LOVE, SEX, MONEY, MARRIAGE, DEATH: ESTATE PLANNING ASPECTS OF DIVORCE

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Agenda

- Pre-marital considerations
- Review estate plan
- Alimony
- Sale or Transfer of a Home as Part of a Divorce
- Property settlement – income and gift tax issues
- Be careful when signing joint returns
- Stock options and deferred compensation – tax consequences
- IRAs and divorce
- Qualified Domestic Relation Orders (QDROs)
- Naming beneficiaries after divorce
- Decanting to protect trust assets
- Social Security
- Alimony trusts - §682
- Gift tax trap – Section 2702

PRE-MARITAL CONSIDERATIONS

Pre-Marital Considerations

CONSIDER THE TAX AND LEGAL CONSEQUENCES

- If property is transferred prior to marriage, it is not covered by §1041.
  - If, pursuant to a prenuptial agreement, and prior to the marriage, appreciated or depreciated property is transferred in exchange for the release of marital rights, such a transfer will not be viewed as a gift for income tax purposes, or an a non-taxable event under §1041.
  - Rather, the transfer will be treated as a taxable sale, with the transferor recognizing gain or loss, and the transferee taking a fair market value basis in the transferred property. Farid-es-Sultaneh v. Commissioner, 160 F.2d 812 (2nd Cir. 1947).
  - However, if an obligation arises under a prenuptial agreement but the transfer of property to satisfy the obligation takes place during or subsequent to the marriage, the rules of §1041 apply to the transfer.

Pre-Marital Considerations

CONSIDER THE TAX AND LEGAL CONSEQUENCES

- Gifts before marriage are subject to gift tax
  - Example: $9 million, 2.5 carat blue diamond engagement ring
  - Taxable gift
  - Sales tax issue
  - Deliver coupon redeemable for ring after wedding?
  - Non-citizen spouse - $148,000 gift tax exemption in 2016
- Qualified plan
  - Survivorship rights to plan benefits cannot be waived in a prenuptial agreement
  - Prenuptial agreement should include a provision requiring the parties to execute a confirmation of a timely waiver after the wedding
  - If spouse refuses to waive rights in a qualified plan after marriage, prenuptial agreement could provide for the refusing spouse's right to alimony or the value of a property settlement is reduced by the value of the plan benefits the spouse refuses to waive.

Pre-Marital Considerations

- CONSIDER THE TAX AND LEGAL CONSEQUENCES
- Pre-nups
  - Make sure estate planning requirements of pre-nup are included in estate planning documents
- Second marriages
  - Make sure estate planning requirements of divorce agreement are included in estate planning documents

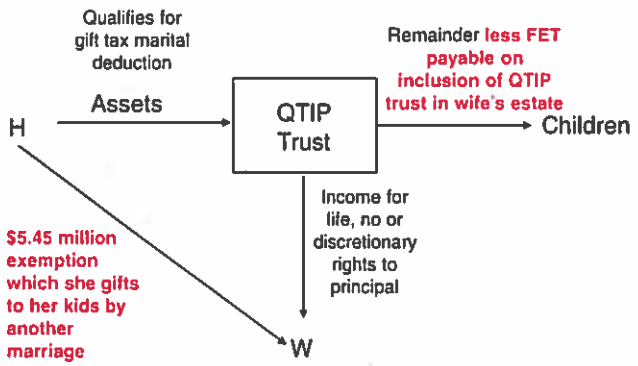
Pre-Marital Considerations - Portability

- Think of the DSUE amount as an asset
  - Possible $2,196,000 ($5,490,000 exemption x 40% estate tax rate) tax dollars at stake
- Issues:
  - Will election be made, by who and who pays?
  - Pre-nuptial requires decedent's executor to elect portability
  - Discuss use of exemption by spouse during life
    - Should spouse seek permission of other spouse before using exemption during life?
  - Should pre-nuptial require spouse to set aside a certain amount of the exclusion for surviving spouse?
  - Disclosure of lifetime taxable gifts to determine the amount of the DSUE
  - Divorcing a later spouse before he or she dies will preserve the DSUE from the last predeceased spouse

Pre-Marital Considerations

PORTABILITY AND QTIP ELECTION

- Leave assets to QTIP, remainder to kids from prior marriage
- Gives surviving spouse a larger portable amount
- Agree in prenuptial agreement that portability election will be made if the surviving spouse agrees to waive reimbursement right under §2207A
- QTIP won't be reduced by estate taxes attributable to increase in surviving spouse's gross estate due to inclusion of QTIP
- Otherwise, surviving spouse could make gifts of his/her assets to his/her own heirs using the deceased spouse's DSUE amount



Result: H's kids pay tax on assets included in W's estate and W gets to use the full amount of H's exemption to make gifts to her children by a previous or subsequent marriage.

