

The Use of Trusts to Structure Divorce Settlements

by
Carlyn S. McCaffrey*

In General

When spouses divorce, one spouse will often be required to make support payments to the other. In some cases, property settlements will be provided. Funding support payments and property settlements through trusts established for that purpose may be an attractive option to both spouses.

The transferee spouse will generally prefer to look to a trustee for payment rather than to his or her former spouse. A trust will protect the transferee from any future financial problems of the former spouse or any future unwillingness to continue payments. On the other hand, in most cases, the transferor spouse would choose an unfunded obligation to make future support payments over the transfer of any significant property interest into a trust. This arrangement gives the transferor the maximum control over his or her assets. But, if the transferee spouse is demanding a lump sum property settlement as well as support payments, a transfer of property to a trust may represent an acceptable compromise. If the transferee spouse is unskilled in managing investments, a trust will provide a way for the transferor spouse to assure himself or herself that the transferred funds will be professionally managed. It will also give the transferor spouse the assurance that the transferred property (except to the extent consumed during the transferee spouse's lifetime) will ultimately pass to his or her children (or some other appropriate designee) at the death of the transferee spouse. In addition, if the separation has been acrimonious, the transferor may

* © Carlyn S. McCaffrey McDermott, Will & Emery, LLP & John C. McCaffrey, Family Asset Transfers Enterprises, LLC. November, 2014. Portions of this article are derived from the manuscript of the forthcoming new edition of *STRUCTURING THE TAX CONSEQUENCES OF MARRIAGE AND DIVORCE* (1995), being prepared by Carlyn S. McCaffrey and John C. McCaffrey.

welcome the separation the trustee provides between him or her and the former spouse.

Part I of this article considers the income tax consequences of transfers into trusts. Part II briefly discusses the taxation of trust income. Part III alerts the reader to various gift tax traps and suggests how these traps might be avoided. Part IV shows the reader how to use trusts to implement estate freezes in connection with a divorce settlement.

I. Income Tax Consequences of Transfers to Trust

A. In General

The U.S. Internal Revenue Code (“I.R.C.”) § 1041 provides that no gain or loss will be recognized on a transfer of property in trust for the benefit of a spouse or, if the transfer is incident to a divorce, to a trust for the benefit of a former spouse.¹ This will be so even if the transfer is in satisfaction of the transferor spouse’s support obligations, his or her other marital obligations, or any other obligations.

When a transferee acquires property in a transfer to which I.R.C. § 1041(a) applies, his or her basis in the transferred property is the same as the adjusted basis in the hands of the transferor immediately before the transfer.² This is so whether the transferor’s basis is higher than the fair market value at the time of the transfer or whether any gift tax is payable as a result of the transfer.³

If the purpose of the trust is to provide support or supplementary payments to the transferor’s minor children, the trust may provide for payments directly to or for the benefit of the children rather than to a spouse. Since the transferor’s spouse is not a beneficiary of the trust, transfers to the trust will not be protected by § 1041.

¹ References to “I.R.C.” are to the Internal Revenue Code of 1986 (26 U.S.C.) (the “Code”), as amended.

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

³ *But see* I.R.C. § 1015(a) (which limits a donee’s basis in gifted property to the lower of the donor’s basis immediately before the transfer or the value of the property at the time of the transfer).

Arguably, such transfers should be treated as gifts for gift tax purposes, but this may not always be the result. A transfer to a trust for the support of minor children may cause gain recognition to the transferor spouse if the transfer to the trust discharges his or her obligation to support dependent children or if the transfer is to provide a reasonable allowance for the support of minor issue of the marriage within the meaning of I.R.C. § 2516.⁴ If the transfer to the trust is a recognition event to the transferor, the trust will receive a fair market value basis in the trust assets.⁵

In the case of a transfer pursuant to a marital settlement agreement, it is likely that the transferee spouse will share beneficiary status with the children of the marriage. Section 1041 draws no distinction between trusts for the sole benefit of the spouse and those that have other beneficiaries, nor does it specify any minimum interest which the spouse must have for I.R.C. § 1041 to apply. The Temporary Regulations offer no clarification.

B. Negative Basis Property

I.R.C. § 1041(e) makes subsection (a) of § 1041 inapplicable to the transfer of property in trust to the extent that the sum of the liabilities assumed plus the amount of liabilities to which the property is subject exceeds the adjusted basis of the property transferred. The basis of the property to the transferee is increased by the amount of gain recognized.⁶

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

Example - Pat owns property having a fair market value of \$1,000,000 and an adjusted basis of \$10,000. Pat borrows \$500,000 using the property as security in contemplation of transferring this property incident to

⁴ See *St. Joseph Bank & Trust Co. v. United States*, 716 F.2d 1180 (7th Cir. 1983), *Spruance v. Comm'r*, 60 T.C. 141 (1973), *aff'd mem.*, 505 F.2d 731 (3d Cir. 1974).

⁵ I.R.C. § 1012.

⁶ I.R.C. § 1041(e).

32 *Journal of the American Academy of Matrimonial Lawyers*

*a divorce from Quinn. Pat then transfers to the trustees of a trust for Quinn and the trustees take the property subject to the liability to pay the \$500,000 debt. Under I.R.C. § 1041(e), Pat recognizes gain of \$490,000 on the transfer of the property and Quinn's basis in the property is \$500,000.*⁷

If the transfer of the interest is made to a trust for the benefit of a spouse rather than a former spouse, and if the transferee spouse's interest in the trust is sufficient to result in the treatment of the entire trust as a so-called grantor trust subject to I.R.C. § 671 (or if other trust provisions would result in the trust being treated as "owned" by the transferor within the meaning of § 671), the transfer would not result in the recognition of gain. This is so because the transferor will continue to be treated as the owner of the transferred property after the transfer.⁸ When the trust ceases to be a grantor trust because of the termination of the spouse's interest or upon the spouse's death,⁹ the transferor will be treated as having transferred ownership of the interest to a different taxable entity.¹⁰ At that time, the transferor will be treated as having disposed of the interest.¹¹

C. Installment Notes

I.R.C. § 453B(g) provides that the non-recognition provision of I.R.C. § 1041, which was made generally applicable to the disposition of installment obligations by § 453B, does not apply to the transfer of an installment obligation to a trust. As a result, a transfer of an installment obligation to a trust for the benefit of a transferor's spouse will be treated as a disposition of that obligation for purposes of § 453B.¹²

⁷ See Temp. Treas. Reg. § 1.1041-1T(d) Q&A (12) (The outcome of the example above is different from the outcome in the Temporary Regulation Q&A because in the example above the transfer is made to a trust rather than outright).

