III. THE TAX CONSEQUENCES OF MARRIAGE

A. Income Tax

1. The Advantages

Joint return tax rates are available to married couples. If the members of the couple have substantially different levels of income, joint return rates are likely to result in lower total taxes than the individuals would have to pay if they were able to file using the rate schedule available to unmarried individuals. The 2017 Tax Act has increased this advantage.

There are two other advantages available to joint filers. First, the losses of one of them are available to offset the gains of the other. Second, for the charitably inclined, the combined adjusted gross income of both of them may permit a larger income tax charitable deduction for one of them.

Additionally, a married individual is able to make tax free sales of property to his or her spouse. These sales are treated as gifts for income tax purposes. The purchasing spouse takes the same basis in the property as the basis of the selling spouse.[16]

If the purchase price is paid with a note that has no stated interest but has a redemption price in excess of the value of the purchased property, the original issue discount inclusion rules of section 1272 through 1274 do not apply. In order for the original issue discount rules of section

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15 293 U.S. 465 (1935).

16 IRC § 1041. The nonrecognition rule does not apply to sales to a spouse who is a nonresident alien.

1272 and 1273 to apply, the redemption price must be in excess of the issue price. Section 1273(b) and its regulations define issue price in the case of a non-publicly traded note issued in exchange for property other than cash, as the redemption price unless section 1274 applies. Section 1274 defines the issue price in the case of a note issued in exchange for property other than cash as the sum of all the present values of all payments due under the note. The regulations under sections. 1274 of the Code, however, specifically provide that the original issue discount rules do not apply to section1041 transfers.[17]

Finally, spouses are treated as one person for purposes of the imputed interest rules of section 7872 of the Code.[18] This enables them to make interest free loans to one another.

2. The Disadvantages

If two individuals who are married both have income, particularly if their incomes are at similar levels, the rate at which their income is taxed may be higher than the rates that would be applicable to their incomes if they were unmarried.[19] The new rate schedules under the 2017 Tax Act eliminated this "marriage penalty" for all levels of combined taxable incomes up to $600,000 in 2018. In 2018, the maximum penalty was $8,000.[20] The rate schedule applicable in 2017 will be reinstated, under current law, for years after 2025.

In addition, the lower tax rates on long term capital gains and on qualified dividend income available under section 1(h) of the Code are less likely to be available to married taxpayers than to single taxpayers. In 2019, married taxpayers with taxable incomes of $488,850 or less enjoyed a 15% maximum tax on this income; each unmarried individual with a taxable income of $434,550 or less enjoyed this benefit.[21]

Several provisions in the Code provide different income tax treatment for married and unmarried individuals depending on the level of taxpayer income. Married individuals, for example, are more likely to be subject to the alternative minimum tax. The alternative minimum tax is imposed on an unmarried individual in 2019 only if his or her alternative minimum taxable income exceeds $71,700. Married individuals share a single exemption of $111,700.[22] The 2017 Tax Act increased the advantage for unmarried individuals. In 2017, an unmarried individual's exempt amount was $50,600; married individuals shared an exempt amount of $78,750.

Other Code provisions impose different limits on the levels of deductions and credits depending on marital status. Section 164 permits taxpayers to deduct state income taxes and

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17 Reg. §§1.483-1(c)(3); 1.1274-1(b)(3)(iii). *See also* Craven v. United States, 215 F.3d 1201 (11th Cir. 2000), Fox v. United States, 510 F.2d 1330 (3d Cir. 1975) and P.L.R. 9644053 (November 1, 1996).

18 I.R.C. §7872(f)(7). Care must be taken in structuring the loan to avoid any provision in the obligation that could be characterized as interest. In a private letter ruling, for example, the IRS imputed interest in the case of a non-interest bearing note because the principal of the note was to be adjusted for inflation. PLR 200624065 (June 16, 2006).

19 I.R.C. § 1 (a) and (c) as modified by Rev. Proc. 2018-57, §3.01, 2018-49 I.R.B. 827.

20 The rate tables are subject to annual adjustments for inflation. I.R.C. §1(j)(3). The $600,000 and $8,000 figures in the text were adjusted to $612,350 and $11,002 for 2019. Rev. Proc. 2018-57, §3.01, 2018-49 I.R.B. 827.

21 I.R.C. §1(h)(1) and (j)((5) as adjusted for inflation in Rev. Proc. 2018-57, §3.31, 2018-49 I.R.B. 827.

22 I.R.C. §55(d)(4) adjusted for inflation as set forth in Rev. Proc. 2018-57, §3.12, 2018-49 I.R.B. 827.

state property taxes. The 2017 Tax Act suspended the full deduction and limited it to $10,000 annually until 2026. Each unmarried taxpayer is entitled to a $10,000 deduction. The $10,000 limitation must be shared by married taxpayers.[23]

Section 163(h) generally permits a taxpayer a limited deduction for interest on acquisition indebtedness that is incurred to acquire, construct, or improve a qualified residence and that is secured by the residence. A taxpayer may have two qualified residences, one of which must be his or her principal residence. The other may be any other residence used by the taxpayer as a personal residence. The aggregate amount treated as the acquisition indebtedness of any unmarried taxpayer is $750,000. Married individuals share the limitation on acquisition indebtedness. The marriage of an unmarried couple with combined acquisition indebtedness on the couple's home equal to $1,500,000 would lose half of their interest deduction.[24]

Section 1411 imposes a 3.8% tax on the lesser of a taxpayer's net investment income or the excess of his or her modified adjusted gross income for the year over his or her threshold amount. A taxpayer's threshold amount depends on his or her marital status. An unmarried taxpayer is entitled to a $200,000 threshold amount. Married individuals share a single $250,000 threshold amount. If two individuals, each of whom have $200,000 of adjusted gross income all of which consists of net investment income marry, their net investment income tax will increase from $0 to $5,700.

A number of Code sections treat spouses as members of the same family for purposes of applying rules that are generally disadvantageous to taxpayers. For example, section 267 disallows loss deductions for sales between spouses.