REVIEW ESTATE PLAN

Review Estate Plan

REVIEW ESTATE PLAN FOR NECESSARY CHANGES

- State law may revoke will or certain provisions in favor of former spouse
  - MUPC §2-804 creates a presumption that divorce revokes will provisions in favor of a decedent's former spouse, and revokes any disposition of property, grant of a power of appointment, nomination as a fiduciary in favor of the decedent's former spouse or a relative of the former spouse under any governing instrument, including beneficiary designations executed by the decedent prior to the divorce.
- Review/change former spouse's designation as executor/personal representative, attorney-in-fact, health care agent, trustee, beneficiary of retirement plan/life insurance
  - Trusts may be needed to protect interests of minors e.g. minor as IRA beneficiary

Review Estate Plan

REVIEW ESTATE PLAN FOR NECESSARY CHANGES

- Filing of divorce complaint does not trigger MUPC §2-804 . Only actual divorce does.
- Documents should be changed when marriage has broken down.
  - Cover situations where beneficiaries divorce and what rights ex-spouses may have in trust
  - Should revocation of estate planning provisions be triggered by separation or other situations prior to final decree of divorce
- Many states impose automatic restraining order affecting finances.
- Estate liquidity – no spouse, no marital deduction. Estate liquidity an issue e.g. life insurance to cover estate taxes

Review Estate Plan

REVIEW ESTATE PLAN FOR NECESSARY CHANGES

- Insurance policies
- If insured has "incidents of ownership" in policy, policy will be included in his gross estate for federal estate tax purposes.
- State law may allocate estate tax to the insurance proceeds, reducing the proceeds payable to the beneficiary.
- The divorce agreement should provide a clear statement on whether any estate taxes on the policy proceeds are paid from the insured's assets or from the policy proceeds.
- See §2206 which states that unless the insured states otherwise in his will, the executor shall be entitled to recover from the insurance beneficiary the estate tax attributable to the insurance.

ALIMONY

Alimony

TAX CONSEQUENCES:

- Alimony is:
  - Includible in the payee spouse's income. § 71(a); §61(a)(8).
  - Deductible by the payor spouse. §215.
  - Defined in §71

Alimony - Statistics

- Treasury Inspector General for Tax Administration (TIGTA) Report 2014-40-022
  - In 2010, 567,887 taxpayers claimed alimony deductions totaling more than $10 billion
  - 266,190 (47%) of those 2010 tax returns showed no corresponding income reported on the recipient's tax return
  - The alimony gap totaled more than $2.3 billion

Alimony

SEVEN REQUIREMENTS – §71:

- Paid in cash
- Required by "qualifying instrument"
- Instrument doesn't designation as "not alimony"
- Spouses live apart
- Not child support
- Payments cease on death
- Parties don't file a joint income tax return

SALE OR TRANSFER OF A HOME AS PART OF DIVORCE

Sale of Home on Divorce

TRANSFER OF HOME ON DIVORCE

- If the provisions of §1041 are satisfied, the transfer of one spouse's interest in home to the other spouse is protected from the recognition of gain

Sale of Home on Divorce

GENERAL REQUIREMENTS FOR $250,000/$500,000 EXCLUSION:

- Principal Residence
- Owned and used for 2 of last 5 years
- $250,000 exclusion if single, $500,000 if married filing joint
- Exclusion not used in last 2 years

Sale of Home on Divorce

TITLE CONTROLS LIABIITY FOR TAX

- The parties in whose name the title is held are liable for the capital gain tax, notwithstanding that the marital settlement agreement or the final judgment awards each party a different division of the proceeds.
- Example: Marital home held has tenants by the entirety (50/50) sold as part of divorce settlement. Balance of sales proceeds, after payment of expenses, was to be split 75% for wife and 25% for husband. Parties did not file a joint return. Husband liable for 50% of the capital gain tax. Urbauer v. Commissioner, 73 T.C.M. 2788 (1997)

Sale of Home on Divorce

TITLE CONTROLS LIABIITY FOR TAX

- Example: Title to principal residence held in the name of the wife. Divorce decree required house to be sold no later than eight years after the divorce and split the net proceeds equally. Wife liable for tax on the gain. Suhr v. Commissioner, 81 T.C.M. 1114 (2001).
  - Tax liability is triggered by a taxpayer's ownership interest in property, not by his or her marital interest in the proceeds from the sale of the property.
- Planning point: if parties are to share the proceeds from the sale of the principal residence, and it is the intent of the parties that each is to pay capital gain tax, if any, out of his or her share, counsel must arrange for title to be in both names.

Sale of Home on Divorce

SELL HOME PRIOR TO DIVORCE TO GET $500,000 EXCLUSION

- H and W owned and used jointly owned home for more than 2 of last 5 years
- Purchase price $200,000, FMV $700,000
- If H transfers his interest to W , they divorce and she later sells, only $250,000 exclusion available
- If H and W sell prior to divorce and file a joint return, $500,000 exclusion available

Sale of Home on Divorce

IMPUTED *OWNERSHIP* OF HOME – SPOUSE WHO OWNS HOME TRANSFERS HOME TO OTHER SPOUSE PURSUANT TO DIVORCE, OWNER-SPOUSE'S PERIOD OF OWNERSHIP IS ATTRIBUTABLE TO THE OTHER SPOUSE'S OWNERSHIP I.E. TACKING OF OWNERSHIP PERIOD - §121(d)(3)(A).

