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How the 2017 Tax Act Changed the Tax Consequences of Marriage and Divorce

Notes from Carlyn McCaffrey's comprehensive presentation at Heckerling 2019.

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Thomas A. Tietz, an associate in the Law Firm of Martin M. Shenkman, P.C., sat in on Carlyn McCaffrey's presentation at the 2019 Heckerling conference, "Decisions and Revisions Which a Minute Will Reverse- How the 2017 Tax Act Changed the Tax

Consequences of Marriage and Divorce" and graciously agreed to share his (copious) notes with our audience.

1. Marriage and Divorce.

a. Marriage is a relationship with tax consequences- both positive and negative. When terminating a marriage, the property transfer caused by that termination has its own consequences. The Tax Cuts and Jobs Act of 2017 (the "Act") has changed numerous tax provisions, with far reaching effects, in this field.

2. Existence of a Marriage and Recognition of Divorce.

a. When does a marriage exist? The Federal government does not have their own recognition of marriage, it will look to state law, or the law of a territory/possession of the United States, to determine if a couple is considered married for federal tax purposes. Treas. Reg. §301.7701-18(b)(1).

b. If the couple married outside of the United States, it will be recognized for Federal tax purposes if any State or Territory recognizes that marriage (even if that state is not the one in which they are domiciled). Treas. Reg. §301.7701-18(b)(2). Rev. Rul. 2013-17.

c. When is a divorce effective? This is also a state or territory level consideration, Federal law looks to a state recognizing a dissolution of marriage.

d. If a couple gets married on December 31st of a year, they will be provided with the benefits of marriage for that entire calendar year. Similarly, being divorced on December 31st will relieve you of the burdens of marriage for that entire year. Code Sec. 6013 (d) (1).

e. Based on the fact that marriage and divorce is determined at a state level, couples may attempt to "toggle" in and out of marriage, similarly to Grantor trust status, in an attempt to achieve tax benefits. The Internal Revenue Service (IRS) has disregarded these toggling attempts in the past. In Rev. Rul. 76-255, 1976-2 C.B. 40, a couple ended a ten-year marriage when in the Dominican Republic, which was subsequently recognized under Maryland law. The IRS did not argue that the divorce was invalid, but raised the issue that the divorce was designed specifically to allow the couple to file individually rather than as married filing jointly, bolstered by the fact that they remarried under Maryland law in the following tax year, about a month after the divorce. The IRS relied on logic from a 1935 case, *Gregory v. Helvering*, 293 U.S. 465 (1935), which established the rules for the validity of a "reorganization" under federal law. In *Gregory*, the court denied the tax benefits of reorganization, indicating that the motives prevented a reorganization for tax purposes specifically, even if that reorganization was valued under state (Delaware) law. The IRS used this logic due to the fact that the Internal Revenue Code ("Code") has an internal definition of reorganization, unlike their lack of a definition of marriage or divorce.

f. **Comment:** While the IRS may have performed mental gymnastics to reach the determination in Rev. Rul. 76-255, considering the facts of the case the result is unsurprising. With the myriad of changes to the tax consequences of marriage and divorce created by the Act, notably the rush to complete Property Settlement Agreements (PSAs) by December 31, 2018 for the previous alimony deduction regime, discussed further below, it will be interesting to see if this topic is revisited in greater detail in the future due to any divorces performed quickly, or potentially in unconventional ways such as being divorced in a foreign country, to get the advantage of those disappearing tax boons. Will the IRS potentially make the argument a divorce was not valid for federal tax purposes in 2018; therefore, the previous alimony deduction is not applicable?

3. Advantages and Burdens of Marriage.

Pros

i. Income Tax.

1. Joint income tax returns are designed to produce a lower tax burden for two married individuals versus a single individual who has the same taxable income as the couple. In 2017, a married couple making $500,000 combined before the Act would have received a tax savings of approximately 7 percent versus an individual making the same amount on his or her own. After the Act, that advantage was increased, with a married couple making $500,000 in 2018 receiving a tax savings of 16 percent versus an individual earning $500,000.

2. The losses of one spouse can offset the gains of the other spouse, allowing for more robust harvesting of gains and losses. Code Sec. 6013(a).

3. The adjusted gross income (AGI) of a charitably inclined spouse can be augmented by the AGI of the other spouse, allowing for larger deductions for significant charitable gifts, which may have exceeded the various AGI caps otherwise. Code Sec. 170.

