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*Alimony, Prenuptial Agreements and Trusts under the New Tax Act*

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The recent passage of the 2017 Tax Act (the “Tax Act”) brought many changes for business and individual taxpayers. Many of the income tax changes have been highly publicized, such as the decreasing of individual income tax rates, the reduction in the taxability of income from certain pass-through entities, and the reduction of the state and local tax deduction.

As with many large tax overhauls, sometimes lesser publicized changes also have a significant impact on taxpayers. With the Tax Act, some of these lesser publicized changes involve the income tax impact of divorce, and, even though the changes do not take effect until 2019, the effects can be far reaching.

The main analysis in this Alert is divided into two parts – the first part focuses on the elimination of alimony as an item of gross income to the recipient spouse (the “recipient”) and the corresponding deduction for the payor spouse (the “payor”), and the second part focuses on situations where clients have an irrevocable trust and a divorce causes a shift in the taxability of certain trust income.<sup>1</sup>

### ***I. Alimony – A Primer***

Under current law, § 71(a)<sup>2</sup> includes in the recipient’s gross income any amounts received as alimony or separate maintenance payments. Correspondingly, § 215(a) provides the payor with a deduction of an amount equal to the alimony or separate maintenance payments paid during the payor’s taxable year.

The logic behind this treatment was simple. If the payor is required to pay her/his income to the recipient, the taxability of that income should follow the payment and the payor should not be subject to income tax on income that she/he no longer has. Likewise, the recipient should be taxed on income that she/he receives if it would have otherwise been taxed to the payor. However, even if the recipient is taxed on such income, it was still income earned by the payor and would be taxed as such. In order to prevent this double taxation, the payor should be able to deduct such alimony payments. In this alert, this is referred to as the “Existing Alimony Rule.”

#### ***(a) History and Rationale Behind Taxing Alimony***

Historically, though, the rules were not always as clear. The taxability issue was first addressed over a century ago in the United States Supreme Court’s 1917 decision in Gould v.

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<sup>1</sup> For all purposes of this Alert, unless otherwise specified, all references to taxes, rates, returns and taxable income shall be to Federal taxes, rates, returns and taxable income.

<sup>2</sup> Unless otherwise indicated, all section references shall be to the Internal Revenue Code of 1986, as amended (the “Code”).

Gould.<sup>3</sup> In Gould, the Court addressed whether monthly payments to Mrs. Gould of \$3,000 per month for her support and maintenance pursuant to a divorce decree was income to her under the 1913 Tax Act. As alimony was not specifically referenced in the then-tax code as an income source,<sup>4</sup> the Supreme Court concluded that alimony paid to a divorced wife could not be taxed to her. Citing its opinion in Audubon v. Shufeldt,<sup>5</sup> the Supreme Court reaffirmed its conclusion in Audubon that alimony does not arise from any business transaction, but from the relation of marriage, and that alimony is regarded as a portion of the husband's estate to which the wife is equitably entitled. Therefore, alimony was not income to the recipient spouse.

From the time of Gould through the introduction of the Internal Revenue Code of 1939, alimony's taxability to the payor varied based upon different factors, such as the differences in local law.<sup>6</sup> This, coupled with increasing income tax rates due to the war effort, strained the resources of many payors.<sup>7</sup> As stated by Professors Bittker and Lokken, "If local law, a want of capital, the wife's resistance, or other factors made a termination of the support obligation impossible, a husband under the impact of rising tax rates might be left with little or no income of his own, especially if his misalliances were lavish in number or in cost."<sup>8</sup>

This led to the introduction in 1942 of §§ 71 and 215 regarding the inclusion and deductibility of alimony. In their historical analysis, Bittker and Lokken cite a statement made in the Congressional Record by Rep. Wesley E. Disney (D-OK), who stated that "the amount of a husband's income which goes to the wife as alimony under a court order is in reality not income to him at all since he has no control over it as to the use to which it is to be put."<sup>9</sup> These sections were later challenged as unconstitutional, most notably in Mahana v. U.S., where the Court of Claims was asked to determine whether alimony, as an income source, was in conflict with Gould since the United States Supreme Court had already determined alimony to be non-taxable to the recipient. The Court of Claims distinguished Gould by stating that the Supreme Court was only asked to determine whether alimony was income within the context of the 1913 Tax Act and was not asked to determine the constitutionality of alimony as income under the Sixteenth Amendment (the amendment that authorized the taxation of income). Because the above-cited 1913 definition of "income" did not include or exclude alimony, the Supreme Court's sole purpose was to determine whether alimony was, by inference, included within that definition.

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<sup>3</sup> 245 U.S. 151 (1917).

<sup>4</sup> As cited in Gould, under the 1913 Tax Act, income was "[t]hat, subject only to such exemptions and deductions as are hereinafter allowed, the net income of a taxable person shall include gains, profits, and income derived from salaries, wages, or compensation for personal service of whatever kind and in whatever form paid, or from professions, vocations, business, trade, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in real or personal property, also from interest, rent, dividends, securities, or the transaction of any lawful business carried on for gain or profit, or gains or profits and income derived from any source whatever, including the income from but not the value of property acquired by gift, bequest, devise, or descent."