- H purchases home in his name in 2006
- H and W occupy home from 2006
- Couple divorce in 2009 and W gets home under divorce decree
- W sells house in 2009
- W qualifies for $250,000 exclusion as H's ownership period is added to her ownership period
- W satisfies both use and ownership requirement

Sale of Home on Divorce

IMPUTED *USE* OF HOME – SPOUSE OWNING HOME TREATED AS *USING* HOME AS PRINCIPAL RESIDENCE DURING ANY PERIOD OTHER SPOUSE IS GRANTED USE OF HOME UNDER DIVORCE OR SEPARATION AGREEMENT - §121(d)(3)(B)

- H (who owns house) moves out of home into an apartment
- H and W divorce – W granted use of home under divorce agreement
- H sells home
- W's use of home is attributed to H
- H can claim $250,000 exclusion

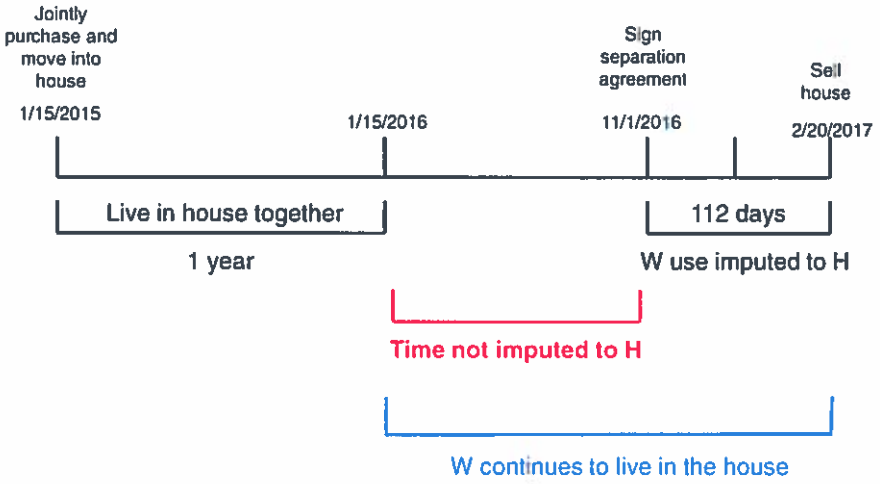
Sale of Home on Divorce

DISPOSITION OF THE MARITAL RESIDENCE

- Caution: a spouse's sole use of the marital home prior to entry or execution of the divorce instrument is not imputed to the non-occupant spouse for purposes of §121(a) or §121(b)(2).

- Thus, the timing of a spouse's departure from the marital home could be strategic from the standpoint of §121, depending on how long he or she has already lived in the house and how long after the entry or execution of the instrument the parties intend to sell the home.

Sale of Home on Divorce



PROPERTY SETTLEMENTS IN DIVORCE

Property Settlements in Divorce

INCOME TAX CONSEQUENCES

- §1041 - Provides for income tax-free property transfers incident to divorce
  - Transfers to a spouse at any time and for any reason during a marriage is a non-recognition event for income tax purposes.
  - Transfers to a former spouse is also a non-recognition event if the transfer is incident to a divorce. Requirements:
    - Transfer is within one year of when the marriage ends or
    - Transfer is related to the end of the marriage
      - Transfer is related to the end of the marriage if the transfer is pursuant to a divorce or separation agreement and the transfer occurs not more than 6 years after the marriage ends
  - Treated as gift under §1041
  - Lifetime, divorce motivated property transfers between spouses result in recipient spouse receiving the basis and holding period of transferor spouse

Property Settlements in Divorce

Example:

- Example: W received royalties earned by her former husband as a member of a rock group (Eagles) which was payable to her under their divorce agreement.
- Under the agreement, W received a 40% share of her former husband's rights under a royalty contract.
- W claimed the royalties were taxable to her husband under an assignment of income doctrine.
- However, the Tax Court said that the test was whether the assignor (her husband) retains sufficient control over the assigned property or over the receipt of income to make it reasonable to treat him as the recipient of the income for tax purposes.
- The court concluded that because the husband retained no control over or interest in the portion of the contract assigned to his wife, the assignment of the royalty interest was a transfer of an income producing asset, not an anticipatory assignment of income. Meisner v. U.S., 133 F.3d 654 (8th Cir. 1998)