4. **Comment:** With the standard deduction for married persons filing jointly increased to $24,000 in 2018, many practitioners have discussed the concept of "bundling" charitable deductions to allow for those charitable gifts to reach the threshold required to itemize deductions. If taxpayers begin to make more significant charitable gifts in specific years under this bundling concept, the potential for the various AGI caps on charitable deductions to be reached increases. In addition, Vanguard has predicted that the annual nominal rate of return for stock and bond investments over the next 10 years to be 3 to 5 percent, compared to the historical average of 9 to 11 percent. When a client has significant wealth, but low income for the year in which charitable gifts are made, the AGI caps for charitable gift deductions may become an unexpected factor for that client.

5. One spouse can sell property to the other spouse without paying tax on gain, as it will be considered a gift that is subject to the unlimited marital gift deduction. This would not apply to any person whose spouse is a non-resident alien. Code Sec. 1041.

6. Married individuals who each earn income may end up paying a higher tax rate combined than they would have paid if they were individuals filing separately. Based upon the rate schedule changes implemented from the Act, the threshold for this penalty to begin affecting taxpayers is income earned above $600,000. After the current rate schedules sunsets for years after 2025, the threshold amount will reduce to $233,350.

7. The state and local tax (SALT) deduction was limited to $10,000 in the Act. However, married couples only receive a single $10,000 deduction, while two individuals would receive a $10,000 deduction each. Code Sec. 164 (b) (6).

8. **Comment:** Married individuals can consider the use of Non-Grantor trusts to potentially gain additional SALT deduction. Each individual can establish a Non-Grantor trust and contribute a portion of a vacation home (or interests in an LLC or other entity that owns the vacation home) with SALT costs (i.e. property taxes), as well as assets which generate income equivalent to or greater than the SALT costs. As the Non-Grantor trust is taxed separately from the Grantor, it receives its own $10,000 SALT deduction and can offset up to $10,000 in income generated inside the trust. Exercise caution when establishing more than one Non-Grantor trust to avoid issues under either the reciprocal trust doctrine or Sec. 643(f) multiple trust rules, to avoid collapse of the trusts through the IRS successfully arguing the trusts were established only for tax avoidance. Include significant differences in each trust if establishing multiple trusts (i.e. different beneficiaries, different powers provided under each instrument, etc.).

9. **Qualified Residence Interest:** Married individuals who have a mortgage on a qualified personal residence, which can include the mortgages secured by the taxpayer's personal residence plus one additional home also used as a personal residence, can deduct the qualified interest payments based on mortgage principal up to $750,000 (this amount was reduced by the Act from $1 million. Any mortgages established before 2017 retain the $1 million cap. This reduction sunsets and increases back to $1 million in 2026. Tax Act § 11043). Two unmarried individuals would each be able to receive interest deductions on

principal up to $750,000, effectively increasing their qualified loan interest deduction to a cap of $1,500,000 in loan principal. Code Sec. 163(h).

Cons

ii. Estate Tax.

1. Spouses can make tax free gifts to each other during life, and the unlimited marital deduction allows for tax free bequests upon death. Code Secs. 2523 and 2056.

2. Spouses can split taxable gifts between each other, effectively doubling the annual gift exclusion amount of $15,000 per person to $30,000 for the couple (so long as each spouse is a US citizen or domiciliary). Code Sec. 2013

3. **Portability.** the surviving spouse can use the deceased spouse's unused exemption ("DSUE") of the first spouse. This helps prevent the loss of the first spouse's unused estate tax exemption of $10 million inflation adjusted (currently $11.4 million in 2019, scheduled to decrease to $5 million inflation adjusted in 2026). Code Sec. 2010(c).

4. Alimony.

a. Before the Act, alimony created a situation that allowed for an individual to "split" their income with another taxpayer whom an individual was not married to, one of the only ways this was possible.

b. Prior to 1942, the Supreme Court decision of *Gould v. Gould* 245 U.S. 151 (1917) had determined that alimony payments were not taxable to the recipient, the individual paying the alimony had to also pay the income tax on that payment. The Tax Act of 1942 statutorily overrode this decision, requiring the recipient individual to report gross income for the alimony received, and allowing the paying individual to deduct from gross income for amounts paid.