<sup>5</sup> 181 U. S. 575 (1901).

<sup>6</sup> See generally, Bittker & Lokken, *Federal Taxation of Income, Estates and Gifts*, THOMSON REUTERS/TAX & ACCOUNTING, 2d/3d ed. 1993-2018 & 2018 Cum. Supp. No. 1, ¶ 77.1.1.

<sup>7</sup> Consider that in 1940, the top income tax rate for individuals was 81.1% for income in excess of \$5,000,000; four years later, in 1944, the top tax rate was increased to 94% for taxable income in excess of \$200,000. See Internal Revenue Service SOI Tax Stats – Historical table 23 at <https://www.irs.gov/statistics/soi-tax-stats-historical-table-23>.

<sup>8</sup> Id.

<sup>9</sup> Id., citing 88 Cong. Rec. 6377 (1942) (remarks of Rep. Disney).

By 1950, a statute had been enacted regarding the taxability of alimony, so Gould was not as pertinent as the plaintiff in Mahana argued. In upholding the taxability, the Court of Claims stated that alimony should be defined in the context of its every-day usage, so that a “woman receiving large sums of money from a man who ceased to be her husband more than twenty years ago would be regarded as having income.”<sup>10</sup>

The conclusion to be drawn from history is that alimony should be regarded as an income source. This has been the settled rule of law for over 75 years.

### **(b) Defining “Alimony”**

What is “alimony”?

Under § 71(b)(1), “alimony” is simply a cash payment from the payor to the recipient that must meet certain other requirements, such as, (A) the payor and recipient cannot be living together at the time that the payment is made, (B) the payments end when the recipient dies, and (C) the divorce or separation instrument must not specifically provide that the payments are not to be included as income by the recipient and deducted by the payor (i.e., the Existing Alimony Rule).

While all of the elements are important, our focus is on the last element – the Existing Alimony Rule. Based on the statutory definition of alimony, if a divorcing couple does not wish for alimony to be subject to the Existing Alimony Rule, all they are required to do is specifically state as such in the divorce decree – in other words, the Existing Alimony Rule is an “opt-out” provision. Simply put, if the divorce decree states that the Existing Alimony Rule is not to apply, it doesn’t apply.

## **II. Part One – When Alimony is No Longer Considered to be Taxable Income**

### **(a) 2019 – A Change in the Rules**

Beginning in January 1, 2019, §§ 71 and 215 are repealed.<sup>11</sup> Under this “New Alimony Rule” the recipient receives the payment without income tax effect. The payor receives no deduction for the payment.

Of all of the questions that might be asked, first and foremost is, “Why was repeal necessary when the Existing Alimony Rule is, by definition, technically optional?”

This Congress justified the change based on the rule set forth by the century-old Gould decision.<sup>12</sup> Their analysis is flawed. Recall in Gould, the Supreme Court did not decide how “alimony” should be taxed as a matter of tax policy, but rather it simply determined that alimony was not an item of income under the then-statute defining income. Therefore, it should not be taxed to the recipient. Twenty-five years after Gould, Congress refined and redefined the term “income” to include alimony. When doing so, Congress based its decision on legitimate policy reasons. This Congress seems to have disregarded the analysis from the Audubon case, concerning the Gould decision, and why it lacks precedential effect.

With this background, the following questions must now be asked: First, if the Existing Alimony Rule has been good tax policy since 1942, what caused this Congress to decide that it was

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<sup>10</sup> Id., citing 88 F. Supp. 285, 288 (Ct. Cl. 1950), cert. denied 339 U.S. 978 (1950), reb’g denied, 340 U.S. 847 (1950).

<sup>11</sup> See, §§ 11051(a) and 11051(b)(1)(B) of the Tax Act.

<sup>12</sup> See, Title I, Section D.8., of the Congressional Conference Agreement.

no longer good tax policy? Second, is there a more legitimate policy reason for upending income tax rules that have been in effect for over 75 years other than citing a 100 year old Supreme Court opinion? Third, can the answers be whittled down to one simple principle –was the change made solely to raise revenue?

***(b) Why the Change? Simple – It Generated More Needed Revenue!***

The only answer that appears to make any sense is that the Tax Act provided major tax cuts and Congress needed to offset these cuts with new income sources. If this is the case, then the change was primarily a “revenue raiser” provision.

Consider an example which helps explain the Existing Alimony Rule’s repeal. In most instances, if alimony is to be paid, the payor is likely to be in a higher income tax bracket than the recipient. Pursuant to the Existing Alimony Rule, the payor has a deduction under § 215. Alimony is deductible directly from gross income as an “above the line” deduction under § 62(10). This means that such deductions are dollar-for-dollar reductions from income and not subject to any thresholds, limitations or phase-outs.

*Example:* Suppose that, in 2017, a divorcing couple negotiates a settlement that is designed for the payor spouse to pay alimony to the recipient spouse in the amount that will net the recipient with \$5,000/month, or \$60,000/year, and the settlement will become part of a divorce decree. Since the Existing Alimony Rule has been around for over 75 years, the parties and the courts understand the impact of income taxes. Assume the payor is in the top income tax bracket, which, for this example, is 40%,<sup>13</sup> and the recipient is in the 25% income tax bracket.