Property Settlements in Divorce

HOW TO AVOID THE ASSIGMENT OF INCOME PROBLEM

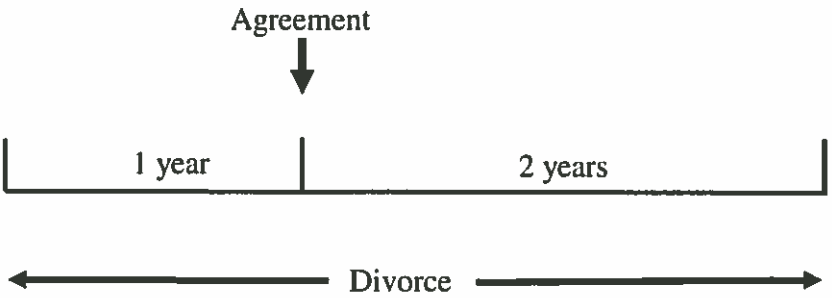
- Assign an undivided fractional interest in the property
- Transferor should not retain a reversionary or contingent interest
- Assignment should survive the death of both the assignor and assignee
- The income from the asset should be paid directly from the payor (not the assignor) to the assignee
- Crucial question: whether the assignor retains sufficient power and control over the assigned property or over receipt of the income to make it reasonable to treat him as the recipient of the income for tax purposes

Property Settlements in Divorce

GIFT TAX CONSEQUENCES - §2516

- Payments of alimony, support for minor child and property settlements made under agreement meeting requirements of §2516 are deemed made for adequate consideration i.e. no gift
- §2516 requirements:
  - Must be a written agreement
  - Regarding spouse's marital or property rights or to provide support for *minor* children
    - §2516 does not apply to transfers to adult children
  - Final decree of divorce required for §2516 to apply
    - Decree of separation, separate maintenance or annulment will not suffice
    - Not necessary for agreement to be adopted, approved or even submitted to court
  - Only payments designated and required by the agreement qualify as non-gifts
  - Divorce must be final either one year prior to or two years after the written agreement
- Transferee takes transferor's basis and holding period
- Note: a divorce transfer not exempt under §2516 may escape tax under general gift tax principles

Property Settlements in Divorce - §2516



Note: the property transfer can be made at any time

SIGNING A JOINT INCOME TAX RETURN

Filing a Joint Income Tax Return

CAN A JOINT RETURN BE FILED?

- If couple are divorced, legally separated or the abandoned spouse rule applies, a joint return cannot be filed.
- Marital status determined at the end of the year.

CONSEQUENCES OF FILING A JOINT RETURN

- Liability is joint and several
- Spousal relief may be available under §6015(b), (c) or (f)
- Spouses can file a "separate liability election" under § 6015(c)(3)(C) which states that neither spouse has liability for the other's tax reporting or taxes

Filing a Joint Income Tax Return

RELIEF FROM JOINT LIABILITY

- §6015 contains 3 exceptions to joint and several liability for tax arising from a joint return:
  - Innocent spouse relief - §6015(b). See Also Publication 971.
  - Election for separate liability - §6015(c)
    - Applicable only to divorced and certain separated taxpayers
  - Equitable tax relief - §6015(f). See also Rev. Proc. 2013-34.
    - Applicable to taxpayers who don't meet the requirements of §6015(b) or (c)

Filing a Joint Income Tax Return

CAN THE IRS LEVY OR SEIZE A SPOUSE'S SHARE OF A QUALIFIED PLAN FOR BACK TAXES?

- Per the terms of a divorce agreement, W receives share of a qualified plan under a QDRO
- Post-divorce, the IRS audits the couple's pre-divorce joint income tax return and establishes a large joint tax deficiency
- While ERISA prevents ordinary creditors from attaching qualified plan payments, courts have unanimously held that a federal tax lien or levy may be imposed on ERISA qualified plans.
- Authority: Ameritrust Co. N.A. v. Derakhshon, 830 F.Supp. 406 (N.D. Ohio 1993)

STOCK OPTIONS AND DEFERRED COMP

Stock Options, Deferred Comp and Divorce – Rev. Rul. 2002-22

HOLDING

- An employee spouse who transfers interests in nonqualified stock options and nonqualified deferred compensation to his former spouse incident to divorce is not required to include an amount in gross income upon the transfer.
- The former spouse is required to include an amount in gross income when the former spouse exercises the stock options or when the deferred compensation is paid or made available to the former spouse.
- Stock options and unfunded deferred compensation are "property" under §1041
  - Entitled to non-recognition treatment under §1041
- Ruling does not apply to nonqualified stock options, unfunded deferred compensation or other future income rights to the extent such options or rights are unvested at the time of transfer or to the extent they are subject to a substantial contingencies at the time of transfer
- Negates FSA 200005006

IRAs AND DIVORCE

IRAs and Divorce – Section 408(d)(6)

TRANSFER OF IRA ON DIVORCE *NOT TAXABLE* IF:

- An *interest* in an IRA is *transferred* from one spouse to the other spouse, and
- Transfer is under a divorce or separation instrument described in Section 71(b)(2)(A) i.e. a decree of divorce or separate maintenance or a written instrument incident to such a decree
  - Notice: does not include a private executed separate agreement not subject to a decree

IRAs and Divorce – Section 408(d)(6)

"The transfer of an individual's interest in an individual retirement account or an individual retirement annuity to his spouse or former spouse under a divorce or separate instrument described in subparagraph (A) of section 71(b)(2) is not to be considered a taxable transfer made by such individual notwithstanding any other provision of this subtitle, and such interest at the time of the transfer is to treated as an individual retirement account of such spouse, and not of such individual. Thereafter such account or annuity for purposes of this subtitle is top be treated as maintained for the benefit of such spouse." (Emphasis added.)