This modified adjusted gross income directly, and was not an itemized deduction, allowing it to be used in conjunction with the standard deduction.

c. This system was reversed by the Act for any payments made under a divorce or separation agreement finalized after December 31, 2018. Currently, any individual paying alimony under divorce decrees or PSAs signed in 2019 or beyond cannot reduce their AGI by the amounts paid, and individuals receiving alimony under these agreements do not need to report that amount as income.

d. The changes to alimony created by the Act are "permanent", as in they are not scheduled to sunset in 2026.

e. It was estimated by the Joint Committee on Taxation that the repeal of the alimony deduction would generate $6.9B of additional revenue between 2019 and 2027, or less than 0.5 percent of the total projected deficit created by the Act of $1.45 trillion.

f. IRS statistics for 2015 tax year- 586,253 taxpayers reported alimony payments to reduce AGI, but only 415,515 reported alimony income. Did it make sense to repeal the alimony deduction due to this, or was better enforcement the right move?

g. The House Ways and Means Committee commented that the choice to repeal the alimony deduction was to remove a "subsidy" for divorce that created a tax advantage for divorced individuals in comparison to married individuals.

h. However, for middle class taxpayers the alimony was less of a "subsidy", and more of a protection from the increasing tax burden caused by a divorce. Example: A family with $189k in income and $165k in taxable income, if that income is generated by two married individuals, the family unit pays about $26,500 in income taxes. If after a divorce only one individual earned the entirety of the $189k in income, that individual would have their income tax burden increased to approximately $38k, an increase of 36 percent. Prior to the

Act, if the individual earning the income had paid alimony of $94,500 (50 percent of total income), the alimony deduction would have created a tax burden approximately equal to what the individuals had when married. Due to the Act, the same amount of income the family generated prior to the divorce would have to support the family with greater tax cost, putting additional strain on these families.

i. As income earned by individual increases, the effect of the change on alimony deductions by the Act decreases. For an individual earning $1,000,000 a year, the increased tax burden caused by the change (if total alimony paid per year is $500,000) is approximately 8.5 percent.

j. **Comment:** The change in the alimony deduction exemplifies additional pressure placed upon American families that many individuals will not truly comprehend until it affects their bottom line. The effects of divorce already placed significant pressure on the income a family unit generated- the cost to maintain separate households, transportation costs, potentially additional child care costs, among many other unforeseen expenses. Practitioners will need to assist their clients in preparing for these additional costs, which could include working with the clients wealth advisers to prepare a budget based upon the changes created by the divorce. Previously, the negotiations of PSAs included the expectation of the individual paying alimony to receive a deduction, with this incentive removed how PSAs are negotiated will need to change to account equitable distribution of assets in the new paradigm.

5. Prenuptial and Postnuptial agreements.

a. The changes to the alimony deduction discussed above will have ripple effects for prenuptial and postnuptial agreements signed before the Act. As these agreements often established certain support levels based upon expectation of the paying spouse taking advantage of the alimony deduction, the support levels negotiated in those agreements may no longer be sustainable or equitable.

b. It is unlikely that prenuptial and postnuptial agreements would be considered as a divorce or separation instrument, so even if the agreement was signed before December 31, 2018 the payments negotiated under these agreements likely will not fall under the aegis of the previous alimony deduction regime.

c. These agreements often include a severance clause, which may contain language that provides if any provision of the agreement is considered unenforceable or illegal under existing law, those provisions will be renegotiated by the parties in good faith to maintain the spirit of the agreement. If the agreement in question includes this kind of clause, it may allow the payor spouse to have an opportunity to renegotiate the support level under the agreement.

d. **Comment:** It may be prudent for practitioners to discuss prenuptial and postnuptial agreements with their clients to specifically raise this concern. Proactively addressing any unexpected results caused under postnuptial and prenuptial agreements due to the changes by the Act. Estate plans put in place by the individuals may also need to be reviewed to determine if the planning in place violates any terms of the prenuptial or postnuptial agreements due to the changed economic results under the agreement.

6. Dealing with existing, and the use of, Trusts during and after Divorce.

a. One tax advantage of married individuals is the ability to perform gift and estate tax free transfers between one another. Sec. 2516 creates a special exception for marital settlements indicating that if a spouse transfers assets to a spouse or ex-spouse pursuant to a PSA there will be no gift tax so long as that transfer happens within either one year before or one year after a finalized divorce agreement. This rule extends to transfers made to trusts in which the spouse is a beneficiary.

i. Caution must be exercised when making transfers to a trust pursuant to Sec. 2516 to avoid a gift tax trap under Sec. 2702, which provides that if the Grantor ex-spouse retains the remainder interest of the trust, the full value of the gift made to the trust will be assessed as a gift made by the Grantor ex-spouse, causing gift tax costs or use of gift tax exemption.

ii. Treasury Regulation § 25.2702-1(c)(7) creates an exception to this gift tax trap if the remainder interest of the trust is retained by the beneficiary ex-spouse.