*Result Under the New Alimony Rule:* Under the New Alimony Rule, if the alimony is paid from the payor’s taxable income, the payor is charged with much more than the \$60,000 in alimony. Applying the payor’s tax rate of 40%, the actual cost to the payor is \$100,000 ( $\$60,000 \div (1 - 40\%)$ ). Stated differently, the payor has to earn \$100,000 to pay a net amount of \$60,000 to the recipient. The payor, thus, pays – and loses the benefit of - the alimony, income taxes on the alimony and the income taxes on the funds used to pay the income taxes on the alimony. Based on this approach, the payor must pay total income taxes of \$40,000 ( $\$100,000 \times 40\%$ ). The recipient has no income tax consequences to the alimony because the alimony is not included in her/his gross income. Therefore, the total combined income tax consequences in this alternative is \$40,000.

*Result Under the Existing Alimony Rule:* Now consider the effect if the alimony is instead subject to the Existing Alimony Rule. Recall that the recipient is required to receive \$60,000 in alimony net of taxes. As the recipient is in the 25% income tax bracket, for the recipient to receive \$60,000 in net payments, the recipient must receive \$80,000 in total alimony, resulting in \$20,000 in income taxes ( $\$80,000 \times 25\% = \$20,000$ ). As the payor is entitled to fully deduct the alimony without any phase-out or limitation, the result is tax-neutral to the payor. Therefore, the total combined income tax consequences under the Existing Alimony Rule is \$20,000, or \$20,000 less than the New Alimony Rule.

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<sup>13</sup> The actual top income tax bracket in 2017 was 39.6%, but 40% is used so that most of the calculations in this example result in whole dollar numbers.

*Conclusions:* Under this analysis, the reason for the elimination of the Existing Alimony Rule for alimony is clear – by doing so, Congress is increasing income tax revenue.

Income taxes aside, the Existing Alimony Rule also benefits the payor in terms of wealth preservation.

Recall that under the New Alimony Rule, the payor loses the benefit of \$100,000 (i.e., \$60,000 in alimony paid to the spouse and \$40,000 in income taxes paid). However, consider that if the payor is not required to pay alimony, the payor, while having the benefit and use of the \$100,000, would also be required to pay income taxes on this amount, which, at 40%, results in income taxes of \$40,000. This means that the payor will lose the use of the \$40,000 regardless of whether alimony was paid, meaning that the actual loss to the payor is \$60,000.

By applying the Existing Alimony Rule, the payor is now required to pay \$80,000 in alimony in order for the recipient to receive the \$60,000 after-tax amount.

Had the payor not paid the alimony, the payor would have paid 40% in income taxes on the \$80,000, or \$32,000, meaning that the true out-of-pocket loss to the payor is only \$48,000.

Comparing the two results, if the Existing Alimony Rule is applied, the payor's out-of-pocket losses are \$48,000, and if the New Alimony Rule is applied, the payor's out-of-pocket losses are \$60,000. Therefore, the Existing Alimony Rule preserves the payor's wealth by \$12,000.

Based on these simple calculations, there is nothing more persuasive about the policy for the repeal of the Existing Alimony Rule – it is simply that Congress needed more revenue to offset other tax cuts.

There may also be a cynical policy element of driving up the costs of divorce. Perhaps the delay in the effective date for these changes was simply to see what fallout occurs during 2018. Certain interest groups, including the Family Law Section of the American Bar Association, are appealing to Congress to preserve the Existing Alimony Rule. The Department of Treasury has also asked for public comments on the application of certain rules in the wake of these changes.<sup>14</sup>

### ***(c) A Moment about the Impact of State Income Taxes***

Although this Alert is focused on the Federal tax aspects, the results are magnified when state law is considered.

*Example:* Consider a divorce where the parties reside in Florida, which has no state income tax. Suppose that the payor accepts a new position in the District of Columbia, which imposes a state income tax (which, for purposes of this example, is deemed to be 8%).<sup>15</sup> If the Existing Alimony Rule is not applicable, the payor's payment of \$60,000 of alimony is subjected to in D.C. taxes which causes further out-of-pocket costs to the payor.

*Result Under the New Alimony Rule:* Isolating only the D.C. income taxes (and disregarding the Federal taxes), the total out-of-pocket cost to the payor is approximately \$65,200 ( $\$60,000 \div (1 - 8\%)$ ). In other words, the payor would have to earn \$65,200 to effectively pay \$60,000. Even though the payor would have been subject to the D.C. income tax if she/he hadn't been required to pay alimony, the tax would have been paid from the funds creating the tax. With the funds being

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<sup>14</sup> Notice 2018-37, I.R.B. 2018-18 (April 13, 2018).

<sup>15</sup> See, D.C. CODE § 47-1806.03; the actual D.C. income tax rates range from 4% to 8.95%. For purposes of this example, the assumption is that the

paid as alimony, the payor receives zero benefit from the funds and must pay the income tax from other funds.

*Result Under Existing Alimony Rule:* Now consider if the Existing Alimony Rule applies – the payor would be able to offset the alimony paid as a deduction against the income, so the impact of the D.C. income tax is neutralized.