A divorce of separation instrument described in Section 71(b)(2)(A) is "a decree of divorce or separate maintenance or a written instrument incident to such a decree." **(Emphasis added.)**

IRAs and Divorce – Section 408(d)(6)

ALTERNATIVE WAYS TO TRANSFER IRA IN DIVORCE

- Change the name of the IRA owner
- Trustee to trustee transfer – IRA owner sets up new IRA
  - In IRA owner's name, then assigns to spouse;
  - In name of spouse; or
  - Ex-spouse sets up own IRA and IRA owner transfers to ex-spouse's IRA

IRAs and Divorce – Section 408(d)(6)

SUGGESTIONS

- Include language in divorce or separation agreement stating intention of parties that the transfer of the IRA be tax-free under §408(d)(6)
- Have actual IRA transfer papers incorporated into the divorce or separation agreement which is approved by the court
- Do a trustee to trustee transfer
- Make sure the divorce or separation instrument is approved by the court
- Do the transfer after the divorce decree is final

IRAs and Divorce – Section 408(d)(6)

ONCE TRANSFERRED, THE IRA IS TREATED AS OWNED BY THE EX-SPOUSE AS OF THE DATE OF THE TRANSFER

- Ex-spouse is taxed on distributions
- 10% penalty applies if ex-spouse is under 59 ½
- Ex-spouse must take MRD when he/she is 70 ½
- Ex-spouse names own IRA beneficiary
- Ex-spouse not bound by his or her former spouse's election to receive SEPP from the IRA

QUALIFIED DOMESTIC RELATIONS ORDER (QDRO)

Qualified Plans – QDRO

BACKGROUND

- As a general rule, a participant's interest in a qualified plan is non-assignable
- REA of 1984 created an exception to the non-assignability for interests in a qualified plan if the assignment is pursuant to a qualified domestic relations order (QDRO)

Qualified Plans – QDRO

TAXATION

- Spouse or former spouse as "alternate payee" – the "alternate payee" will be taxed on the plan distributions, not the participant spouse.
  - A spouse that receives a distribution under a QDRO from his or her spouse's qualified retirement plan can avoid taxation by rolling the distribution into an IRA. Reg. 1.402(c)-2, Q&A 12.
- Payments to a child (or other dependent) pursuant to a QDRO are taxable to the participant spouse.

Qualified Plans – QDRO

WITHDRAWAL FROM QUALIFIED PLAN BY ALTERNATE PAYEE SPOUSE PURSUANT TO QDRO

- Not subject to early withdrawal penalty. §72(t)(2)(C); Notice 87-13, 1987-1 C.B. 432.
  - A similar exception does not apply to IRAs. §72(t)(3)(A).
- Alternatively, alternate payee spouse could R/O distribution to an IRA
  - However, there is a 20% withholding requirement. §3405(c).
- A direct trustee to trustee transfer from the qualified plan to the IRA will avoid the 20% withholding requirement

NAMING BENEFICIARY AFTER DIVORCE

Naming Beneficiary After Divorce
Case #1 - Facts

- Wife named as beneficiary on husband's IRA
- Couple gets divorced
- Wife agrees she's not entitled to husband's assets
- Also waives any right she has in husband's assets
- Husband remarries
- Completes new paperwork for IRA but names no beneficiary
- Husband dies – ex-wife and new wife claim the IRA

Who Gets the IRA???

Naming Beneficiary After Divorce
Case #1 - Facts

- Wife's right in IRA was revocable prior to death
- At time of divorce she had no property interest in IRA
- At time of divorce, wife #1 has no rights to surrender
- At death, IRA beneficiary designation became irrevocable
  - Wife #1 was the beneficiary

The Ex-Wife

(However, result would be different if the state had a revocation statute similar to UPC 2-804)

Paine Webber, Inc. v. East, Maryland Court of Appeals (March, 2001).

Naming Beneficiary After Divorce
Case #2 - Facts

- Wife named as beneficiary on husband's pension
- Couple gets divorced
- Husband neglects to change pension beneficiary
- Husband dies in car accident 2 months after divorce
- State statute says divorce revokes beneficiary designation of ex-spouse
- Ex-wife and kids by previous marriage claim pension

Who Gets the Pension???

Naming Beneficiary After Divorce
Case #2 - Facts

- ERISA preempts state law that revokes beneficiary designations
- ERISA says beneficiary is determined by plan documents which includes the beneficiary designation form
- Under state law (Washington), ex-wife was named the beneficiary

The Ex-Wife

Egelhoff v. Egelhoff, 532 U.S. 141 (2001)

Naming Beneficiary After Divorce
Case #3 - Facts

- Wife named as beneficiary on husband's pension
- Couple gets divorces
- Wife gives up all right to pension under divorce decree
- Husband neglects to change pension beneficiary
- Husband dies
- Estate sues claiming rights to plan benefits

Who Gets the Pension???