⁸ Rev. Rul. 85-13, 1985-1 C.B. 184. The Second Circuit reached a contrary conclusion in *Rothstein v. United States*, 735 F.2d 704 (2d Cir. 1984). The Internal Revenue Service announced its decision not to follow *Rothstein* in Rev. Rul. 85-13.

⁹ I.R.C. § 672(e) (Grantor trust status will not terminate merely because of the divorce of the transferor and his or her spouse).

¹⁰ Treas. Reg. § 1.1001-2(c), Ex. (5).

¹¹ See *id.* § 1.001-2(c); *Madorin v. Comm'r*, 84 T.C. 667 (1985); Rev. Rul. 79-84, 1979-1 C.B. 223; Rev. Rul. 77-402, 1977-2 C.B. 222 (1977).

¹² I.R.C. §§ 453B(a), (g)(1).

Vol. 27, 2014-2015 Trusts to Structure Divorce Settlements 33

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

In the case of a disposition of an installment note by gift to which I.R.C. § 1015 applies, the language of § 1015 seems to provide the necessary adjustment. I.R.C. § 1015 indicates that the transferee's basis will "be the same as it would be in the hands of the [transferor]."¹³ The Internal Revenue Service (the "IRS") has ruled that this language requires that the transferor's basis take into account the gain resulting from the transfer because, if he or she held the note after the disposition, the basis would have been increased by the amount of such gain.¹⁴

I.R.C. § 1041(b), however, not § 1015(a), applies to a transfer of an installment note to a trust for the benefit of the transferor's spouse. The language of § 1041(b) states only that the "basis of the transferee shall be the adjusted basis of the transferor." Unlike § 1015, it does not suggest a test that looks to see what the transferor's basis would be if he or she still held the transferred property. To avoid a double tax on the same gain, the Treasury Regulations should construe § 1041(b) to require the same test as § 1015.¹⁵

Recognition will be avoided if the transferor transfers the installment note to a trust the terms of which result in the grantor being treated as the "owner" (within the meaning of I.R.C. § 671) of that portion of the trust consisting of the right to receive the principal of the note.¹⁶ Since the original owner continues to be treated as the owner after the transfer, the transfer is not treated as a disposition for purposes of I.R.C. § 453B.

¹³ I.R.C. § 1015(a).

¹⁴ Rev. Rul. 79-371, 1979-2 C.B. 294.

¹⁵ *But cf.* Rev. Rul. 87-112, 1987-2 C.B. 207 (in which the IRS allowed the transferee spouse of E-savings bonds to increase his or her basis by the amount of income the transferor spouse recognized on the transfer).

¹⁶ Rev. Rul. 81-98, 1981-1 C.B. 40; Rev. Rul. 74-613, 1974-2 C.B. 153; Rev. Rul. 67-70, 1967-1 C.B. 106.

When the power over or interest in the trust that caused the transferor to be treated as owner is terminated, the termination will be treated as a disposition.¹⁷

II. Taxation of Trust Income

A. *In General*

There are two principal tax types of trusts that are likely to be used in connection with a property settlement agreement, a standard trust and a grantor trust. A trust may share the characteristics of both a standard trust and a grantor trust. If so, it will be subject to the rules applicable to both types of trusts.

A detailed discussion of the manner in which each of these different kinds of trusts is treated for income tax purposes is beyond the scope of this article. A brief summary is provided below since some knowledge of how the trust tax rules work is necessary to an understanding of the tax consequences of using trusts in connection with a divorce or separation.¹⁸

B. *Standard Trusts*

1. *Rates*

The tax rates imposed on the income of a standard trust are set forth in the table that appears in I.R.C. § 1(e). The table provides five different brackets, a 15% bracket, a 25% bracket, a 28% bracket, a 33% bracket and a 39.6% bracket. The tax rate table applicable to trusts is the most steeply progressive of the five different tax tables that are provided in I.R.C. § 1. Trust taxable income is subjected to the 39.6% rate on amounts in excess of \$12,150.¹⁹ In addition, the net investment income of trusts is subject to the I.R.C. § 1411 Medicare Tax at income levels above \$12,150.

¹⁷ See Treas. Reg. § 1.1001-2(c), Ex. (5); *Madorin*, 84 T.C. 667; Rev. Rul. 79-84, 1979-1 C.B. 223; Rev. Rul. 77-402, 1977-2 C.B. 222.

¹⁸ See BYRLE M. ABBIN, *INCOME TAXATION OF FIDUCIARIES AND BENEFICIARIES* (CCH 2014), for a comprehensive discussion of this subject,

¹⁹ See I.R.C. § 1(f) (requiring Treasury to prescribe new tables annually to reflect increases in the cost of living); see also Rev. Proc. 2013-35, 2013-46 I.R.B. 749 (establishing the \$12,150 taxable income level).

2. Deductions

In most cases, the deductions allowed to a trust are the same as those allowed to an individual. The principal exception, discussed below, provides the mechanism for allocating trust income between the trust and its beneficiaries.