**(d) Grandfathering Can Preserve Current Law for Certain Divorces**

In addition to the delayed implementation of the statutory repeal, the new law incorporates grandfathering rules. The repeal of §§ 71 and 215 applies to any “divorce or separation instrument” executed after December 31, 2018. This means that for any divorce or separation agreement that is in effect before January 1, 2019, the repeal of §§ 71 and 215 does not apply (the “Grandfathering Exception”).<sup>16</sup> For example, if a divorce decree is issued before January 1, 2019, then, irrespective of the new law, the Existing Alimony Rule continues to apply.

**(e) Are Prenuptial Agreements Covered Under the Grandfathering Exception?**

As stated above, the Existing Alimony Rule is an “opt-out” rule, meaning if the decree specifically states that it is not to apply, then it does not apply. Under current law, one way to ensure that the Existing Alimony Rule would apply is to specifically provide for the Existing Alimony Rule in a prenuptial agreement. Likewise, if the parties wish to elect out of the Existing Alimony Rule, the parties would mandate this in a prenuptial agreement. Keep in mind that the Existing Alimony Rule has been established as part of the law during the entire career of most every practicing divorce and tax lawyer. This is a known matter – it was not “sneaking up” on an unsuspecting alimony recipient.

Suppose that, prior to January 1, 2019, parties engage in a prenuptial agreement and specifically reference that the Existing Alimony Rule is to apply. The question is now as to the status of the election for the Existing Alimony Rule. As stated above, if a decree is issued prior to January 1, 2019 which implements the Existing Alimony Rule, the repeal of §§ 71 and 215 does not apply as to the alimony payments under that decree. The decree, in this instance, must be a “divorce or separation agreement” for purposes of the Tax Act.

Is, however, a prenuptial agreement deemed to be a “divorce or separation agreement” for purposes of the Tax Act? If it is, then the alimony provisions under a prenuptial agreement mandating the Existing Alimony Rule would fall within the Grandfathering Exception even if the parties were not divorced prior to January 1, 2019.

The analysis begins with § 71(b)(2), which defines a “divorce or separation agreement” as, (1) a decree of divorce or separate maintenance or rewritten instrument incident to such a decree, (2) a written separation agreement, or, (3) a decree requiring a spouse to make payments for the support or maintenance of the other spouse.<sup>17</sup> The definition includes decrees (which denotes issuance by a court) and a written separation agreement, which is an agreement to provide for the rights of a

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<sup>16</sup> See, § 11051(e) of the Tax Act.

<sup>17</sup> The Act fixes a potential statutory glitch - the definition of “divorce or separation agreement” is contained in § 71(b)(2), which, as stated above, is repealed as of January 1, 2019. Under § 11051(b)(3)(A) of the Tax Act, the definition is moved to § 121(d)(3).

married couple who are then separating. Unfortunately, it does not appear that definition encompasses prenuptial agreements. Presumably this is because a prenuptial agreement is not a court decree or a document where the actions and remedies are to take effect currently – rather, a prenuptial agreement forms a contractual relationship between the parties to provide for the enforcement of certain marital and other rights upon a future event, i.e., a separation or the termination of the marriage.

Suppose that, prior to January 1, 2019, a couple enters into a prenuptial agreement that imposes the Existing Alimony Rule for alimony payments. Because the definition of a “divorce or separation agreement” seemingly does not include prenuptial agreements, such agreements would not be included within the Grandfathering Exception. Thus, even though the parties entered into the prenuptial agreement prior to January 1, 2019, if the divorce decree which incorporates the prenuptial agreement’s provisions is issued after December 31, 2018, the Tax Act prevents the application of the Existing Alimony Rule because §§ 71 and 215 would not be part of the law at time that the transfer obligation ripens (i.e., the alimony payment)!

It is imperative, then, that the advisers and clients review existing prenuptial agreements and determine whether the prenuptial agreement requires the application of the Existing Alimony Rule. If this is the case, the advisers and clients need to consider the options and ramifications if a divorce were to occur after December 31, 2018.

### ***III. Part Two - Alimony Trusts, Income Trusts and the Shifting of Income***

The Tax Act includes an additional change related to alimony; it repeals § 682 regarding the taxability of certain trust income as a result of a divorce.<sup>18</sup> As innocuous as this change may appear to be, it could have major ramifications for a divorced individual who previously created an irrevocable trust for the benefit of his or her former spouse during their marriage.

#### ***(a) “Grantor Trusts” and the Definition of “Spouse” for Certain Trusts***

When an individual creates an irrevocable trust (said individual is customarily referred to as the “grantor” of the trust), a provision is often included in the trust that causes the trust income and expenses to be reported for income tax purposes by the grantor and not by the trust. This is colloquially referred to as a “grantor trust.” Often, the inclusion of these provisions is intentional, as they allow for a “free gift” by the grantor to the trust in the amount of the income taxes paid by the grantor instead of the trust. An example of such a provision is found in § 675(4)(C), which applies “grantor trust” treatment if the grantor retains the right, at any time, to withdraw the trust’s assets and substitute other assets of equivalent value in their place (the “Substitution Power”).