3. Differences That Could be Advantageous or Disadvantageous

Section 671 through section 679 provide rules for determining when the grantor of a trust will be treated as owning the trust and taxed on the trust's income. One set of these rules treats a trust as owned by its grantor (a "grantor trust") if trust income can be distributed to or accumulated for future distribution to the grantor's spouse without the consent of an adverse party or when the grantor's spouse has certain powers over the trust. When a grantor wants a trust to be treated as a grantor trust, these rules are advantageous; when the grantor does not want grantor trust treatment, they are not.

B. Estate and Gift Tax

1. The Advantages

Sections 2523 and 2056 of the Code permit gift tax-free gifts and estate tax-free bequests to spouses who are U.S. citizens.

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23 I.R.C. § 164(b)(6).

24 The 2017 Tax Act reduced the limitation on acquisition indebtedness acquired after 2017 from $1,000,000 to $750,000 for debt incurred after December 31, 2017. Tax Act § 11043. The larger limitation is scheduled to apply again starting in 2026.

Section 2503(b) (as currently adjusted for inflation) permits individuals to make annual $15,000 gift tax-free gifts to unlimited numbers of individuals. Section 2010 permits an individual to make lifetime gift tax free gifts of $11,400,000. A married donor can double the amounts of annual gift tax-free gifts if the donor's spouse is willing to treat one-half of the donor's gifts as having been made by him or her.[25] Section 2010's lifetime exemption level was temporarily doubled to this level starting in 2018. Under current tax law, it is scheduled to be cut in half starting in 2026.

Section 2010(c) permits a surviving spouse to increase his or her applicable exclusion amount by the amount of his or her deceased spouse's unused applicable exclusion amount. This permits a surviving spouse to double the amount of property that can be given tax-free during life or left tax-free at death from $11,400,000 to $22,800,000. Under the regulations, an individual whose spouse dies before 2026 with an unused exemption will be able to use the total amount of that unused exemption even if he or she dies after 2025 when the total amount of the exemption is expected to be cut in half.[26]

2. The Disadvantages

Section 2701 creates a substantial gift tax disadvantage for those individuals who would like to give interests in an investment or business entity to family members if immediately after the gift the individual or certain family members, including a spouse, holds a preferred interest in that entity. If two individuals who are married to each other want to use this planning device for the benefit of their children, a divorce prior to implementing the plan would avoid the disadvantages of section 2701.

Section 2702 creates similar tax disadvantages for spouses who would like to give interests in trusts to certain family members if he or she or certain other family members, including a spouse, retain other interests in those same trusts.

IV. THE TAX CONSEQUENCES OF DIVORCE

A. The Costs of Divorce

Certain fees and costs associated with the process of divorce are deductible as itemized deductions under section 212. These include legal fees and related costs incurred in order to obtain an award of taxable alimony,[27] to structure settlements and property divisions to produce desired tax effects,[28] to obtain a support trust to make taxable payment,[29] and to prepare and enforce a qualified domestic support order.[30] The 2017 Tax Act suspended all itemized deductions until 2026. As a result, these deductions will not be available to a divorcing taxpayer for more than six years. As discussed in more detail below, alimony is no longer includable in

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25 I.R.C. § 2013. The split-gift option is not available to a donor or decedent married to an individual who is neither a citizen nor domiciliary of the United States.
26 Treas. Reg. §20.2010-2(c).
27 I.R.C. §212(1); Treas. Reg. §262-1(b)(7).
28 I.R.C. §212(3).
29 I.R.C. §212(1).
30 *Id.*

gross income. As a result, the expected availability of the deduction for section 212 expenses in 2026 will not restore the deduction for the expenses of obtaining an award of alimony.

Expenses incurred in connection with a divorce that are attributable to acquiring property or defending title to property may continue to be capitalized and added to the tax basis of the property.[31]

B. Allocating Child Related Tax Benefits

1. In General

The Code provides a number of child related tax benefits. Some of them inure automatically to the parent who has custody of the child or with whom the child spends more than half of his or her time. Others may be allocated between the parents by agreement.

2. Head of Household Status

One of the tax benefits of divorce for couples with children is the availability after divorce of head of household filing status for the parent who has the children living with him or her for more time than the other parent. There are two principal advantages of head of household status over unmarried status - lower rates and a higher standard deduction. The 2017 Tax Act reduced the tax rate advantage of head of household status to about $1,420 per year for the years 2018 through 2025.[32] A more significant tax rate advantage is available for head of household taxpayers with long term capital gain income or qualified dividend income. In 2019, a taxpayer who is a head of households pays no tax on this income if the taxpayer's taxable income is no more than $52,750 and 15%, if his or her taxable income is no more than $461,700. A single individual loses tax exempt status for this income if his or her taxable income is more than $39,375 and loses the advantage of the 15% rate if his or her taxable income is more than $434,550.[33]

Taxpayers who are heads of household are also entitled to a more generous standard deduction than other unmarried taxpayers. The standard deduction for head of household taxpayers for 2019 is $18,350. The standard deduction for other unmarried taxpayers is $12,200.[34] The higher standard deduction is not available for taxpayers who itemize their deductions. Any taxpayer, for example, with state and local taxes, mortgage interest and charitable deductions in excess of the standard deduction amount will not receive any benefit from the increased standard deduction.

Head of household filing status is available for taxpayers who are unmarried or deemed unmarried under section 7703(b) if they maintain as their home a household which constitutes the principal place of abode for more than one-half of the year of a qualifying child within the meaning of section 152(c) without regard to section 152(e).[35] The term qualifying child includes

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31 Treas. Reg. I.R.C. §1.212-1(k); Gilmore v. United States, 245 F. Supp. 383 (DC-CA 1965).

32 I.R.C. §1(b) and (c) as modified by Rev. Proc. 2018-57, §3.01, 2018-49 I.R.B. 827.

33 I.R.C. §1(h)(1) and (j)((5) as adjusted for inflation in Rev. Proc. 2018-57, §3.03, 2018-49 I.R.B. 827.

34 I.R.C. §63(c)(7) as adjusted for inflation in Rev. Proc. 2018-57, §3.16, 2018-49 I.R.B. 827

35 A child who would otherwise be a qualifying child is not a qualifying child for purposes of determining head of household status if the child is married at the end of the year and is not a dependent of the taxpayer because the

a child who is younger than age 19 or a child who is a student and who is younger than age 24 and does not provide more than one-half of his or her support.