3. Allocating Income Between a Trust and its Beneficiaries

Trust income is allocated between a standard trust and its beneficiaries through the deductions permitted to the trust under I.R.C. §§ 651 and 661 for distributions made to beneficiaries. The deductions remove the income from the trust's taxable income and put it in the beneficiary's gross income.²⁰ In each case the deduction is limited to the amount of the trust's "distributable net income" ("DNI")²¹ regardless of the actual amount of the deduction.²² If an item of income is not reflected in DNI, it will be taxed to the trust rather than to its beneficiaries. A trust's DNI is its taxable income with several adjustments, the most significant of which are described below.²³

Capital gains are not included if they are allocated to corpus and are not "paid, credited, or required to be distributed to any beneficiary during the taxable year."²⁴ Capital losses are also not taken into account except to the extent that they reduce the amount of gains included under the preceding sentence.²⁵ Furthermore, the 50% exclusion from gross income under I.R.C. § 1202 for any gain from the sale or exchange of qualified small business stock held for more than five years is not taken into account.²⁶

A trust's tax-exempt income is included, reduced by any amounts that would be deductible in connection with this income but for I.R.C. § 265 (which disallows certain deductions relating to tax exempt income).²⁷

²⁰ I.R.C. §§ 651, 652, 661, 662.

²¹ I.R.C. § 643(a).

²² I.R.C. §§ 651, 661.

²³ I.R.C. § 643(a).

²⁴ I.R.C. § 643(a)(3).

²⁵ *Id.*

²⁶ *Id.*

²⁷ I.R.C. § 643(a)(5).

36 *Journal of the American Academy of Matrimonial Lawyers*

A trust's distribution deduction is added back to taxable income.²⁸ In calculating its taxable income, the trust is permitted to deduct distributions to beneficiaries actually made and distributions that were required to be made to the extent they do not exceed its DNI.²⁹ For purposes of calculating the DNI limitation on the deduction, DNI is calculated without including tax-exempt income and the deductions allocable to such income.³⁰

I.R.C. §§ 652 and 662 require that amounts distributed (or required to be distributed) to trust beneficiaries from trusts are to be included in the beneficiaries' gross incomes to the extent such distributions do not exceed the trust's DNI.³¹ The distributions have the same tax character in the hands of the beneficiaries as they had in the hands of the trustee.³²

If a trust agreement requires the distribution of a specific sum of money at one time or in not more than three installments, a distribution in satisfaction of this requirement will not be treated as a distribution of trust income.³³ As a result, the distribution will not be deductible to the trust or includible in the gross income of the beneficiary.

The exception for distributions of specific sums does not apply to amounts which can be paid only out of trust income or to annuities or payments of periodic amounts that have the effect of an annuity.³⁴

C. Grantor Trusts

1. In General

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

²⁸ I.R.C. § 643(a)(1).

²⁹ I.R.C. § 651(b).

³⁰ I.R.C. § 661(c).

³¹ I.R.C. §§ 652(a), 662(a) (DNI is computed without the deduction allowed under § 642(c) for payments to charities); *see also* I.R.C. §§ 651(a)(2), 662(b).

³² I.R.C. §§ 652(b), 662(b).

³³ I.R.C. § 663(a).

³⁴ Treas. Reg. § 1.663(a)-1(b)(2).

2. Consequences of Grantor Trust Treatment

The primary tax consequence of grantor trust treatment is that the deemed owner of the trust will calculate his or her taxable income and credits by including the trust's income, deductions, and credits.³⁵ This means that the deemed owner, not the trust, will pay tax on the trust's income. If the trust has losses, or deductions in excess of income, they are usable by the deemed owner. Of particular importance to some clients will be the fact that this means the trust is no longer subject to the highly compressed rate structure imposed by I.R.C. § 1(e).

The IRS's application of the grantor trust rules goes beyond the simple reflection of income, deduction, and credits. In a series of rulings, it has taken the position that the owner of a trust under the grantor trust rules will be treated as owning, for tax purposes, the trust property itself. The effect of this position is to permit the deemed owner to enter into transactions with the trust without any income tax consequence to himself or herself or the trust.³⁶

An individual may be the deemed owner of an entire trust or only a portion of the trust.³⁷ If the individual is treated as the owner of only a portion of a trust, only the items of income, deduction, and credit attributable to that portion are to be reflected in the calculation of his or her taxable income.³⁸ Items of income, deduction, and credit attributable to a portion of the trust not deemed owned by an individual are subject to the tax rules applicable to standard trusts as discussed above.³⁹

³⁵ I.R.C. § 671.

³⁶ See Rev. Rul. 85-13, 1985-1 C.B. 184; *contra* Rothstein v. United States, 735 F.2d 704 (2d Cir. 1984). See also *supra* text at notes 6-17, which discusses the transfer to trusts of installment notes and property subject to debt in excess of basis.

³⁷ I.R.C. § 671(a).

³⁸ Treas. Reg. § 1.671-3(a).

³⁹ *Id.*

3. *When the Rules Apply*

a) *In General*

The grantor trust rules apply when the grantor or any person other than an adverse party⁴⁰ has retained certain interests in or powers over trust income and assets. For purposes of determining the powers and interests held by a grantor, I.R.C. § 672(e) provides that he or she will be treated as holding any power or interest held by an individual to whom the grantor was married at the time of the creation of the power or interest or whom he or she married after such creation. There is no provision of the Code that causes this treatment to terminate if the spouses divorce.

An individual is an adverse party as to a particular power if he or she is a person who has a “substantial beneficial interest in the trust which would be adversely affected by the exercise or nonexercise of [his or her] power.”⁴¹

b) *Reversionary Interests*

I.R.C. § 673(a) provides that the grantor of a trust will be treated as the owner of any portion of the trust in which he or she has a reversionary interest in either corpus or income if, as of the creation of that portion of the trust, the value of that reversionary interest is more than 5% of the value of the portion.

c) *Power to Control Beneficial Enjoyment*

I.R.C. § 674(a) provides that the grantor will be treated as the owner of any portion of the trust if the beneficial enjoyment of such portion is subject to a power exercisable by the grantor or a nonadverse party without the consent of an adverse party. There are a number of exceptions to this rule.⁴² The most significant exception is in § 674(c): Such powers will not cause grantor trust treatment if held by trustees none of whom is the grantor and no more than half of whom are related or subordinate parties who are subservient to the grantor. Because § 672(e) imputes to the grantor any power held by his or her spouse, it is

⁴⁰ I.R.C. §672(b) (referring to a person who is not an adverse party as a “nonadverse party”).