Naming Beneficiary After Divorce
Case #3 - Facts

- ERISA plan documents trump the waiver in the divorce decree
- Plan documents, of which beneficiary designation is part, govern who gets plan benefits
- Bottom line: plan documents govern who gets plan benefits
- Aside: estate may have contract claim against ex-wife

The Ex-Wife

Kennedy v. DuPont, 555 U.S. 285 (2009)

DECANTING TO PROTECT TRUST ASSETS

Decanting To Protect Trust Assets

Ferri v. Powell-Ferri, Case No. SJC-12070, 2017 Mass. LEXIS 198 (March 20, 2017)

- In March, 2011, following the filing of a divorce action in CT between the beneficiary and his wife, the trustees of the 1983 trust (under which the beneficiary had rights of withdrawal at stated ages) decanted its assets to a new (2011) spendthrift trust (under which the trustee had complete discretion as to distributions and which eliminated the beneficiary's withdrawal rights) without informing the beneficiary and without his consent.
  - The trustees decanted the 1983 trust out of concern that the wife would reach the assets of the 1983 trust as a result of the divorce action.

Decanting To Protect Trust Assets

Ferri v. Powell-Ferri, Case No. SJC-12070, 2017 Mass. LEXIS 198 (March 20, 2017)

- Court held if trustee has the discretionary power to distribute property to or for the benefit of the beneficiaries, then the trustee likewise has the authority to distribute the property to another trust for the benefit of the those same beneficiaries.
- Concurring opinion of 3 judges made clear that SJC was not deciding whether Massachusetts law will permit trustees to decant for the sole purpose of removing the trust's assets from the marital estate that might be distributed to the beneficiary's spouse in a divorce action.
  - Court could find that decanting for such a purpose violates public policy
  - Trial court found decanting was done without beneficiary's knowledge or consent
  - Case answered question certified to it by Connecticut Supreme Court – opinion on public policy issue was not requested

Social Security

IN GENERAL

- A divorced spouse (Mary) who was married for at least 10 years and has been divorced for at least two years can claim spousal benefits on the former spouse's (John) earning record. 42 U.S.C. §416(d)(1).
- Divorced spousal (Mary) benefits are available when the former spouse (John) reaches their full retirement age – age 66 in 2016.

Social Security

REQUIREMENTS AND LIMITATIONS

- The divorced spouse (Mary) must be at least age 62 and unmarried – however, they receive reduced benefits if they claim benefits before reaching their full retirement age
- Earnings limit applies if the divorced spouse (Mary) has not reached full retirement age
- Benefits are available regardless of whether the former spouse (John) applied for benefits based on his own work record
  - The divorced spouse (Mary) benefit is based on what the former spouse (John) would receive at full retirement age and is not affected by when the former spouse (John) claimed benefits or even if his benefits were reduced because of excess earnings

Social Security

REMARRIAGE

- Remarriage by the former spouse (John) does not affect the divorced spouse's (Mary) benefits.
- Remarriage by the divorced spouse (Mary) terminates benefits based on the prior marriage
  - Provides an incentive to 'live in sin""

Social Security

FORMER SPOUSE IS DECEASED

- If the former spouse (John) is deceased, the divorced spouse (Mary) is eligible for benefits if:
  - they are at least age 60,
  - the marriage lasted for at least 10 years, and
  - his or her own retirement benefit would not be higher.

Social Security

REMARRIAGE IF FORMER SPOUSE IS DECEASED

- If the divorced spouse (Mary) of a former spouse (John) remarries before age 60 (age 50, if disabled), they are not eligible for the benefit
- However, a marriage after age 60 (age 50, if disabled) does not disqualify them but they will either receive benefits based on the former marriage (to John) or the current marriage, whichever benefit is higher.

Social Security

EFFECT ON THE BENEFITS PAID TO THE FORMER SPOUSE

- The benefits paid to a divorced spouse (Mary) have no effect on the benefits paid to the former spouse (John) or the current spouse or any other spouse of the former spouse (John).

ALIMONY TRUSTS

Alimony Trusts

- Transfers in trust are frequently utilized in the context of divorce and separation.
- A trust provides the recipient spouse with a regular source of funds, rather than the payor spouse's unfunded promise to make alimony payments.
- Most transfers in trust fall under the rules of §1041(a) and do not result in the recognition of gain or loss to the transferor.
  - The transfer is treated as if the transferee spouse received the beneficial interest in the trust as a gift from the transferor spouse.
  - The trust obtains a carryover basis in the transferred property.
  - The transferor's transfer to the trust is generally protected from gift tax liability by §2516.

Alimony Trusts

- For income tax purposes, §682 applies to trusts involved in a divorce or separation, not §71.
  - §682 applies if the transferor and transferee are divorced, have a written separation agreement, or are legally separated.
  - §682 provides that the transferee spouse is taxed as a trust beneficiary, and not as the recipient of alimony, on the amount of any trust income that the transferee spouse is entitled to receive.
    - But for this provision, such trust income would otherwise have been taxable to the transferor spouse under the grantor trust rules of §§671-679 as payment used to satisfy the grantor's support obligation).