iii. If the remainder interest is provided to the children of the transferor, the transferor is likely to avoid any issues under Sec. 2702, as the transferor did not retain any remainder interest under the trust. However, under the joint purchase rule of Code Sec.2702, creating a trust in this manner may cause negative gift tax results for the transferee beneficiary ex-spouse. Code Sec.2702(c)(2) provides a result that the beneficiary ex-spouse, from receiving a term interest in the trust, with the remainder interest to go to the transferor (and transferee's) children, will be considered as having received the entirety of the value of the trust, and thereafter transferring to the other family member (i.e. the beneficiary ex-spouses children in this example), with the beneficiary ex-spouse incurring a gift tax cost as a result.

iv. **Comment:** The entirety of the gift tax trap concerns posed by Sec. 2702 are beyond the scope of these expeditiously created notes. Practitioners should exercise caution to understand the potential repercussions of any transactions made to a trust under the aegis of Sec. 2516, and to inform clients of any potential gift tax issues related to the proposed planning. Consider the current high gift tax exemption amount of $11.4 million in 2019 and contrast it with potential income tax savings this technique would provide. If the divorcing spouses are well under the gift and estate tax exemption amount (taking into account that it is slated to reduce by half in 2026) this planning can potentially be a boon even with the gift tax concerns.

b. Under Sec. 1041, no gain should be recognized for such transfers, and the basis of the asset within the trust will carry over from the Grantor.

c. Non-Grantor Trusts.

i. Through the use of trusts, the significance of the repeal of the alimony deduction can be mitigated for wealthy taxpayers. If a Non-Grantor trust is established after the divorce, pursuant to the terms of a divorce or settlement agreement, and the trust ends the support obligation of the Grantor of the trust to the beneficiary ex-spouse under state law, the Grantor ex-spouse will not have to pay any taxes for the income generated in the trust, and the beneficiary ex-spouse who receives payments pursuant to the trust will pay the income tax to the extent the amount received is income for the trust that year. The trust itself would pay income taxes on any income remaining within the trust, avoiding the payment of additional income taxes by the Grantor ex-spouse.

ii. **Comment:** Carlyn S. McCaffrey has demonstrated a unique potential use for the Non-Grantor trust created by the Act. Practitioners should consider, and discuss with their clients, if the potential tax savings created through the use of a trust in this situation is worth the administrative time and costs of establishing the Non-Grantor trust, as well as the gift tax concerns discussed above, this technique has the potential to become another arrow in the quiver of both the matrimonial attorney and the estate planning attorney on the team. Another advantage for the Grantor ex-spouse that cannot be quantified, or underestimated, is the ability to "cut ties" through the use of this technique and end the alimony support obligations to his or her ex-spouse.

d. Grantor Trust concerns.

i. A trust created for the purpose of offsetting the loss of the alimony deduction should not be a Grantor trust, as it would then cause the Grantor ex-spouse to shoulder the tax burden for the trust.

ii. **Comment:** As shown below, practitioners need to be cautious in establishing a trust for the purpose of reducing the tax burden of the loss of the alimony deduction after the Act. Attempting to "thread the needle" of Non-Grantor trust status in this situation is fraught with potential pitfalls. Additional concerns regarding avoiding grantor trust status that are not discussed in these notes will need to be addressed, and practitioners should thoroughly review the Grantor trust rules contained within Secs. 671 through 679.

iii. If the trust income or principal is used to discharge an obligation the Grantor ex-spouse to the beneficiary ex-spouse, it would cause the trust to be tainted and deemed a Grantor trust, with income tax being attributed to the Grantor. Sec. 677(b). As discussed above, it is important to ensure that the contribution by the Grantor to the trust completely ends the obligation the Grantor has to the beneficiary ex-spouse.

iv. Sec. 677 states that if the Grantor's spouse is a beneficiary, that particular trust is considered a Grantor Trust.

· This impact is limited in divorced spouses whose divorce or settlement agreements were finalized before December 31, 2018, due to receiving the alimony deduction even if it was a Grantor Trust (see Sec. 682).

· As Sec. 682 was repealed by the Act, divorcing spouses can no longer rely upon this protection.

· Note that divorce does not solve this problem, if the trust is established before the divorce is finalized, due to Sec. 672(e). This section states that any powers or interests the Grantor's spouse holds will be considered powers held by the grantor. This is known as the spousal unity rule, and it is probable it does not cease to operate after divorce. Therefore, if Sec. 672(e) applies due to the trust being established before divorce, it may cause aggregation of beneficial interests and powers under Sec. 677 and taint the trust as a Grantor trust.