⁴¹ I.R.C. § 672(a).

⁴² I.R.C. §§ 674(b)-(d).

likely that this exception does not apply if the grantor's spouse is a trustee with any power to control beneficial enjoyment.

d) *Administrative Powers*

I.R.C. § 675 provides that the grantor will be treated as the owner of any portion of a trust if (i) the grantor or a nonadverse party has the power to deal with the trust property for less than a full and adequate consideration in money or money's worth, (ii) the grantor or a nonadverse party enables the grantor to borrow trust corpus or income without adequate interest or without adequate security unless the power is exercisable by a trustee (other than the grantor) under a general lending power that enables the trustee to make loans to any person without regard to interest or security, (iii) the grantor has borrowed corpus or income of the trust and has not completely repaid the loan before the beginning of the year,⁴³ or (iv) if a power of administration is exercisable in a nonfiduciary capacity without the consent of a fiduciary. For this purpose, the term "power of administration" means (a) a power to vote securities held by the trust when the holdings of the grantor and the trust are significant from the viewpoint of voting control, (b) a power to control the investment of trust funds to the extent that they consist of securities in corporations in which the holdings of the grantor and the trust are significant from the standpoint of voting control, or (c) the power to reacquire the trust corpus by substituting other property of equal value.⁴⁴

e) *Power to Revoke*

I.R.C. § 676(a) provides that the grantor will be treated as the owner of any portion of the trust if he or she or any nonadverse party has the power to revert title to such portion in the grantor.

⁴³ I.R.C. § 675(3) (stating this provision does not apply to a loan made for adequate interest and adequate security if made by a trustee other than the grantor or a related or subordinate trustee subservient to the grantor within the meaning of § 672(c)).

⁴⁴ I.R.C. § 675(4).

f) *Power to Distribute or Accumulate Income to or for the Grantor of the Grantor's Spouse*

Section 677(a) provides that the grantor will be treated as the owner of any portion of the trust if the income from that portion may, without the consent of an adverse party, be distributed to or accumulated for future distribution to the grantor or the grantor's spouse, or used to pay premiums on life insurance policies on the grantor's life or on the life of the grantor's spouse.

Some trust agreements give the trustee the power to use trust property to support a beneficiary whom the grantor may be obligated to support. Such a power could be viewed as a power to distribute trust property to the grantor. I.R.C. § 677(b) prevents this result by providing that income will not be taxable to the grantor under this section (or under any other provision) merely because the income could be used to discharge a support obligation of the grantor unless it is actually used for this purpose. It also provides that if trust property other than income is used to discharge a support obligation of the grantor, the payment is treated as a distribution within the meaning of I.R.C. § 661(a)(2) and will be taxed to the grantor under § 662.⁴⁵

4. *Person Other Than Grantor Treated as Owner*

I.R.C. § 678 provides that an individual other than the grantor of the trust is treated as the owner of a portion of the trust if he or she has the unilateral right to withdraw the corpus or the income.⁴⁶ A person other than the grantor will also be treated as the owner the person other than the grantor partially released or modified such a power, and after such partial release or modification he or she or nonadverse parties have the type of power over or interest in the trust that would have resulted in the power holder being treated as the owner if he or she had been the grantor.⁴⁷

⁴⁵ I.R.C. § 677(b).

⁴⁶ I.R.C. § 678(a)(1).

⁴⁷ I.R.C. § 687(a)(2).

5. *Taxation of Trusts Established in Connection with Divorce or Separation*

a) *In General*

If one spouse transfers property to a trust for the benefit of the other spouse in connection with a divorce or separation, the taxation of that trust and of the transferee spouse would generally follow the rules reviewed above.⁴⁸ Taxability will depend on the particular characteristics of the trust. If the trust is a standard trust, the spouse rather than the trust would be taxed on trust income to the extent distributed to him or her.

b) *The Grantor Trust Rules*

A trust created in connection with a divorce or separation, however, is likely to be subject to the grantor trust rules for one of several reasons. The transferor spouse may have a reversionary interest the actuarial value of which was more than five percent at the inception of the trust.⁴⁹ This might occur, for example, if the transferor spouse retained the right to receive the trust principal on the death or remarriage of the transferee spouse. Or, the transferor may have the right to decide how his or her children will share in the trust property at the death or remarriage of the transferee spouse.⁵⁰

If the transferor spouse's transfer to the trust does not, under state law, completely terminate the obligation to support the other spouse, the trust would be subject to the grantor trust rules to the extent payments were made from the trust to the transferee spouse.⁵¹ Such payments would be treated as having been made for his or her benefit since they would discharge a continuing legal obligation.⁵²

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

⁴⁸ See *supra* text at notes 18-34.

⁴⁹ I.R.C. § 673(a).

⁵⁰ I.R.C. § 674(a).

⁵¹ See *Helvering v. Leonard*, 310 U.S. 80, 85 (1940). See generally, *Tax Aspects of Alimony Trusts*, 66 *YALE L.J.* 881 (1957).

⁵² I.R.C. § 677(b).