Another “grantor trust” provision is found in § 677(a)(1), which provides that the grantor is to be treated as the owner of any portion of a trust (and therefore taxed on the trust income) if the income from the trust may be distributed to the grantor or the grantor’s spouse.

Throughout the “grantor trust” provisions of the Code, some terms are defined in a way that they don’t mean what you might think that they should mean. “Spouse” is one of those terms. Under § 672(e)(1)(A), a grantor is treated as holding any power or interest of the grantor's spouse,

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<sup>18</sup> See, § 11051(b)(1)(C) of the Tax Act.

which is defined as any individual who was the spouse of the grantor at the time of the creation of such power or interest. For the definition of “spouse,” the only time frame that is critical is the moment that the spouse’s interest was created, i.e., upon the creation of the trust. For the “grantor trust” rules, if a person is a “spouse” at that time, that person remains the “spouse” even if such spouse and the grantor subsequently divorce – there is no continuing review of the marital status of the parties.

Stated differently, based on this definition, if the trust income is required to be paid to the grantor’s spouse, the trust is a “grantor trust” as to the grantor, and the grantor - and not to the grantor’s spouse – is taxed on the income regardless of whether the grantor and the spouse remain married during the duration of the trust.

### ***(b) Trust Planning with Spouses***

With many married couples, “spousal trusts” exist within their respective estate plans. In advanced estate plans, spouses may use irrevocable trusts created for the benefit of the other spouse, with the trust qualifying for the gift tax marital deduction as “qualified terminable interest property” (“QTIP”). These trusts, called “inter-vivos QTIP trusts” were, and remain currently, a cornerstone of creative estate planning techniques.<sup>19</sup>

Another type of spousal trust became very popular in 2012 when individuals were seeking ways in which to use their available estate and gift tax exemption before the end of the year for fear of a “sunset” of the then newly-increased exemption amount (which was \$5.12 million at the time) and a reversion back to the 2001 exclusion threshold of \$1,000,000 (the “use it or lose it” paradigm). In order to utilize the exemption without sacrificing assets within the marital relationship, many clients created a trust called a “spousal lifetime access trust,” or “SLAT.” The typical SLAT would be a taxable gift by one spouse (the “grantor”) to the SLAT which would provide the other spouse (the “donee spouse”) with discretionary distributions of trust income and principal. The SLAT may also be a “sprinkle” trust by including the descendants into the class of individuals who could receive discretionary distributions of trust income and principal, with a direction that the needs of the spouse are to be considered before any distributions are to be made to the descendants (referred to as a “Preference Clause”). The effect of a SLAT is to utilize gift tax exemption while allowing the assets to technically remain within the “marital unit.”

When it comes to divorce, trusts may play an important role. Sometimes, instead of having alimony paid directly to the recipient, the payor may be required to establish a trust for the benefit of the recipient that would provide the recipient with trust income in lieu of requiring the payor to pay recurring alimony payments. These trusts are often referred to as “alimony trusts.” Interestingly, alimony trusts are not always created as a result of the divorce – if, for example, the donor had previously created an inter-vivos QTIP Trust, the court decree may reduce or eliminate the alimony requirement on account of the income that the recipient receives from the trust.

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<sup>19</sup> For background on Lifetime QTIP Trusts, ideas for specific uses of Lifetime QTIP Trusts, and practical implementation information, see Richard S. Franklin, *Lifetime QTIPs – Why They Should be Ubiquitous in Estate Planning*, 50 U. MIAMI HECKERLING INSTITUTE ON ESTATE PLANNING, ¶ 16 (Jan. 14, 2016); see also Richard S. Franklin and George D. Karibjanian, *An Oxymoron? The Deathbed Lifetime QTIP for Basis Adjustment and Asset Protection*, 41 BBNA TAX MANAGEMENT ESTATES, GIFTS, AND TRUSTS JOURNAL No. 6, p.219 (11/10/2016).

**(c) Alimony Trusts and § 682 – the Shifting of Taxability**

As stated above, a trust created by a grantor that requires the income to be distributed to, or gives the trustee the discretion to pay the income to, the donee spouse would be a “grantor trust” as to the grantor under § 677(a)(1) because the income was, or could be, paid to the donee spouse. The income taxation was not an issue because the spouses were part of the “marital unit.”

However, upon a divorce, because § 677(a)(1) only looks to the marital status at the time of the “creation” of the power or interest, the “grantor trust” provisions remain applicable. As a result of the divorce, because the parties are no longer part of a “marital unit,” not only does the grantor lose the benefit from the trust income, but the grantor is also taxed on such trust income. Under these circumstances, not only does the donee spouse receive the trust income, but the donee spouse would not be required to report any trust taxable income or expenses on her/his income tax return because the trust is a “grantor trust” as to the grantor. The end result is that the donee spouse receives the trust income free of income tax.