· The IRS requested comments for application of 672(e) after divorce. ACTEC requested to IRS that 672(e) application is terminated after divorce is finalized. The comments by ACTEC indicated the thought process included that the spousal unit has economic unity, and when that economic unity is sundered through divorce, it is a logical that 672(e) should no longer apply. As of the time of the presentation, the IRS has not responded.

· Trusts to be used to satisfy support obligations should not be established before the settlement agreement, but the establishment of the trust can be agreed upon in the PSA.

· The PSA can provide for either the establishment of a trust to satisfy the support obligations of the spouse, OR have the spouse that is supposed to establish the trust pay alimony. This gives the Grantor ex-spouse a choice in how to satisfy his or her support obligations, and it likely avoids the 672(e) issues discussed above.

e. Irrevocable Trusts established during the marriage.

i. Consider that in many situations irrevocable trusts are exempt from laws put into place after the trust was established. For example, trusts established before September 25, 1985 are exempt from generation skipping tax as they were established before it was codified.

ii. All trusts created during marriage, which means 672(e) aggregation applies both to beneficial interests and powers the Grantor's spouse has, should be reviewed to determine the effect divorce has upon those trusts.

iii. A tax reimbursement clause included in the separation agreement relating to any distributions received by the beneficiary ex-spouse from Grantor trusts established before the divorce can be an effective way to avoid the Grantor ex-spouse continuing to pay income tax on trust relating to those distributions.

iv. Suggestions on dealing with various kinds of trusts typically established before divorce.

- **Spousal Lifetime Access Trust ("SLAT").** Usually for this kind of trust the beneficiaries are the Grantor's spouse and the descendants of the Grantor. A SLAT due to the Grantor's spouse (at the time the trust was established) being a beneficiary is a Grantor trust. If nothing is done to modify this trust, then the Grantor will continue to pay the income tax on distributions made to the ex-spouse, which may be an undesirable result. If there is an invasion of principal provision in the trust, the Trustee can use this to distribute out all assets in the trust as part of the beneficiary ex-spouses claims under the divorce or settlement agreement. Outright distribution may not be the best solution, as it would unravel the estate tax planning that was the reasoning for establishing the trust. Consider decanting as a method to preserve the estate tax planning goals Grantor initially wanted to achieve (if the increased estate tax exemption amount of $11.4 million did not change, or possibly even eliminate, the need for the estate tax planning originally conceived).

- **Comment:** As Carlyn S. McCaffrey indicated, outright distributions out of the SLAT should be avoided unless it is determined to be the best choice after careful review. A review of the trust terms and powers provided to preserve the goals of the estate planning, and potentially adapt the trust to the new paradigm of the family, may allow the SLAT to continue to be a powerful tool of protection for the family. Consider that if the state the SLAT is located in allows for non-judicial modifications, this technique can also potentially be used to update the administrative provisions of the trust if all parties, including the Grantor, would be willing to sign the modification.

· **Qualified Terminable Interest Trust ("QTIP").** This trust prevents distributions to anyone other than the Grantor's spouse. Therefore, as decanting cannot change the beneficial interests in the trust, modifying the beneficial interest to anyone other than the ex-spouse would not be possible. If there is an ability to invade the principal, one approach could be to distribute all assets out of the trust and include this distribution in negotiations for the settlement agreement.

a. Consider asset protection advantages of the QTIP trust before making a determination to terminate. Example: Florida has a statute to protect the remainder interest in a QTIP for the remainder beneficiaries from creditors. This is good asset protection for the remainder beneficiaries, and creates a reason to choose not to collapse the QTIP trust.

· A spendthrift clause may make using the techniques discussed above for the SLAT and QTIP difficult to achieve. Consider including a provision for a fiduciary of the trust to terminate the spendthrift provision in the trust for these kinds of situations.

· **Qualified Personal Residence Trust ("QPRT").** The Grantor of the QPRT typically retains the right to live in the home for a certain period. Often as both spouses own the house jointly, there would be two QPRTs established, each owning 50 percent of the personal residence. It is rare (but not unheard of) that the spouses will want to live together after getting divorced. Typically, they will want to divide the house as part of the assets and not live together. If the separation agreement gives the right of one spouse to live in the marital home, the agreement can require the other spouse to transfer their beneficial interest in their particular QPRT so that the spouse living in the marital house has all interests in the home. Note this transfer should not happen until after the separation agreement is signed.

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