42 *Journal of the American Academy of Matrimonial Lawyers*

or may be distributed or accumulated for future distribution to the grantor's spouse (without the consent of an adverse party), I.R.C. § 677(a) treats the grantor as the deemed owner. If trust income may be allocated among a group of beneficiaries at the discretion of the trustees one of whom is the grantor's spouse, I.R.C. §§ 674(a) and (c) treat the grantor as the deemed owner. If the grantor's spouse has borrowed trust funds, under some circumstances § 675(3) will treat the grantor as the deemed owner. These provisions do not apply after the grantor and the beneficiary or power holder are divorced.⁵³ As a result, the grantor trust rules would be of concern to individuals who are structuring a marital settlement agreement only in connection with the period of time covered by the agreement that precedes the divorce unless the interests and powers they cover fall within the scope of § 672(e).

I.R.C. § 672(e) is more difficult to avoid. It provides that a trust grantor will be treated as holding any trust interest or power held by an individual to whom the grantor was married at the time of the power's creation.⁵⁴ Section 672(e) does not cease to operate after the grantor and spouse are divorced.

If § 672(e) is applicable, the determination of whether the grantor will be treated as the deemed owner of the trust will depend upon whether the grantor would be the deemed owner if he or she held the interest or power held by the spouse.

Example - Hugh created a trust to pay his daughter Pat income for fifteen years, remainder to his spouse Winona. The actuarial value of Winona's interest in the trust corpus at the inception of the trust was 10%. Because Hugh is treated as owning the reversionary interest held by Winona and because that reversionary interest is worth more than 5%, Hugh will be treated as the owner of 100% of the trust under I.R.C. § 673(a).

⁵³ The portions of I.R.C. §§ 674(c) and 675(3) which treat a power held or a loan made by a grantor's spouse as having been made by the grantor specifically do not apply after a divorce or separation under a decree of separate maintenance. The regulations under I.R.C. § 677 provide that § 677(a)'s provisions affecting income payable to the grantor's spouse apply "solely during the period of the marriage of the grantor to a beneficiary." Treas. Reg. § 1.677(a)-1(b)(2).

⁵⁴ See I.R.C. § 672(e) (applying to interests or powers held by an individual who became the grantor's spouse after the creation of the trust, but only for periods after the marriage).

The result in the preceding example will not change if Hugh and Winona are divorced. Section 672(e)'s test is administered at the time the interest is created. It contains no mechanism for a later retesting to take into account a change in marital status.

It is probable that I.R.C. § 672(e) operates to extend the application of § 677(a) to periods after the divorce. As discussed above, if trust income is or may be distributed or accumulated for future distribution to the grantor's spouse (without the consent of an adverse party), § 677(a) treats the grantor as the deemed owner. If the spouse's status as a mandatory or discretionary recipient of trust income is a trust "interest" within the meaning of § 672(e), then that status would continue to be attributed to the grantor after a divorce and would result in grantor trust status.

Example - Wilma, pursuant to the requirements of a marital settlement agreement, transferred \$500,000 to a trust to pay her spouse Winnie for life. The independent trustee had discretion to distribute principal to Winnie if the independent trustee deemed it advisable. At Winnie's death, the remainder was to be paid to Wilma's children. The transfer was made prior to Wilma's divorce from Winnie. I.R.C. § 677(a) applies to treat Wilma as the deemed owner of the entire trust before the divorce and probably after the divorce as well.

The result suggested by the preceding example seems inappropriate.⁵⁵ It will be partially, but not completely, avoided in most cases by the operation of I.R.C. § 682(c), which is discussed below.

⁵⁵ This result seems to be required by the language of the statute but is inconsistent with the results obtained under I.R.C. §§ 674(c) and 675(3). Both of these sections disengage the grantor from the spouse's powers and loans upon divorce or legal separation pursuant to a decree of separate maintenance. The IRS in Treas. Reg. § 1.1361-1(k)(1), Ex. 10 (ii), a regulation dealing with Subchapter S rules, takes the position that I.R.C. § 682 will shield a taxpayer from being treated as the grantor-owner of a trust under Code Sec. 677 because of the trustee's power to distribute income to his or her spouse, after the couple divorces. This regulation seems incorrect for two reasons. First it is misreading § 682. I.R.C. § 682 does not eliminate grantor trust status. It simply says that the grantor won't be taxed on income the spouse is entitled to receive even though the trust may be a grantor trust. Second, its conclusion as to § 677 fails to take into account the fact that the spouse's beneficial interest is attributed to the grantor under § 672(e) even after divorce. It is true that the trust is no longer a grantor trust under § 677 because of the possible distributions to the former spouse, but under § 672, the power to distribute to the former spouse is treated as the power to distribute to the grantor. That is what is reached by § 677 after divorce.

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

6. *I.R.C. § 682 Trusts*

a) *In General*

I.R.C. § 682(a) provides that if spouses are divorced from each other or are separated under a decree of separate maintenance or under a written separation agreement, the amount of any income one of them receives or is entitled to receive from a trust will be included in his or her gross income and will not be included in the gross income of the other spouse. This will be so despite any other provision of the Code such as the grantor trust rules.⁵⁶ Section 682(a) does not apply to any part of trust income that the terms of the decree, written separation agreement, or trust agreement fix as payable for the support of minor children of the other spouse. Trusts that are subject to I.R.C. § 682(a) are usually referred to as “Section 682 Trusts.”