A taxpayer is considered unmarried for a particular calendar year even though married for state law purposes if he or she maintains as his or her home a household that constituted for more than one-half the year the principal place of abode of a child for whom the taxpayer is entitled to a deduction for a personal exemption under section 151 (or would be but for section 152(e)), if he or she furnishes over one-half of the cost of maintaining the household during the year, and if during the last 6 months of the taxable year the individual's spouse was not a member of the household.[36]

C. Dependency Deduction

Section 151 allows a taxpayer to deduct the exempt amount for certain dependents as defined in section 152. The term dependent includes a qualifying child. As mentioned above, the term qualifying child includes a child or stepchild of the taxpayer who has the same principal place of abode as the taxpayer for more than one-half the year, who is younger than age 19 or who is a student and who is younger than age 24, who does not provide more than one-half of his or her support, and who has not filed a joint return with his or her spouse for the year. The deduction available for each dependent in 2017 was \$4,050.[37] The deduction phased out in 2017 for head of household taxpayers with adjusted gross incomes in excess of \$287,650 and for single taxpayers with adjusted gross incomes in excess of \$261,500. The exemption was reduced by 2% for every \$2,000 by which the taxpayer's adjusted gross income exceeded the amounts set forth in the preceding sentence. As a result, the exemption available for a head of household taxpayer with an adjusted gross income of \$410,150 or an unmarried taxpayer with an adjusted gross income of \$384,000 was zero.

If both parents of a child can claim the child as a dependent, the parent with whom the child resided for the longer period of time during the taxable year has the right to claim the child as his or her qualifying child.[38] A special rule is available for the parents of a child who was a qualifying child with respect to one of the parents that allowed them to shift the advantage of the deduction to the other parent.[39] The rule applies to parents who are divorced or legally separated, who are separated under a written separation agreement, or who live apart during the last six months of the year. If the child is in the custody of one or both of his or her parents during a particular year, the child will be treated as the qualifying child of the parent with whom the child resided for the shorter period of time (the "noncustodial parent") during that year if the other parent (the "custodial parent") releases his or her claim to the exemption for the year. The parent who is relinquishing the claim should sign Form 8332 for the year stating that he or she

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child files a joint return with his or her spouse or because the child is a not a citizen of the United States and does not live in the United States, Canada, or Mexico. I.R.C. §2(b).

36 As discussed more fully below, I.R.C. §151(d)(5)(A) provides that the deduction for personal exemptions under I.R.C. §151 is zero for the years 2018 through 2025. I.R.C. §151(d)(5)(B) provides that for purposes of any other provision of the Code, the reduction of the exemption amount to zero is not to be taken into account in determining whether a deduction is allowed or allowable or whether a taxpayer is entitled to a deduction under I.R.C.§ 151.

37 I.R.C. § 151(d)(1) as adjusted for inflation in Rev. Proc. 2016-55, §3.24, 2016-45 I.R.B. 707.

38 I.R.C. § 152(c)(4).

39 I.R.C. § 152(e).

will not claim an exemption for the child for the year, and the other parent should attach the form to his or her income tax return. The availability of the exemption should be provided for in a divorce settlement agreement.

The 2017 Tax Act reduced the amount of the dependency exempt amount to zero for the years 2018 through 2025.[40] Despite the fact that the amount is zero, the availability of the deduction remains significant from a technical point of view for purposes of determining the taxpayer's eligibility for other tax benefits such as the child tax credit, which is discussed below. Section 151(d)(5) says that for purposes of any other section of the Code, the reduction of the exemption amount to zero is not to be taken into account in determining whether the section 151 deduction is available.

D. Child Tax Credit

A taxpayer who is allowed a deduction under section 151 for a qualifying child is also entitled to a credit for that child.[41] For purposes of this provision a qualifying child must be younger than 17. Prior to 2018, the maximum credit per child was $1,000. The amount of the credit was reduced by $50 for each $1,000 of the taxpayer's modified gross income in excess of $110,000 for married taxpayers filing joint returns and $75,000 for unmarried taxpayers. These amounts were temporarily increased by the 2017 Tax Act. For the years 2018 through 2025, the child tax credit will be $2,000 per child and the reduction will not start for married taxpayers filing joint returns until their modified adjusted gross income is more than $400,000 and for unmarried taxpayers until their modified adjusted gross income is more than $200,000.[42]

E. The Alimony Deduction and its Repeal

1. In General

When spouses divorce, one of them is often obligated to make support payments to the other for some period of time. These payments are generally referred to as alimony or maintenance. The tax law has permitted the paying spouse some form of deduction for alimony payments and has imposed on the receiving spouse some form of inclusion requirement since 1942.[43]

The payments must be made under a divorce or separation instrument.[44] The term "divorce or separation instrument" is defined in the Code as (a) a decree of divorce or separate maintenance or a written instrument incident to such a decree,[45] (b) a written separation

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40 I.R.C. § 151(d)(5).

41 I.R.C. § 24.

42 I.R.C. § 24(h).

43 I.R.C. §§ 71 and 215.

44 I.R.C. § 71(b)(1)(A). *See* Peterson v. Commissioner, 75 T.C.M. 1620 (1998) (state court "Minute Order" held to be valid support decree under I.R.C. § 71).

45 The IRS has ruled that an agreement to amend a divorce decree by providing for a lump sum payment in discharge of future alimony obligations could be treated as a written instrument pursuant to the decree when the purpose of the amendment was to carry out the terms of the divorce decree. Letter Ruling 200233022 (August 16, 2002), citing Young v. Commissioner, 113 T.C. 152 (1999) for the proposition that an amendment completing the division of marital property was "incident" to the divorce decree.

agreement, or (c) a decree other than one described in "(a)" requiring support or maintenance payments.[46]

Prior to 1942, the Supreme Court had decided in *Gould v. Gould* that alimony payments were not taxable to the recipient.[47] Congress overrode *Gould* in the Tax Act of 1942 by legislatively mandating a different outcome. It was responding to concerns that a steeply progressive income tax rate structure could result in an individual paying income tax and alimony in excess of the individual's income and an uneasiness over the inconsistent tax treatment from state to state developing through the use of irrevocable alimony trusts.[48] The Revenue Act of 1942 permitted an individual who was required to pay alimony under a decree of divorce or separate maintenance to deduct the payments from gross income and required the recipient to include the payments in gross income.[49] The Internal Revenue Code of 1954 expanded the inclusion and deduction rules to reach the same kinds of payments made under written separation agreements and support orders.[50]