To avoid this seemingly harsh result, Congress enacted § 682 to shift the taxability away from the grantor. Generally, if trust income is distributed to a married person from a trust created by her/his spouse, then, upon a divorce and irrespective of any other income tax provision, § 682(a) taxes the income to the recipient (except as to any income specifically determined to be allocated for child support).<sup>20</sup>

*Example:* Suppose that A is married to B. During the marriage, for estate planning purposes, A irrevocably transfers property to a trust that A created for B. Under the trust, B is to receive all of the income for her/his lifetime. Some years later, B obtains a divorce from A under a court decree. Acknowledging that B receives sufficient income from the trust, the court does not award any alimony to B. Because A and B were married at the time that A created the trust, A would be taxed on the trust income under § 677(a)(1) notwithstanding the fact the income is paid to B. This would seem logical and non-controversial because, as a married couple, A and B are the equivalent of one “marital unit,” so together, they receive and are taxed together on the income. However, upon divorce, even though A and B cease to be one “marital unit,” the “grantor trust” rules of § 677(a)(1) still apply to tax all trust income to A even though B receives such trust income.

*Result:* For this reason, until the beginning of next year, § 682 comes to A’s rescue and taxed the trust income to B.<sup>21</sup> By its design, § 682 is designed to match tax implications to economic reality.

**(d) 2017 Tax Act and § 682 Repeal – Re-Shifting of Taxability**

Unfortunately, § 682 is repealed as of January 1, 2019.<sup>22</sup>

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<sup>20</sup> Note that such taxability appears to only shift the taxability of ordinary income; capital gains, if remaining in the trust and not allocated to trust income, may still be taxed to the grantor under the grantor trust rules. See Barry Nelson & Richard Franklin, *Inter Vivos QTIP Trusts Could Have Unanticipated Income Tax Results to Donor Post-Divorce*, LISI ESTATE PLANNING NEWSLETTER #2244, (September 15, 2014).

<sup>21</sup> See generally Treas. Reg. § 1.682(a)-1(a)(4) Example 1. Again, as stated earlier, this applies to ordinary income and not capital gains (unless capital gains are directed to be allocated to income).

<sup>22</sup> See, § 11051(b)(1)(C) of the Tax Act.

Starting on January 1, 2019, the income taxability of certain alimony trusts is determined under other Code provisions, such as the “grantor trust” rules. However, the Grandfathering Exception described above should be applicable in that it applies to all of the § 11051 provisions of the Tax Act and not just to the provisions affecting §§ 71 and 215. Although it is not clearly stated in the Tax Act, presumably, if a trust is referenced in a pre-January 1, 2019 divorce decree as paying its income in lieu of alimony, the income tax treatment under § 682 should continue to apply.

Recall that in the above example, if A and B’s divorce occurs prior to 2019, § 682 taxes the trust income to B. Based on the wording of the Grandfathering Exception, § 11051 of the Tax Act applies to any divorce or separation instrument executed after December 31, 2018. If the divorce decree references that the trust income is in lieu of a higher alimony (or any alimony) payment, then, since the decree was issued prior to 2019, § 682 should still apply even after December 31, 2018.

Timing, though, is everything!

*Example:* Suppose in the prior example that the divorce decree is executed after December 31, 2018; § 682 would not be applicable and other income tax provisions would determine the trust’s income taxability.

*Example:* What if, in December 2018, in an effort to resolve the open issues between the parties and expedite the issuance of a final divorce decree, A creates and funds a trust that pays all of the income to B? The parties agree that the divorce decree should reference the trust and state that the income paid to B is in lieu of alimony. The divorce decree, however, is not issued until January 4, 2019. Under these facts, because it was created during the marriage, the trust would be a “grantor trust” as to A pursuant to § 677(a)(1) and, upon the issuance of the divorce decree, the trust remains a “grantor trust” because after January 1, 2019, § 682 would not then exist.

### ***(e) Can § 682 Apply Even if the Divorce Decree is Silent?***

An interesting anomaly concerning § 682 is the fact that § 682(a) applies even if a trust was not specifically created pursuant to a property settlement agreement or a decree of divorce or separate maintenance. To invoke § 682(a), the divorce decree is not required to reference the trust - the only requirement is that income be paid, or used for the benefit of, the donee spouse.<sup>23</sup>

Recall that the Grandfathering Exception only applies to any divorce or separation instrument executed after December 31, 2018, which means that § 682 should still apply to any divorce or separation instrument executed prior to January 1, 2019. Although the Congressional Conference Report did not give a specific reason for the grandfathering, it is likely that the exception is provided because the alimony payments were a factor in the particular settlement.

What happens, though, when the decree fails to mention the source of payments in lieu of alimony, i.e., payments already coming to a spouse under an existing trust?

*Example:* Suppose that, in the above example, the alimony trust created by A is not referenced in the 2018 divorce decree. Should the Grandfathering Exception apply? Technically, there was a divorce decree and the decree was entered prior to January 1, 2019; however, the decree

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<sup>23</sup> H. Zaritsky & N. Lane, *Federal Income Taxation of Estates and Trusts* (THOMSON REUTERS/WG&L, 3D ED. 2001, WITH UPDATES THROUGH OCTOBER 2017) (ONLINE VERSION ACCESSED ON CHECKPOINT ([www.checkpoint.riag.com](http://www.checkpoint.riag.com))), ¶17.01. Alimony Trusts.

appears to be mutually exclusive from the trust because there is no reference whatsoever to the trust in the decree. Given that § 682 governs the taxability of the trust in 2018, should this trust fall within the Grandfathering Exception, or does the lack of a specific reference to the trust in the divorce decree now subject A to the “grantor trust” rules under § 677(a)(1) even though it was obvious to the parties, but not stated in any manner in the decree, that the trust income was in lieu of alimony? The answer to this is unclear, and, technically, guidance is needed on this issue as well as to provide clarification as the applicability of the Grandfathering Exception to all trusts subject to § 682.