Before the 1984 Act, I.R.C. § 71 prevented the application of § 682 to trusts that were created at the same time as or in contemplation of a divorce or separation. Instead, such trusts were subjected to the prior version of § 71. Under § 71, all payments to the beneficiary were taxable whether or not they would be taxable to the beneficiary under the rules applicable to standard trusts and their beneficiaries. As a result, distributions of

⁵⁶ I.R.C. § 682(a). There is at least one regulation and two private letter rulings in which the IRS has taken a position contrary to the one described in the text. In Treas. Reg. § 1.1361-1(k)(1), Ex. 10 (ii), the IRS concludes that § 682 will cause the termination of the grantor trust status of an *inter vivos* QTIP trust when the grantor and his or her spouse divorce. A similar conclusion is reached in PLR 9235032 (August 28, 1992). The conclusions seem clearly wrong. Nothing in § 682 operates to terminate grantor trust status. It simply protects the grantor, who would ordinarily be taxed on trust income, from taxation on income required to be paid to his or her spouse.

trust principal and distributions of tax exempt income were all included in the transferee spouse's gross income and excluded from the transferor spouse's income. This result occurred because § 71 specifically required gross income inclusion of payments attributable to property transferred in trust.⁵⁷

Section 682(a) was not needed to protect the transferor spouse from tax because the former version of § 71 expressly excluded from one spouse's gross income the income from transferred property that § 71(a) required the other spouse to include. The required inclusion in the gross income of the receiving spouse regardless of the tax character of the payments made these trusts tax inefficient.

b) *Avoiding Possible Application of § 71 to Trust Distributions*

The current version of I.R.C. § 71 contains no similar provision. A literal reading of it, however, could lead to almost the same result. Section 71 does not require that payments to one spouse be made by the other in order to be taxed to the transferee spouse. It seems to apply to any payment received by a spouse under a divorce or separation instrument if all of the other requirements set forth in § 71(b) are met.⁵⁸ As a result, if a divorce or separation instrument requires the establishment of a trust to make payments for life to one spouse, § 71(a) may require all payments from the trust to be included in the transferee spouse's gross income whether or not such payments are from trust income.⁵⁹

⁵⁷ Treas. Reg. §§ 1.71-1(c)(2), 1.682(a)-1(a)(2); Rev. Rul. 65-283, 1965-2 C.B. 25; *contra* *Ellis v. United States*, 416 F.2d 894 (6th Cir. 1969); *Stewart v. Comm'r*, 9 T.C. 195 (1947).

⁵⁸ The legislative history suggests an intention to prevent this result: "Where . . . a beneficial interest in a trust is transferred or created, incident to divorce or separation, the transferee will be entitled to the usual . . . treatment as the beneficiary of a trust (by reason of sec. 682), notwithstanding that the . . . payments by the trust qualify as alimony or otherwise discharge a support obligation." H.R. 432, 98th Cong. (1984).

⁵⁹ In that event, the transferor spouse, if he or she were treated as owner of the trust, would probably be able to deduct the payment under I.R.C. § 215 since the payment would be treated as having been paid by the transferor. Treas. Reg. § 1.671-2(c).

To avoid this result, it is advisable to include a provision in the divorce or separation instrument stating that the distributions to the transferee spouse are not to be included in his or her gross income under § 71(a). The inclusion of this simple statement will prevent the operation of § 71(a)'s inclusion rule.⁶⁰

c) Tax Treatment of Transferee Spouse Under § 682(a)

The spouse who receives or is entitled to receive the income from a § 682 Trust is treated as a beneficiary of the trust for purposes of the rules governing the taxation of standard trusts and their beneficiaries.⁶¹ This means that the transferee spouse must include in his or her gross income the amounts allocated to him or her through the DNI mechanism discussed above.

If the divorce decree, marital settlement agreement, or trust agreement fixes, in terms of an amount of money or a portion of trust income, a sum which is payable for the support of the minor children of the transferor spouse, § 682(a) does not apply to such part. The concept of "fix" for I.R.C. § 682 purposes should have the same meaning as it does for I.R.C. § 71(c).

There is an important difference. Section 682 does not include the rules in §§ 71(c)(1) and (2) which treat certain spousal payments as child support because of the timing of payment reductions. Thus, if the terms of a trust require that distributions be made to the spouse of the trust's grantor until the child of the transferor reaches age eighteen, the payments will be income to the spouse to the extent of the trust's DNI. If trust income is less than the amount required to be paid for child support, trust income is allocated first to the child support portion of the amount paid to the transferee spouse.⁶²

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

Subchapter J, the portion of the Code that determines how trusts and their beneficiaries are to be taxed, and its regulations,

⁶⁰ I.R.C. § 71(b)(1)(B).

⁶¹ I.R.C. § 682(b).

⁶² I.R.C. § 682(a).

contain two conflicting definitions of “income.” I.R.C. § 643(b) provides that the term “income” generally means the amount of accounting income of a trust determined under the trust instrument and local law. Provisions in the trust instrument that differ substantially from traditional principles of income and principal are disregarded.⁶³ This definition applies for purposes of the standard trust tax rules. If this definition applies to I.R.C. § 682(a), the transferee spouse would not be taxed on capital gain income distributed to him or her since gain from the disposition of assets is not trust accounting income. In contrast, the regulations under the grantor trust rules provide that “income” means income for tax purposes rather than trust accounting income.⁶⁴

Applying this definition to § 682(a), if the transferor spouse is the deemed owner of the entire trust under the grantor trust rules so that the capital gain income would, unless § 682(a) applies, be taxed to him or her, a distribution to the transferee spouse in excess of trust accounting income would be taxed to the transferee spouse to the extent of the trust’s capital gain income. Because § 682(a) serves the purpose of overriding the grantor trust rules, these rules are probably the proper source for the definition.

d) *Tax Treatment of Transferor Spouse Under § 682(a)*

The tax treatment of the transferor spouse depends upon whether he or she is deemed to own the trust under the grantor trust rules.⁶⁵ If the trust is not treated as owned by the transferor and if no portion of the payments to the transferee spouse are specified for child support, no portion of the trust income would be taxed to the transferor spouse.⁶⁶

If the trust is treated as owned by the transferor spouse, he or she will be taxed, under the grantor trust rules, on all trust income not distributed to the transferee spouse.⁶⁷ Defining what

⁶³ Treas. Reg. § 1.643-1(b).

⁶⁴ Treas. Reg. § 1.671-2(b).

⁶⁵ I.R.C. § 671(a).

⁶⁶ I.R.C. § 682(a).