The alimony deduction is a particularly valuable deduction. It is a deduction allowable in computing adjusted gross income rather than a so-called "itemized deduction."[51] Because it is not an itemized deduction, it can be used along with the standard deduction[52] and is allowable in calculating alternative minimum taxable income.[53]

B. Repeal of the alimony deduction

1. In General

The 2017 Tax Act repealed the deduction for alimony payments and the section of the Code that requires the inclusion of alimony payments in gross income. The repeal is effective for payments made under any divorce or separation instrument executed after December 31, 2018.[54]

2. Reasons for repeal

There is limited legislative history explaining why Congress chose to repeal the alimony deduction. Revenue generation may have been one reason. The Joint Committee on Taxation estimated that the elimination of the alimony deduction increases the revenue collected from the

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46 I.R.C. § 71(b)(2).

47 245 U.S. 151 (1917) ("Permanent alimony is regarded rather as a portion of the husband's estate to which the wife is equitably entitled, than as strictly a debt; alimony from time to time may be regarded as a portion of his current income or earnings. . . . The net income of the divorced husband subject to taxation was not decreased by payment of alimony under the court's order; and, on the other hand, the sum received by the wife on account thereof cannot be regarded as income arising or accruing to her within the enactment.").

48 H.R. Rep. No. 2333, 77th Cong., 2d Sess. 46, 69-72(1941). In 1942, the top federal income tax bracket was 88%, applicable to taxable incomes in excess of $200,000 (about $3,000,000 in 2018 dollars.). https://www.irs.gov/statistics/soi-tax-stats-historical-table-23

49 Revenue Act of 1942, P.L. 77-353, §120, 56 St. 798,816-17 (1942).

50 I.R.C. §71 (a) (2) (written separation agreement); (a) (3) (decree for support).

51 I.R.C. §62 (a) (10).

52 I.R.C. §63.

53 I.R.C. §56.

54 2017 Tax Act §11051.

income tax by $6.9 billion from 2018 through 2027.[55] But this represents only .47% of the total $1.456 trillion estimated loss in revenue attributable to the 2017 Tax Act.[56]

The House Ways and Means Committee, the committee which originated the repeal, suggested another motive. It viewed the deduction as a divorce subsidy. The Committee supported its repeal proposal by pointing out that repeal would "eliminate what is effectively a 'divorce subsidy' under current law, in that a divorced couple can often achieve a better tax result for payments between them than a married couple can."[57]

3. Impact of Repeal

For middle-class taxpayers, the alimony deduction was not so much a subsidy as a means of preventing their divorce from causing a meaningful tax increase. Consider, for example, A, who earns $192,800 per year and who is married to B who earns nothing. They use the standard deduction. If they are married and file a joint income tax return in 2019, their combined income tax liability will be $24,765. If they divorce, A's income tax liability will increase by 42% to $35,109. If alimony had remained deductible and if A paid alimony of $52,287.50 to B, their combined income tax liability would remain at the pre-divorce level.

For wealthy taxpayers, the cost of the loss of the alimony deduction is also substantial when measured in dollars but not as significant as a percent of their total tax liability. The maximum cost of the loss of the alimony deduction in 2019 is $36,431. This cost is incurred by a taxpayer with $1,020,600 or more of taxable income who pays alimony of $510,310 to a former spouse.

Wealthy individuals with investment assets can avoid the economic impact of repeal by establishing trusts to make annual payments to former spouses or by transferring income producing property to them. Suppose, for example, that one spouse has agreed to provide the other spouse with an annual taxable income of $200,000. If their agreement had been signed in 2018, the obligation could have been met with annual, deductible alimony payments. Now the obligation could be met by the transfer of investment assets expected to produce an annual return of $200,000 to a trust with the requirement that the trustee pay $200,000 per year to the spouse. If the trust is established after the divorce and its establishment effectively terminates the transferor spouse's support obligation to the other spouse, the beneficiary spouse will pay tax on the $200,000 he or she receives (up to the income of the trust), and the transferor spouse will not be taxed on the income.

Prenuptial and postnuptial agreements often contain provisions that require one spouse to pay alimony to the other in the case of separation or divorce and that the alimony recipient include the payments in his or her gross income. The parties who negotiated and executed these agreements before the House Ways and Means Committee proposed the repeal of the alimony deduction in 2017, likely did so with the expectation that the payments would be

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55 Joint Explanatory Statement of the Committee of Conference, H.R. 115-466 (2018), Schedule at 561.

56 Joint Committee on Taxation, Estimated Budget Effects of the Conference Agreement for H.R. 1, "The Tax Cuts and Jobs Act," Fiscal Years 2018 – 2027, JCX-67-17 (Dec. 18, 2017).

57 *See* U.S. House of Representatives Committee on Ways and Means, Tax Cut and Jobs Act, H.R. I, As Ordered Reported by the Committee, Section-by-Section Summary (2017), p. 17.

deductible by the payor. In fact, the terms of the agreement probably provided that the recipient would treat the payments as alimony includable in his or her gross income and that the payor would be entitled to deduct the payments.

It is unlikely that a prenuptial agreement would be treated as a divorce or separation instrument for purposes of qualifying payments made under it for inclusion under section 71 or deduction under section 215. Unless a postnuptial agreement provides for an imminent separation, it is also unlikely that a postnuptial agreement would qualify as a divorce or separation instrument. If these agreements do not qualify as divorce or separation instruments, the cost to the payor spouse will be greater than he or she bargained for and the recipient spouse will receive an unanticipated benefit.