**(f) SLATs and §682**

What about SLATs – does § 682 apply to them? The answer is more ominous than with income trusts. As stated above, the typical SLAT is not an income trust but is a discretionary trust. In other words, all distributions to the donee spouse are at the discretion of the trustee and the donee spouse has no entitlement to any distributions. Pursuant to § 677(a)(1), § 677(a) applies to trusts where income may (as opposed to shall) be distributable to a spouse (“... whose income without the approval or consent of any adverse party is, or, in the discretion of the grantor or a nonadverse party, or both, may be ... distributed to the grantor or the grantor’s spouse”). This means that a SLAT would be a grantor trust as to the grantor.

As further described above, with an income trust for a donee spouse, upon a divorce, § 682 applies to shift the income taxation to the recipient. However, the language of § 682(a) is specific as to the distributions – the section provides, in pertinent part, as follows:

*“There shall be included in the gross income of a wife who is divorced or legally separated under a decree of divorce or of separate maintenance (or who is separated from her husband under a written separation agreement) the amount of the income of any trust which such wife is entitled to receive ...”*

In a discretionary trust, such as a SLAT, the donee spouse has no entitlement to receive any distributions – all distributions are at the Trustee’s discretion. In this instance, the SLAT would continue to be a “grantor trust” as to the grantor. This would appear to be surprising news for any grantor who created a discretionary trust for donee spouse, such as those grantors who created SLATs in 2012, and become divorced from the donee spouse after December 31, 2018.

**(g) Any Recourse for the Grantor - Modification? Decanting? Death on Divorce Clause?**

Section 682 applies to certain trusts regardless if they are referenced in the divorce decree. If a trust is not so referenced, as of January 1, 2019, such trusts are governed under other provisions of the Code, which, since spouses are involved, reverts to the “grantor trust” provisions.

Ordinarily, when an individual creates a “grantor trust,” it is possible to “toggle” the taxability on-and-off by relinquishing a power. For example, if a trust is a “grantor trust” on account of the inclusion of the Substitution Power, the grantor can “turn off” the “grantor trust” provisions by renouncing the Substitution Power. However, from the above analysis, §677(a)(1) cannot be “turned off” – it remains in effect for as long as the grantor remains alive during the trust term. Similar to the news of the tax treatment of SLATs, this, too, would appear to be surprising

news for any grantor who created an income trust for donee spouse and then became divorced from the donee spouse after December 31, 2018.

Unfortunately, courtesy of the power of § 677(a)(1), if a divorce occurs after 2018 there may be few options, if any, to switch the income taxability to the donee spouse (to reflect economic reality).

Under any trust other than an inter-vivos QTIP trust, one way to disable § 677(a)(1) is to modify the trust so that the income provisions are outside the scope of § 677(a)(1). For example, if the trust provides for a “trust adviser,”<sup>24</sup> the adviser could amend the income distribution provision so as to negate the applicability of §677(a)(1) by requiring income distributions to the spouse to be approved by an adverse party. If the trust does not provide for a trust adviser, the trust could possibly be judicially or non-judicially reformed or could be “decanted” to provide for one.<sup>25</sup> However, the question arises as to whether such a change by the trust adviser, if the law provides that the trust adviser is a fiduciary, would be a breach of fiduciary duty as to the donee spouse in her/his capacity as the income beneficiary of the trust.<sup>26</sup>

These suggested strategies are probably not possible with an inter-vivos QTIP because these changes could be considered to be a restriction on the donee spouse’s income interest. Such a restriction could thereby disqualify the trust for the gift tax marital deduction under § 2523(f). Alternatively, if the QTIP election is not invalidated, upon implementation of such a strategy, it may cause the entire trust to be immediately subject to transfer taxation pursuant to § 2519.

Taking another approach, for those decrees that are issued before January 1, 2019 but fail to reference the particular trust, would it be possible for the decree to be amended after December 31, 2018 and have the amendment act to bring the trust within the Grandfathering Exception? There is no current answer to this question – the next likely step would be to request guidance from the Internal Revenue Service in the form of a private letter ruling request.<sup>27</sup>

If the trust is a discretionary trust, such as a SLAT, whereby distributions can be made for any one or more of the spouse or the grantor’s descendants, it may be possible for the trustee to effect distributions only to the descendants. This way, even though the trust would remain a “grantor trust” under § 677(a)(1), the income would benefit the descendants and not the ex-spouse. However, this might not be feasible if the trust contains a Preference Clause, as the ex-spouse could object that her/his needs must be considered before any distributions can be made to the descendants.