⁶⁷ I.R.C. § 671(a).

that income is presents the same issue discussed above in connection with determining the transferee spouse's income.⁶⁸

Until this issue is resolved, drafters of trusts that will be subject to § 682(a) should consider providing a tax reimbursement mechanism. For example, if the parties believe that income should include capital gain income, the transferee spouse should agree that he or she will be responsible for the tax on capital gain income to the extent of his or her distributions in excess of ordinary income. To protect the transferor spouse against a possible contrary conclusion by the IRS, the agreement between the spouses should require the transferee spouse to reimburse the transferor spouse for any taxes attributable to the inclusion in his or her gross income of the amount of income the parties had expected to be taxed to the transferor spouse. Additionally, to protect the reimbursement payments from treatment as income under § 71(a), the agreement should contain a statement that the payments are not to be included in the receiving spouse's gross income and are not to be deducted by the paying spouse.⁶⁹ If a portion of the trust payments to the transferee spouse is fixed in the divorce decree, separation agreement, or trust instrument as a sum payable for the support of the transferor spouse's minor children, that portion will be included in the transferor spouse's income.⁷⁰

III. Avoiding Gift Tax Traps

A. *In General*

Despite the fact that the parties who are negotiating a marital settlement agreement generally will not have a donative intent toward each other, their agreement and the transfers made pursuant to that agreement may be subject to the federal gift tax. This is so because the application of the gift tax does not depend on the existence of a subjective donative intent. The federal gift tax creates an objective standard for determining whether a gift has occurred. It treats transfers of cash and other property as a

⁶⁸ See *supra* discussion in text at notes 61-64.

⁶⁹ I.R.C. § 71(b)(1)(B).

⁷⁰ Treas. Reg. § 1.682(a)-1(b).

gift except to the extent the transferor received full consideration in money or money's worth for the transfer.⁷¹

The best method of assuring that the transfer to a spouse or former spouse in connection with a divorce will not be subject to the gift tax is to qualify it for I.R.C. § 2516's special exception for property settlements. To qualify for this exception, the transfer must be made pursuant to a written marital settlement agreement and divorce must occur within either the one-year period before the execution of the agreement or the one-year period after the execution of the agreement.⁷²

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

1. *The Problem*

I.R.C. § 2702, which was added to the Code in 1990 as part of Chapter 14, may present significant difficulties for many typical marital settlement patterns.⁷³ Section 2702 was designed to attack the ordinary method of valuing term interests in property for gift tax purposes. Transferors and the IRS are required to use Treasury valuation tables established under I.R.C. § 7520, which assume a particular rate of return regardless of the actual rate of return expected to be earned on the transferred property. As a result, it was possible for transferors to reduce the gift tax value of transferred remainders by a deemed value of a retained income interest that had little relation to the actual value of the retained interest.

Congress's solution to the problem was simple but draconian. Because it could not be sure that a retained income interest would have any particular value, Congress decided to give it a value of zero when a remainder interest is transferred to certain

⁷¹ I.R.C. § 2512(b).

⁷² *Harris v. Comm'r*, 340 U.S. 106 (1950) (discussing how gift tax protection may also be achieved if the transfer of the interest in the qualified personal residence trust ("QPRT") is made pursuant to a court decree); *see also* Rev. Rul. 68-379, 1968-2 C.B. 414 (holding gift tax protection is also achieved if it can be established that the transfer of the interest in the QPRT was made in exchange for the relinquishment of support rights and that those rights had a value equal to the value of the transferred QPRT interest).

⁷³ Pub. L. No. 101-508, 104 Stat. 1388 (1990) (adding I.R.C. § 2702 to the Code as part of the Omnibus Budget Reconciliation Act of 1990).

family members.⁷⁴ As a result, the transferor's taxable gift would be the full value of the transferred property.⁷⁵

Section 2702 applies generally to transfers of term or remainder interests in property, in trust or otherwise, to a family member, if the transferor or an applicable family member⁷⁶ retains an interest in the transferred property. Unless the transfer is made in one of several qualified forms, the retained interest is deemed to have a zero value.

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

Example - Harold transfers \$100,000 in trust to pay his spouse, Wanda, income for ten years, and then to pay the trust principal to him. The actuarial value of Harold's retained interest is \$45,000. But I.R.C. § 2702 will treat it as having a zero value. The value of the gift, therefore, is \$100,000.

Similarly, a transfer of a term interest in property to a spouse would be subject to § 2702 if the transferor retains a remainder interest in the property. Transfers of term interests in property frequently take place in connection with a divorce or separation. Consider the following example:

Example - Wendy and Henry own their home as joint tenants. Their marital settlement agreement gives him the right to live in it for five years. At the end of the five-year period, the home will be sold and the proceeds divided equally between them.

The arrangement described is within the scope of I.R.C. § 2702. As a result, the value of Wendy's retained interest in the residence will be deemed to be zero.

If the transfers described above were part of a marital settlement, § 2702 will be avoided if the requirements of I.R.C. § 2516 are satisfied. Treasury Regulation § 25.2702-1(c)(7) creates an exception for "the transfer of an interest to a spouse [if it] is

⁷⁴ For this purpose, other family members include the 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.

⁷⁵ I.R.C. § 2702(a)(2)(A).

⁷⁶ The term "applicable family member" means the transferor's spouse, an ancestor of the transferor or his or her spouse, and the spouse of any such ancestor. I.R.C. §§ 2701(e)(2), 2702(a)(1).

Vol. 27, 2014-2015 Trusts to Structure Divorce Settlements 51

deemed to be for full and adequate consideration by reason of section 2516 . . . and the remaining interests in the trust are retained by the other spouse.”⁷⁷

The exception contained in the regulations does not apply to transfers that are protected from the gift tax for any reason other than the application of § 2516. As a result, the spouse who makes a gift tax protected transfer of a term interest in trust or otherwise and retains the remainder interest may be treated as having made a taxable gift equal to the value of the remainder interest. Even if the parties are married at the time, the marital deduction will not protect the transfer (unless the trust is eligible for a QTIP election) since the remainder interest will not actually pass to the transferee spouse.