These types of agreements often contain severability clauses similar to the following:

> *Each provision of this Agreement shall be considered severable and if for any reason any provision or provisions herein are determined to be invalid, unenforceable or illegal under any existing or future law, such invalidity, unenforceability or illegality shall not impair the operation of or affect those portions of this Agreement which are valid, enforceable and legal. Upon any determination that any term or other provision of this Agreement is invalid, illegal or incapable of being enforced, the parties to this Agreement shall negotiate in good faith to modify this Agreement so as to effect the original intent of the parties as closely as possible in an acceptable manner to the end that the transactions contemplated by this Agreement are fulfilled to the greatest extent possible.*

If a prenuptial or postnuptial agreement executed before the enactment of the 2017 Tax Act contains a clause similar to the one shown above, it may give the payor spouse a basis for arguing that the required payment amounts must be renegotiated because it is no longer legal to include alimony receipts in gross income or to deduct alimony payments. The payor spouse's position in the negotiation would be that the payments be reduced to an amount that would have been equal to the amount of his or her after tax cost if the alimony deduction had not been repealed. The recipient spouse would presumably take the position that he or she should not be left with less than the amount he or she would have been left with after tax if the alimony deduction had not been repealed.

V. DEALING WITH TRUSTS IN THE CONTEXT OF DIVORCE

A. Income Tax Consequences of Transfers to Trusts

Section 1041 provides that no gain or loss will be recognized on a transfer of property in trust for the benefit of a spouse or, if the transfer is incident to a divorce, to a trust for the benefit of a former spouse.[58] This will be so even if the transfer is in satisfaction of the transferor

[58] This provision is not applicable to transfers to a trust for the benefit of a spouse or former spouse who is a nonresident alien of the United States.

spouse's support obligations, his or her other marital obligations, or any other obligations. Transfers that take place within one year after divorce are treated as incident to the divorce.[59]

When a transferee acquires property in a transfer to which section 1041 (a) applies, his or her basis in the transferred property is the same as the adjusted basis in the hands of the transferor immediately before the transfer.[60] This is so whether the transferor's basis is higher than the fair market value at the time of the transfer or whether any gift tax is payable as a result of the transfer.[61]

If divorcing spouses have children, it is likely that a trust established pursuant to a marital settlement agreement will include the couple's children as remainder beneficiaries. Section 1041 of the Code draws no distinction between trusts for the sole benefit of the spouse and those that have other beneficiaries, nor does it specify any minimum interest which the spouse must have for section 1041 to apply. The Temporary Regulations offer no clarification.

Section 1041(e) makes subsection (a) of section 1041 inapplicable to the transfer of property in trust to the extent that the sum of the liabilities assumed plus the amount of liabilities to which the property is subject exceeds the adjusted basis of the property transferred. This kind of property is often referred to as "negative basis" property. The basis of the property to the transferee is increased by the amount of gain recognized.[62]

Section 1041 (e) is limited to section 1041 (a). It does not prevent the application of section 1041(b). As a result, the transferee spouse and the trust continue to be treated as having received the transferred property as a gift, and their basis in the property is determined under section 1041 rather than section 1015, adjusted to reflect the amount of gain recognized by the transferor as a result of the transfer.

If the transfer of the interest is made to a trust for the benefit of a spouse rather than a former spouse, and if the transferee spouse's interest in the trust is sufficient to result in the treatment of the entire trust as a grantor trust subject to section 671 (or if other trust provisions would result in the trust being treated as "owned" by the transferor within the meaning of section 671), the transfer would not result in the recognition of gain. This is so because the transferor will continue to be treated as the owner of the transferred property after the transfer.[63] When the trust ceases to be a grantor trust because of the termination of the spouse's interest or the death of the

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59 I.R.C. § 1041(c). Temp. Treas. Reg. §1.1041-1T Q&A 7 treats a transfer that is made pursuant to a divorce or separation instrument that occurs within six years after the divorce as related to the cessation of the marriage.

60 I.R.C. § 1041(b)(2); Temp. Treas. Reg. § 1.1041-1T(d) Q&A 11.

61 *Compare* I.R.C. § 1015(a) (which limits a donee's basis in gifted property to the lower of the donor's basis immediately before the transfer or the value of the property at the time of the transfer).

62 I.R.C. § 1041 (e).

63 Rev. Rul. 85-13, 1985-1 C.B. 184. The Second Circuit reached a contrary conclusion in Rothstein v. United States, 735 F.2d 704 (2d Cir. 1984). The Internal Revenue Service announced its decision not to follow Rothstein in Rev. Rul. 85-13. Under the right circumstances, the trustee of a trust for the benefit of one spouse that has received trust property pursuant to a marital settlement agreement might take the position that gain was recognized when the transferor spouse transferred negative basis property to the trust. If this position were successful, the trust would hold the property with an increase in basis.

spouse,[64] the transferor will be treated as having transferred ownership of the interest to a different taxable entity.[65] At that time, the transferor will be treated as having disposed of the interest.[66]

Section 453B(g) provides that the non-recognition provision of Section 1041, which was made generally applicable to the disposition of installment obligations by Section 453B, does not apply to the transfer of an installment obligation to a trust. As a result, a transfer of an installment obligation to a trust for the benefit of a transferor's spouse will be treated as a disposition of that obligation for purposes of Section 453B.[67]

Unlike Section 1041(e), discussed above, no provision of Section 1041 or Section 453B provides for a basis adjustment to reflect the gain recognized by the transferor. A basis adjustment is necessary to prevent the imposition of an income tax twice on the same gain—first on the gain recognized by the transferor, and then on that recognized by the trust on disposition of the property.

In the case of a disposition of an installment note by gift to which Section § 1015 applies, the language of § 1015 seems to provide the necessary adjustment. Section § 1015 indicates that the transferee's basis will "be the same as it would be in the hands of the [transferor]."[68] The IRS has ruled that this language requires that the transferor's basis take into account the gain resulting from the transfer because, if he or she held the note after the disposition, the basis would have been increased by the amount of such gain.[69]

Section 1041 (b), however, not section 1015 (a), applies to a transfer of an installment note to a trust for the benefit of the transferor's spouse. The language of section 1041(b) states only that the "basis of the transferee shall be the adjusted basis of the transferor." Unlike section 1015, it does not suggest a test that looks to see what the transferor's basis would be if he or she still held the transferred property. To avoid a double tax on the same gain, the Treasury Regulations should construe section 1041(b) to require the same test as section 1015.[70]

Recognition will be avoided if the transferor transfers the installment note to a trust the terms of which result in the grantor being treated as the "owner" (within the meaning of section 671) of that portion of the trust consisting of the right to receive the principal of the note.[71] Since the original owner continues to be treated as the owner after the transfer, the transfer is not treated as a disposition for purposes of section 453B.