Alimony Trusts

- Since the recipient spouse is not receiving alimony, the transferor spouse is not entitled to an income tax deduction when the trust is created
- §682 does not apply to the portion of any income of a trust fixed as child support payments under a divorce decree, written separation agreement or the trust instrument.
  - Child support payments, made from a trust are considered payments for support, and the income attributable to them is taxed to the transferor spouse.
  - Thus, the rules of §682 tax the grantor spouse on trust income fixed for child support, and the beneficiary spouse is taxed on the balance of the trust income payable to him or her.
  - If the trust income in a given year is insufficient to make the required distributions for support of the spouse and for child support, income distributions are deemed to be applied first to child support. §682(a).

Alimony Trusts – Income Tax Issues

SECTION 682 TRUSTS

- If H and W 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 paid to the beneficiary spouse will be included in the income of the beneficiary spouse and not in the income of the grantor spouse
- The distribution rules of Subchapter J determine the amount the spouse/beneficiary must include in income
- Section 682(a) trumps the grantor trust rules

Alimony Trusts – Income Tax Issues

SECTION 682 TRUSTS – 3 CONDITIONS:

- The parties are divorced or separated under a decree of divorce or separate maintenance or under written separation agreement;
- The spouse/beneficiary is entitled to receive the income under the terms of the trust; and
- The income would otherwise have been taxable to the grantor spouse

Alimony Trusts

GOVERNED BY §682 of IRC

- Used to protect recipient spouse's interest in alimony where assets of obligor spouse could be jeopardized in the future or the alimony recipient is financially unsophisticated
- Obligor spouse transfers cash or assets to trust
- Managed by neutral third party trustee
- Trust provides that income from trust is payable to obligee spouse in satisfaction of alimony and/or support obligations
- Absent §682, obligor spouse taxable on trust income
- §682 taxes obligee/recipient spouse on trust income (except income for child support)
- Trust generally governed by rules of Subchapter J

Alimony Trusts

ADVANTAGE OF ALIMONY TRUST

- Minimizes or eliminates post-divorce interaction between spouses
- Guarantees that payments will be made
  - Ex-spouse could otherwise refuse to pay
  - Ex-spouse could die
  - Ex-spouse could lose assets to creditors
- Opportunity for professional money management
- Benefit of third party (trustee) oversight
- Provides transferor spouse with a way of protecting assets used to fund the settlement e.g., a closely held business interest

Alimony Trusts

ADVANTAGE OF ALIMONY TRUST

- Payments can continue after the death of the payee spouse (unlike alimony)
- Payments can be frontloaded without fear of recapture (unlike alimony)
- Payments may be reduced for contingencies related to the child (unlike alimony).
- May avoid estate tax and provide creditor protection
- Gives transferor spouse assurance that assets not consumed by the transferee spouse will ultimately pass according to the transferor's wishes at the transferee's death

Alimony Trust – Avoiding a Taxable Gift - §2516

HOW TO AVOID TAXABLE GIFT WHEN ESTABLISHING AN ALIMONY TRUST

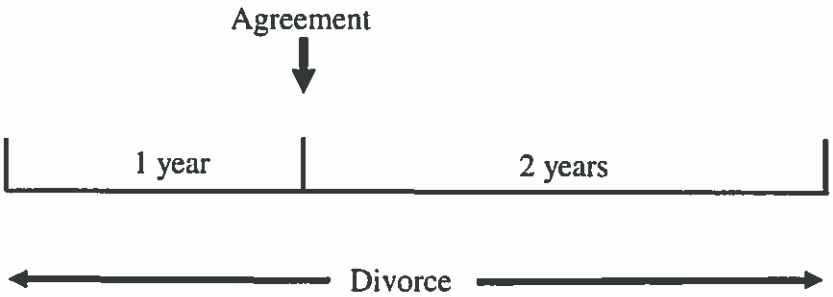
- Generally, comply with Section 2516

Alimony Trust – Avoiding a Taxable Gift - §2516

GIFT TAX CONSEQUENCES - §2516

- Payments of alimony, support for minor child and property settlements made under agreement meeting requirements of §2516 are deemed made for adequate consideration i.e. no gift
- §2516 requirements:
  - Must be a written agreement
  - Regarding spouse's marital or property rights or to provide support for *minor* children
    - §2516 does not apply to transfers to adult children
  - Final decree of divorce required for §2516 to apply
    - Decree of separation, separate maintenance or annulment will not suffice
    - Not necessary for agreement to be adopted, approved or even submitted to court
  - Only payments designated and required by the agreement qualify as non-gifts
  - Divorce must be final either one year prior to or two years after the written agreement
- Transferee takes transferor's basis and holding period
- Note: a divorce transfer not exempt under §2516 may escape tax under general gift tax principles

Alimony Trusts – Avoiding a Taxable Gift - §2516



Note: the property transfer can be made at any time

GIFT TAX TRAP – SECTION 2702

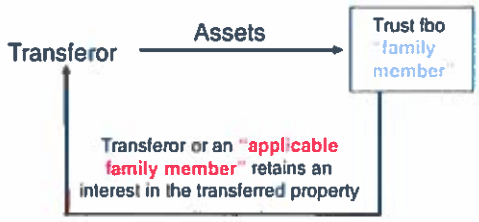
Gift Tax Trap – Section 2702

CAN CAUSE DIFFICULTIES FOR MARITAL SETTLEMENTS THAT REQUIRE TRUSTS

- Applies 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
  - Spouse is obviously a family member
- Result: unless the retained interest is in one of several qualified forms, the retained interest is deemed to have a value of zero i.e., the full FMV of the asset transferred is a taxable gift.