One final thought on this topic. When creating a spousal trust, a fairly common – but certainly not universal – boilerplate clause involves divorce. Such a clause – referred to as “death on divorce” clause – is a legal fiction providing that, in the event of a divorce and for all purposes of

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<sup>24</sup> As discussed in the Official Comments to §808 of the Uniform Trust Code, and as codified in D.C. CODE §19-1308.08; MARYLAND EST. & TR. CODE §14.5-808; VA. CODE §64.2-770; and FLA. STAT. §736.0808. “Advisers” or “Trust Protectors” are also referred to as the “Trust Director” under the newly adopted Uniform Directed Trust Act, as issued by the Uniform Law Commission in July 2017.

<sup>25</sup> “Decanting” is a concept in certain states where a trustee can distribute the trust assets to another trust in which all of the beneficiaries are beneficiaries under the distributing trust and in which certain provisions may be different.

<sup>26</sup> Note that the concepts raised in this section of the Alert are beyond the scope of this article, but are mentioned solely to address the problems facing grantors by the repeal of § 682.

<sup>27</sup> This may be one of the issues for which Comments will be submitted pursuant to Notice 2018-37. See Note 14.

the trust, the donee spouse will be “deemed” to have then died and all of the donee spouse’s interests in the trust will then terminate. The only spousal trust where a “death on divorce” is not possible is in an inter-vivos QTIP trust because, in order to qualify for the gift tax marital deduction, the trust must continue unimpeded for the spouse’s lifetime, and a “death on divorce” clause prevents this from occurring. If any other form of spousal trust contains a “death on divorce” clause, upon the divorce the spouse’s income interest ends which thereby terminates the applicability of § 677(a)(1) and, with it, “grantor trust” status based on the spouse’s interest in the trust. Of course, the trust could still be a “grantor trust” based on other provisions, such as the Substitution Power, but, even in those situations, the grantor is not being taxed on income payable to the donee spouse.

What if a trust does not contain a “death on divorce” clause; can it be added? If the trust is not an inter-vivos QTIP trust, there are several potential ways to add the clause, such as a trust modification proceeding, decanting (if permissible within the particular jurisdiction) or modification by a trust adviser (if authorized in the trust and/or under the governing law). Of course, at the time of a divorce, the parties could agree upon the termination of the spousal interest in the trust.

As illustrated above, there are extremely complicated tax implications of a divorce even without the changes implemented by the Tax Act, and such new changes provide further layers of issues.

This is a perfect example of why the estate planning adviser should be a part of any divorce planning. The changes brought about by the new Tax Act is the perfect impetus for the family law and estate planning advisers to meet with the client to review the entire estate plan in light of a potential divorce, even if a divorce is not even remotely then contemplated.

#### ***IV. Conclusion – Change is Permanent, So What Can Be Done?***

Until January 1, 2019, the income tax laws regarding current and pending divorces and legal separation are somewhat clear. After December 31, 2018, “clarity” can become a fluid term of art.

For example, what happens with prenuptial agreements entered into before January 1, 2019 where alimony is required and subject to the Existing Alimony Rule but the divorce or legal separation occurs on or after January 1, 2019? Based on the plain meaning of “divorce or separation agreement,” it would appear that a prenuptial agreement does not qualify as a “divorce or separation agreement” and therefore the Existing Alimony Rule for alimony would appear to be ineffectual. It is certainly possible for the parties to reopen the prenuptial agreement to provide for some form of alternate provision. However, especially if other financial circumstances have changed, many parties would probably not wish to reopen the prenuptial agreement for fear that additional concessions would have to be made. The difference to the payor spouse could be dramatic, however.

The Tax Act also changes the effect of divorce on trust income. What, if anything, can be changed regarding the shifting of taxable income after December 31, 2018? If the divorce decree references the trust and is issued before January 1, 2019, the special taxability rules of § 682 should continue to apply even after December 31, 2018.

If a couple is seeking a divorce and trust income is involved in the settlement, the couple and counsel should work as expeditiously as possible to have the divorce finalized prior to January 1,

2019 and to satisfy the requirements of the Grandfathering Exception. The decree should reference any trust created by the grantor which provides that the income is payable to the donee spouse.

If the decree fails to reference a particular trust where the trust income is payable to a recipient in lieu of divorce, the only possible way to fall within the Grandfathering Exception is to seek a clarification and amendment to the divorce decree specifically referencing the trust income as a means of satisfying an alimony obligation.

As for other trusts that are not “alimony trusts,” while the decree can be revised to reference such trusts, it is unknown whether that change will be retroactively accepted within the Grandfathering Exception.

Formal guidance from either Treasury, the Internal Revenue Service, or both, is needed on these §682 grandfathering points. Additional spousal trusts must be reviewed to determine whether such trusts are “grantor trusts” and, if so, does the spousal interest continue after the divorce.

Finally, with respect to many of the tax law changes created under the Tax Act, there is a “sunsetting” of such provisions, meaning that the changes expire after a certain date and the law reverts back to the 2017 law. The provisions regarding alimony and divorce, however, do **not** sunset – these changes are permanent (or as permanent as tax law changes can be) and their pain will be enduring.

These and all other issues pertaining to a divorce or other marriage termination should be discussed over the next few months with matrimonial and estate planning counsel.

If you have any questions about these issues, please contact one of our lawyers.

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