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64 Grantor trust status will not terminate merely because of the divorce of the transferor and his or her spouse. Section 672 (e).

65 Treas. Reg. § 1.1001-2(c), Ex. (5).

66 *See id.* § 1.1001-2(c); Madorin v. Comm'r, 84 T.C. 667 (1985); Rev. Rul. 79-84, 1979-1 C.B. 223; Rev. Rul. 77-402, 1977-2 C.B. 222 (1977).

67 Section 453B (a), (g) (1).

68 Section 1015 (a).

69 Rev. Rul. 79-371, 1979-2 C.B. 294.

70 *Cf.* Rev. Rul. 87-112, 1987-2 C.B. 207 (in which the IRS allowed the transferee spouse of E savings bonds to increase the tax basis by the amount of income the transferor spouse recognized on the transfer).

71 Rev. Rul. 81-98, 1981-1 C.B. 40; Rev. Rul. 74-613, 1974-2 C.B. 153; Rev. Rul. 67-70, 1967-1 C.B. 106.

When the power over or interest in the trust that caused the transferor to be treated as owner is terminated, the termination will be treated as a disposition.[72]

B. Taxation of Trust Income

1. In General

There are two principal tax types of trusts that are likely to be used in connection with a property settlement agreement: a nongrantor trust and a grantor trust. A trust may share the characteristics of both a nongrantor trust and a grantor trust.

A detailed discussion of the manner in which each of these different kinds of trusts is treated for income tax purposes is beyond the scope of this article. A brief summary is provided below since some knowledge of how the trust tax rules work is necessary to an understanding of the tax consequences of using trusts in connection with a divorce or separation.

2. Nongrantor Trusts

The tax rates imposed on the income of a nongrantor trust are set forth in the table that appears in section 1(e). The table provides four different brackets, a 10% bracket, a 24% bracket, a 35% bracket, and a 37% bracket. The tax rate table applicable to trusts is the most steeply progressive of the five different tax tables that are provided in Section 1. Trust taxable income is subjected to the 37% rate on amounts in excess of $12,750.[73] In addition, the net investment income of the trusts is also subject to 3.8% Medicare Tax under Section 1411 at income levels above $12,500.

The income of a nongrantor trust is allocated between the trust and its beneficiaries through the deductions permitted to the trust under sections 651 and 661 for distributions made to beneficiaries. The deductions remove the income from the trust's taxable income and put it in the beneficiary's gross income.[74] In each case the deduction is limited to the amount of the trust's "distributable net income" ("DNI")[75] regardless of the actual amount of the deduction.[76] If an item of income is not reflected in DNI, it will be taxed to the trust rather than to its beneficiaries. A trust's DNI is its taxable income with several adjustments, the most significant of which are discussed below.

Capital gains are not included if they are allocated to corpus and are not "paid, credited, or required to be distributed to any beneficiary during the taxable year."[77] Capital losses are also not taken into account except to the extent that they reduce the amount of gains included under the preceding sentence.[78] Furthermore, the 50% exclusion from gross income under Section 1202 for

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72 *See* Treas. Reg. § 1.1001-2(c), Ex. (5); Madorin v. Comm'r, 84 T.C. 667; Rev. Rul. 79-84, 1979-1 C.B. 223; Rev. Rul. 77-402, 1977-2 C.B. 222.

73 I.R.C. § 1 (f) requires Treasury to prescribe new tables annually to reflect increases in the cost of living. The $12,750 taxable income level is in effect for 2019. Rev. Proc. 2018-57, §3.01, 2018-49 I.R.B. 827.

74 I.R.C. §§ 651, 652, 661, 662.

75 I.R.C. § 643(a).

76 I.R.C. §§ 651, 661.

77 I.R.C. § §643(a) (3).

78 *Id.*

any gain from the sale or exchange of qualified small business stock held for more than five years is not taken into account.[79]

A trust's tax-exempt income is included, reduced by any amounts that would be deductible in connection with this income but for Section 265 (which disallows certain deductions relating to tax exempt income).[80] A trust's distribution deduction, discussed below, is added back to taxable income.[81]

In calculating its taxable income, the trust is permitted to deduct distributions to beneficiaries actually made and distributions that were required to be made to the extent they do not exceed its DNI. For purposes of calculating the DNI limitation on the deduction, DNI is calculated without including tax-exempt income and the deductions allocable to such income.

Sections 652 and 662 require that amounts distributed (or required to be distributed) to trust beneficiaries from trusts are to be included in the beneficiaries' gross incomes to the extent such distributions do not exceed the trust's DNI.[82] The distributions have the same tax character in the hands of the beneficiaries as they had in the hands of the trustee.[83]

If a trust agreement requires the distribution of a specific sum of money at one time or in not more than three installments, a distribution in satisfaction of this requirement will not be treated as a distribution of trust income.[84] As a result, the distribution will not be deductible to the trust or includible in the gross income of the beneficiary.

The exception for distributions of specific sums does not apply to amounts which can be paid only out of trust income or to annuities or payments of periodic amounts that have the effect of an annuity.[85]

3. Grantor Trusts

The term "grantor trust" is used to describe a trust that is treated as "owned" by its creator, the grantor, or, in some cases, by another individual. The rules governing grantor trusts are described in sections 671 through 679.

The primary tax consequence of grantor trust treatment is the requirement that the deemed owner of the trust calculate his or her taxable income and credits by including the trust's income, deductions, and credits.[86] This means that the deemed owner, not the trust, will pay tax on the trust's income. If the trust has losses, or deductions in excess of income, they are usable by the deemed owner.

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79 *Id.*

80 I.R.C. § 643(a) (5).

81 I.R.C. § 643(a) (1).

82 I.R.C. § 652(a), 662(a). DNI is computed without the deduction allowed under I.R.C.§ 642(c) for payments to charities. *See* I.R.C. §§ 651(a) (2), 662(b).