Section 2702 Transaction Diagram

"Family member" = transferor's spouse, his or her ancestors and issue and the ancestors and issue of his or her spouse, his or her siblings and the spouses of any such ancestor, issue or sibling



"Applicable family member" = transferor's spouse, an ancestor of the transferor or his or her spouse, and the spouse of any such ancestor

Gift Tax Trap – Section 2702

EXAMPLES

- Transfer of property in trust to pay income to transferor's spouse for a term of years, remainder to transferor.
- Transfer of home to spouse for term or years, or for life, remainder to transferor
  - Note: Section 2702 is not restricted to trusts
- H and W own home as joint tenants. Agree that upon divorce W gets to live in the house for 5 years and at the end of the 5 year term the house is sold and the proceeds split between them
- Result: H's retained interest is valued at zero and he has made a gift of the entire value of the property to the W

Gift Tax Trap – Section 2702

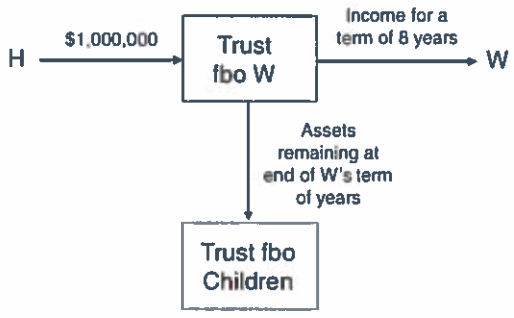
RELIEF

- Section 2702 doesn't apply if the transfer is protected from gift tax by the provisions of Section 2516 and the only beneficiaries of the trust interests are the two spouses
- The exception doesn't apply if Section 2516 doesn't apply or where the remainder interest passes to somebody other than the spouse.
  - Exception doesn't apply if the remainder interest passes to the children
- Alternatively, structure income interest as a "qualified interest" e.g., a GRAT

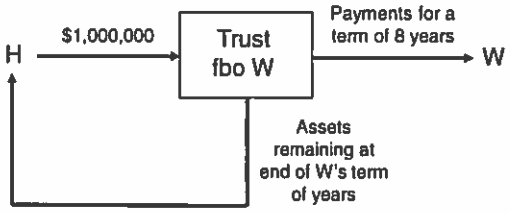
Gift Tax Trap – Section 2702

PERMISSIBLE TRANSACTION

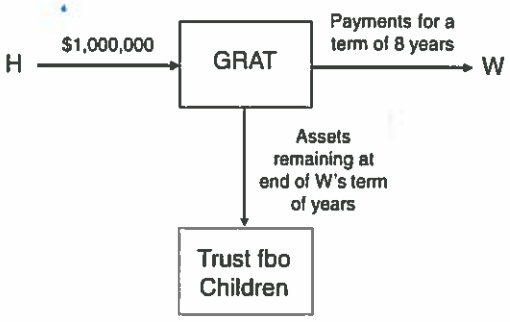
- H transfers $1,000,000 to a trust to pay W income for 8 years, remainder in trust for the children. In exchange, W has relinquished her rights to support which were worth $400,000. W's income interest is valued at $400,000 and the remainder interest is valued at $600,000.
- Section 2702 does not apply because neither H nor an "applicable family member" has retained an interest in the trust.
  - The only person who qualifies as an "applicable family member" is H and he has not retained an interest.
  - H is deemed to have made a gift of the value of the remainder interest to the children ($600,000) and not the value of the entire amount ($1,000,000) transferred to the trust.



No 2702 Problem – neither H not an "applicable family member" has retained an interest in the trust



Section 2702 problem unless transfer is deemed to be for full and adequate consideration under Section 2516 and the remaining interests in the trust are retained by the other spouse. Reg. 25.2702-1(c)(7).



No 2702 Problem – Trust structured as a GRAT with "qualified interest" payments to W

Conclusion

- Pre-marital considerations
- Review estate plan
- Alimony
- Sale or Transfer of a Home as Part of a Divorce
- Property settlement – income and gift tax issues
- Be careful when signing joint returns
- Stock options and deferred compensation – tax consequences
- IRAs and divorce
- Qualified Domestic Relation Orders (QDROs)
- Naming beneficiaries after divorce
- Decanting to protect trust assets
- Social Security
- Alimony trusts - §682
- Gift tax trap – Section 2702

Thank You!