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TRUSTS & ESTATES

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DOMESTIC RELATIONS

Warn Clients About Change in Taxation Of Trust Income After Divorce

Would your client be surprised to learn that he is responsible for paying the income taxes on trust distributions made to a former spouse, who will enjoy those distributions tax-free on his dime? That is exactly the result that may ensue as a result of recent changes to the law.

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An individual can create irrevocable trusts for the benefit of family members, moving the assets transferred to those trusts out of the trust creator's estate for estate tax purposes, while remaining responsible for paying the trusts' income and capital gains taxes. Creating these so-called "grantor trusts" (trusts considered owned by the grantor for income tax purposes) is a popular planning tool because it allows the grantor, in effect, to make gifts to the trust in the amount of the income tax payment, which otherwise would be payable by the trust or trust beneficiaries. Accordingly, practitioners often purposely include provisions in trusts that will trigger grantor trust status, allowing these trusts effectively to grow tax-free for the beneficiaries.

Additionally, under Internal Revenue Code Section 677(a)(1), a grantor is treated as the owner of any portion of a trust if income may be distributed to the grantor or the grantor's spouse. Under IRC Section 672(e)(1) (the so-called "spousal unity rule"), a grantor is treated as holding any power or interest held by an individual who was the grantor's spouse at the time the power or interest was *created*. Accordingly, if a trust was created while the parties were married and trust income may have been distributed to the grantor's spouse, that trust likely will be a grantor trust and *will remain a grantor trust even if the grantor and the grantor's spouse subsequently divorce*. That is, after a divorce, the grantor would be liable to pay the taxes attributable to trust income that was paid to the grantor's ex-spouse, and the ex-spouse would receive the income tax free. Until Dec. 31, 2018, IRC Section 682 prevented that result by providing that the income distributed to a spouse after a divorce is taxable to the recipient and not the grantor. That protection has ended. The Tax Cuts and Jobs Act (the Tax Act), signed into law on Dec. 22, 2017, repeals Section 682 for divorce or separation agreements executed after Dec. 31, 2018.

The Tax Act changes regarding the repeal of Section 682 are permanent and don't sunset.

Affected Trusts

All trusts created during the marriage are potentially affected. Note that the effective date of the repeal is keyed to the date the divorce or separation agreement is signed, not the date a trust was executed. This means that, beginning this year, if a couple gets divorced and one spouse created a trust at any point during the course of the marriage from which the other spouse could receive income, that trust generally will be a grantor trust, and the spouse who created the trust will continue to be liable to pay the taxes on all future distributions received by her ex-spouse! This will affect some of the staple techniques of marital estate planning, such as the lifetime marital trust and the popular spousal limited access trust.

IRS Guidance

The Department of the Treasury and the Internal Revenue Service issued Notice 2018-37, announcing they'll issue regulations clarifying that Section 682 will continue to apply with regard to trust income payable

to a former spouse who was divorced or legally separated under a divorce or separation instrument executed on or before Dec. 31, 2018, unless that instrument is modified after that date and the modification provides that the changes made by the Tax Act apply to the modification. They requested comments regarding the application of certain grantor trust rules to the taxation of trusts for the benefit of a spouse following a divorce or separation in light of the repeal of Section 682. Written comments were to be submitted by July 11, 2018.

The American College of Trusts and Estates Counsel (ACTEC) submitted two sets of comments. In a comment letter submitted on July 2, 2018, ACTEC suggests terminating the application of the spousal unity rule in Section 672(e) once the spousal relationship has been terminated by decree of divorce or legal separation or by the execution of a separation agreement. According to the letter, the spousal unity rule is presumably based on a belief that spouses form a single economic unit. When the end of the marriage separates the unit, there's no longer a reason for the rule to apply. According to the comment letter submitted on July 5, 2018, ACTEC believes that tying the effective date provision to the date the divorce or separation agreement is signed, not the date a trust was executed, unfairly applies the repeal to trusts that were irrevocable on the date the Tax Act was enacted. As explained in the letter, a grantor who created a trust for the benefit of his spouse before the repeal of Section 682 likely wouldn't have done so had the grantor expected to continue to be taxed on trust income after divorce. Accordingly, ACTEC recommends that Section 682 continue to apply to the income of trusts that were irrevocable on Dec. 22, 2017.

Whether either of the ACTEC comment letter suggestions will be adopted is yet to be seen.

Take Action

If you're currently planning for married couples, consider the impact the repeal of Section 682 might have on any trusts drafted if the couple later gets divorced.

If trusts have been previously created and a couple is contemplating divorce or in the process of getting divorced, it will be key to collaborate with a client's matrimonial attorneys in investigating any techniques that potentially could change grantor trust status without triggering any adverse tax consequences (for example, in jeopardizing a trust that previously was created without a gift tax consequence because it qualified for the marital deduction). With that caveat, possibilities might include terminating the trust on divorce, decanting the trust to a new trust or otherwise modifying the trust in favor of other beneficiaries and, in any of those scenarios, equalizing with other assets.

Another solution might be to include a reimbursement provision or other equalization mechanism in a marital agreement for the taxes that will continue to be payable by the grantor spouse after a divorce.

Bottom Line

For future planning with clients, carefully consider the tax impact of every trust created during a marriage in the event the parties get divorced in the future. If a couple is in the process of getting divorced, the tax implications of existing trusts should be factored into the divorce settlement negotiations or presented in evidence to a court.

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