83 I.R.C. §§ 652(b), 662(b).

84 I.R.C. §§ 663(a).

85 Treas. Reg. 1.663(a)-1(b) (2).

86 I.R.C. § 671.

The grantor trust rules generally apply when the grantor or any person other than an adverse party has retained certain interests in or powers over trust income and assets and when trust income can be distributed to or accumulated for future distribution to the grantor or his or her spouse without the consent of an adverse party, and when the grantor or the grantor's spouse has certain powers over the trusts that can be exercised without the consent of an adverse party.[87] For purposes of determining the powers and interests held by a grantor, section 672(e) provides that he or she will be treated as holding any power or interest held by an individual to whom the grantor was married at the time of the creation of the power or interest or whom he or she married after the creation. There is no provision of the Code that causes this treatment to terminate if the spouses divorce.

3. Taxation of Trusts Established in Connection with Divorce or Separation

If one spouse transfers property to a trust for the benefit of the other spouse in connection with a divorce or separation, the taxation of that trust and of the transferee spouse would generally follow the rules reviewed above.[88] Taxability will depend on the particular characteristics of the trust. If the trust is a standard trust, the transferee spouse rather than the trust would be taxed on trust income to the extent distributed to him or her.

A trust created in connection with a divorce or separation, however, is likely to be subject to the grantor trust rules for one of two reasons.

First, if the transferor spouse's transfer to the trust does not, under state law, completely terminate the obligation to support the other spouse, the trust would be subject to the grantor trust rules to the extent payments were made from the trust to the transferee spouse.[89] The payments would be treated as having been made for his or her benefit since they would discharge a continuing legal obligation.[90]

Second, if the transferor spouse and the transferee spouse are still married to each other when the trust is created, the grantor trust rules are likely to impose grantor trust status because of the existence of the marital relationship.

<u>Example</u> – *A, pursuant to the requirements of a marital settlement agreement, transferred $500,000 to a trust to pay the transferee spouse B income for life. The independent trustee had discretion to distribute principal to B if the independent trustee deemed it advisable. At B's death, the remainder was to be paid to A's children. The transfer was made prior to A's divorce from B. Section 677 (a) applies to treat A as the deemed owner of the entire trust before the divorce and probably after the divorce as well.*

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87 An adverse party means any person having a substantial beneficial interest in the trust that would be adversely affected by the exercise or nonexercise of the power he or she possesses over a trust. There are other powers that can cause a trust to be treated as a grantor trust that are not relevant to this discussion.

88 *See supra* text at notes 38-44.

89 *See* Helvering v. Leonard, 310 U.S. 80 (1940). *See generally* Comment, *Tax Aspects of Alimony Trusts*, and 66 YALE L.J. 881 (1957).

90 I.R.C. § 677(b).

Grantor trust status will not be limited to those trusts that are created as part of the divorce or separation negotiations. It will apply also to trusts that one spouse created for the other during their marriage. For example, the trust created by A for B described above might have been an *inter vivos* qualified terminable interest property trust (a so-called "QTIP") originating as part of their combined estate plan. All trusts created by one spouse of which the other spouse is a beneficiary or over which he or she has a power should be identified during the negotiation process so that the impact of future taxes on trust income can be taken into account.

Section 682(a) provides that if spouses are divorced from each other or are separated under a decree of separate maintenance or under a written separation agreement, the amount of any income one of them receives or is entitled to receive from a trust will be included in his or her gross income and will not be included in the gross income of the other spouse. This will be so despite any other provision of the Code such as the grantor trust rules.[91] Section 682(a) does not apply to any part of trust income that the terms of the decree, written separation agreement, or trust agreement fix as payable for the support of minor children of the other spouse. Trusts that are subject to Section 682(a) are usually referred to as "Section 682 Trusts."

The spouse who receives or is entitled to receive the income from a Section 682 Trust is treated as a beneficiary of the trust for the purposes of the rules governing the taxation of trusts and their beneficiaries.[92] This means that the transferee spouse must include in his or her gross income the amounts allocated to him or her through the DNI mechanism discussed above.

If a Section 682 Trust receives capital gain income and the transferee spouse's distribution exceeds DNI, section 682(a) may require that the transferee spouse include the capital gain income in his or her gross income. Whether this is the correct result is unclear because neither Section 682 (a) nor its regulations contain a definition of "income."

The tax treatment of the transferor spouse depends upon whether he or she is deemed to own the trust under the grantor trust rules.[93] If the trust is not treated as owned by the transferor and if no portion of the payments to the transferee spouse are specified for child support, no portion of the trust income would be taxed to the transferor spouse.[94]

If the trust is treated as owned by the transferor spouse, he or she will be taxed, under the grantor trust rules, on all trust income not distributed to the transferee spouse.[95]

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91 I.R.C. § 682(a). There is at least one regulation and two private letter rulings in which the IRS has taken a position contrary to the one described in the text. In Treas. Reg. § 1.1361-1(k)(1), Ex. 10 (ii), the IRS concludes that I.R.C. § 682 will cause the termination of the grantor trust status of an inter vivos QTIP when the grantor and his or her spouse divorce. A similar conclusion is reached in PLR 9235032 (August 28, 1992). The conclusions seem clearly wrong. Nothing in I.R.C. § 682 operates to terminate grantor trust status. It simply protects the grantor, who would ordinarily be taxed on trust income, from taxation on income required to be paid to his or her spouse.

92 I.R.C. § 682(b).

93 I.R.C. § 671(a).

94 I.R.C. § 682(a).

95 I.R.C. § 671(a).

The 2017 Tax Act repealed section 682 effective for spouses whose divorce or separation instruments are executed after December 31, 2018.[96] Because the effective date is keyed to the date of the divorce or separation instrument, the repeal applies to trusts that were created and funded before January 1, 2019 if the divorce or separation instrument of the trust's grantor was executed after December 31, 2018.

Negotiators of marital settlement agreements that require the establishment of a trust by one spouse for the benefit of the other should provide for the creation of the trust after the divorce takes place if it is not intended that the transferor spouse pay income tax on income paid to the other spouse.

If trusts for the benefit of one spouse are already in place when negotiations for a marital settlement agreement begin, the grantor's attorney could negotiate for provisions requiring the beneficiary spouse to reimburse the grantor spouse for income taxes attributable to the trust distributions he or she receives.

Alternatively, consideration could be given to restructuring the trusts to avoid the problem. The three types of trusts that are frequently created during a marriage that will now cause problems for the transferor spouse after a divorce are (1) the spousal lifetime access trust (the "SLAT"), (2) the qualified terminable interest trust (the "QTIP"), and the qualified personal residence trust (the "QPRT"). Possible methods for dealing with each of these trusts are discussed below.

The beneficiaries of a SLAT generally include the transferor's descendants and the transferee spouse. If the trustee has an unlimited invasion power, the trustee could exercise it to distribute all trust property outright to the transferee spouse or to decant the trust property to another trust of which the spouse is not a beneficiary.

The terms of the QTIP will prevent distributions to any person other than the beneficiary spouse. If the terms permit distribution of principal to the spouse, the trustee could terminate the trust by distributing all trust property to the spouse.

The creator of a QPRT generally retains the right to live in the residence that is transferred to the QPRT for a period of time. Because spouses often own their residences jointly, when QPRTs are created, they are usually created simultaneously by both spouses. If the terms of the marital settlement agreement require that one spouse will have the right to live in the residence for the remaining term of the QPRT, the agreement can require that the other spouse transfer his or her rights under the QPRT to the other. In order to avoid subjecting the transferor spouse to continuous income tax on the QPRT income, the transfer should be postponed until after the divorce.

IV. AVOIDING GIFT TAX TRAPS

A. In General

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[96] An Act to provide for the reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal 2018 (Pub. L. 115-97) §10051.

Despite the fact that the parties who are negotiating a marital settlement agreement generally will not have a donative intent toward each other, their agreement and the transfers made pursuant to that agreement may be subject to the federal gift tax.

The best method of assuring that the transfer to a spouse or former spouse in connection with a divorce will not be subject to the gift tax is to qualify it for section 2516's special exception for property settlements. To qualify for this exception, the transfer must be made pursuant to a written marital settlement agreement and divorce must occur within either the one-year period before the execution of the agreement or the one-year period after the execution of the agreement.[97]

B. Special Problems Created by Transfers of Term Interests and Transfers in Trust

Section 2702 may present significant difficulties for many typical marital settlement patterns.[98] Section 2702 applies generally to transfers of term or remainder interests in property, in trust or otherwise, to a family member, if the transferor or an applicable family member retains an interest in the transferred property. Unless the transfer is made in one of several qualified forms, the retained interest is deemed to have a zero value.

Because an individual's spouse is a family member,[99] a transfer of property in trust to pay income to the transferor's spouse for a term of years or for life is subject to section 2702 if the transferor retains the remainder.

If the transfers described above were part of a marital settlement, section 2702 will be avoided if the requirements of section 2516 are satisfied. Treasury Regulation § 25.2702-1(c)(7) creates an exception for "the transfer of an interest to a spouse [if it] is deemed to be for full and adequate consideration by reason of section 2516 . . . and the remaining interests in the trust are retained by the other spouse."[100]

The exception contained in the regulations does not apply to transfers that are protected from the gift tax for any reason other than the application of section 2516 or if any person other than the two spouses acquires an interest in the trust. If a remainder interest in a trust will pass to the children, which is not uncommon in a section 2516 transfer, the exception will not protect the transfer.

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[97] Gift tax protection may also be achieved if the transfer of the interest in the qualified personal residence trust ("QPRT") is made pursuant to a court decree, Harris v. Comm'r, 340 U.S. 106 (1950), or if it can be established that the transfer of the interest in the QPRT was made in exchange for the relinquishment of support rights and that those rights had a value equal to the value of the transferred QPRT interest. Rev. Rul. 68-379, 1968-2 C.B. 414.

[98] I.R.C. §2702 was added to the Code as part of the Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 101-508, 104 Stat. 1388 (1990).

[99] The term "applicable family member" means the transferor's spouse, an ancestor of the transferor or his or her spouse, and the spouse of any such ancestor. I.R.C. §§ 2701(e)(2), 2702(a)(1). The term "family member" means any of the transferor's spouse, ancestors and descendants, any of the transferor's spouse's ancestors or descendants, any of the transferor's siblings, and any spouse of any of such ancestors, descendants and siblings I.R.C. §§ 2702(e), 2704(c)(2).

[100] Treas. Reg. § 25.2702-1(c)(7).

From the standpoint of the actual transferor, the lack of protection when the remainder passes to the children is not important. This is so because section 2702 does not reach his or her transfer unless the transferor or an applicable family member retains an interest in the trust. Although the transferor's spouse is an applicable family member, the spouse has not retained an interest in the trust. Instead the spouse has acquired an interest. Under the regulations, an interest of an applicable family member is treated as retained only if the applicable family member held the interest before and after the transfer.[101]

The joint purchase rule of section 2702, however, is likely to cause a gift tax problem for the transferee spouse. Subsection (c)(2) provides that if two or more family members acquire interests in property in the same transaction or in a series of related transactions, and one of them acquires a term interest (*i.e.*, a life interest or an interest for a term of years), the family member who acquired the term interest will be treated as if he or she had acquired the entire property and then transferred to the other family member the interest he or she acquired.[102]

The joint purchase rule will treat the full value of any term interest acquired by a transferee spouse in a transfer protected by section 2516 as a taxable gift from him or her if a family member other than the transferor spouse retains or acquires any interest other than a term interest in the transferred property. The joint purchase rule recharacterizes the transaction as one made by the transferee spouse.

There are at least three ways of avoiding the impact of section 2702 on a section 2516 transfer in which family members other than spouses acquire remainder interests in trusts or property.

First, the transfer could be structured as a qualified annuity or unitrust interest or as a personal residence trust.[103]

Second, if the transferee spouse does not insist on a transfer of a remainder interest to the children, section 2702 can be avoided, if section 2516 is otherwise applicable, by the transferor's retention of the remainder interest. A later transfer of that interest to the children would be unlikely to resurrect the possible application of section 2702 so long as there was no commitment or understanding that the second transfer would be made at the time the spouses entered into the marital settlement agreement.

Finally, the transferee spouse could be given a power of appointment over the remainder of the trust. The power could be limited to a power to appoint to issue. By giving him or her this power, the gift he or she would be deemed to have made by application of the joint purchase rule will be an incomplete gift.[104]

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101 Treas. Reg. § 25.2702-2(a)(3).

102 I.R.C. § 2702(c)(2).

103 I.R.C. § 2702(a)(3)(A)(ii), (b).

104 If this approach is used, the transferee spouse should retain the interest until death in order to avoid gift tax on the completion of the gift.