The exception contained in the regulations does not apply if any person other than the two spouses acquires an interest in the trust. If a remainder interest in a trust will pass to the children, which is not uncommon in a § 2516 transfer, the exception will not protect the transfer.

From the standpoint of the actual transferor, the lack of protection is not important. This is so because § 2702 does not reach his or her transfer unless the transferor retains an interest in the trust. If he or she transfers a term interest to the spouse and a remainder interest to their children, § 2702 will not apply to the transferor because neither the transferor nor an applicable family member has retained an interest.

Example - Henry transferred \$100,000 in trust to pay his spouse Hans income for ten years and then to pay the trust principal to their children. The value of the income interest is \$55,000. In exchange, Hans relinquished his right to be supported by Henry. His support rights were worth \$55,000. Henry has retained no interest in the trust. His gift to the children will be \$45,000. Hans is an applicable family member as to Henry but he has “acquired” rather than “retained” an interest in the trust.⁷⁸

The joint purchase rule of § 2702, however, is likely to cause a gift tax problem for the transferee spouse. Subsection (c)(2) provides that if two or more family members acquire interests in

⁷⁷ Treas. Reg. § 25.2702-1(c)(7).

⁷⁸ Treas. Reg. § 25.2702-2(c)(3) (defining “retained” for any individual other than the transferor as “held by the same individual both before and after the transfer in trust”).

52 *Journal of the American Academy of Matrimonial Lawyers*

property in the same transaction or in a series of related transactions, and one of them acquires a term interest (i.e., a life interest or an interest for a term of years), the family member who acquired the term interest will be treated as if he or she had acquired the entire property and then transferred to the other family member the interest he or she acquired.⁷⁹

Example - John and his daughter Cleo acquired Blackacre from John's father Jim for a total purchase price of \$100,000. John acquired a ten-year term interest and Cleo acquired the remainder. John paid Jim \$55,000 for his interest, an amount equal to the actuarial value of his ten-year interest, and Cleo paid Jim \$45,000. John will be treated under I.R.C. § 2702(c)(2) as having acquired all of Blackacre for \$100,000 and as then having transferred the remainder interest to Cleo for \$45,000. Since the value of John's retained interest in Blackacre is zero, the net result is a taxable gift to Cleo by John of \$55,000.

The joint purchase rule will treat the full value of any term interest acquired by a transferee spouse in a transfer protected by § 2516 as a taxable gift from him or her if a family member other than the transferor spouse retains or acquires any interest other than a term interest in the transferred property. This will probably be so even if the non-term interests are transferred to provide a reasonable support allowance for minor children. The joint purchase rule recharacterizes the transaction as one made by the transferee spouse.

Example - Hank and Winnie entered into a marital settlement agreement that required her transfer of \$100,000 into a trust to pay income to Hank for fifteen years and then to pay the remaining trust principal to their adult children. In exchange, Hank relinquished his marital rights. Hank and Winnie were divorced within two years of the date of the agreement. The actuarial value of Hank's interest in the trust is \$68,500; the actuarial value of the children's interest, \$31,500. Winnie's transfer to the trust was protected from gift tax, to the extent of Hank's interest, by § 2516. She paid a gift tax on the value of the children's remainder interest. Hank will be caught by the joint purchase rule. He will be treated as having acquired the full \$100,000 interest in the trust and then as having transferred it in trust to pay himself income for fifteen years, remainder to the children. The value of his retained interest in the trust is zero but the consideration he furnished, marital rights deemed to be worth \$68,500, limits the amount of his taxable gift.

The result in this example would probably be the same even if Winnie's transfer to the children had also been protected by

⁷⁹ I.R.C. § 2702(c)(2).

§ 2516. This part of the transfer would have been protected if the children were minors and if the purpose of the transfer to them had been to provide for their support during their minority. The protection afforded by I.R.C. § 2516, however, seems to be limited to Winnie, since she was the one who made the actual transfer. For § 2516 to apply to Hank, his deemed transfer would also have to be treated as having been made for the support of the children. Since the portion of his deemed transfer that consists of the value of the retained interest is clearly not intended for the support of the children, § 2516 seems to be unavailable.

2. Possible Solutions

There are several ways of avoiding the impact of I.R.C. § 2702 on a § 2516 transfer in which family members other than spouses acquire remainder interests in trusts or property. The transfer could be structured as a qualified annuity or unitrust interest or as a personal residence trust. These techniques are discussed in further detail below.

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

Finally, the transferee spouse could be given a power of appointment over the remainder of the trust. The power could be limited to a power to appoint to issue. By giving him or her such a power, the gift he or she would be deemed to have made by application of the joint purchase rule will be an incomplete gift. The IRS dealt with such a transfer in Letter Ruling 201116006.⁸⁰ That ruling dealt with the consequences to the transferee spouse of the creation of a trust for her benefit for life, remainder to her issue as she appointed by will. The husband's transfer to the trust was protected from gift tax by § 2516. The IRS concluded, without any analysis of the joint purchase rule, that the wife had not made a transfer within the meaning of I.R.C. § 2702. The

⁸⁰ I.R.S. Priv. Ltr. Rul. 201116006 (Apr. 22, 2011).

IRS's conclusion in that ruling seems clearly incorrect. But, in that case, the application of the joint purchase rule should not have produced any taxable gift because the gift should have been treated as incomplete.

IV. Using Trusts to Implement Estate Freezes in Connection with Divorces

A. In General

Divorce and an accompanying property settlement may present an opportunity to accomplish an estate freeze type transaction either outside or within the scope of I.R.C. § 2702. The object is to transfer to the transferee spouse an interest in property that is not likely to appreciate while simultaneously (or shortly thereafter) transferring an interest in the same property that is likely to appreciate to the couple's issue.

One of the most common types of freeze transfers is the transfer of a term interest in property to a spouse and a remainder interest in the same property to issue. If § 2702 can be avoided, this type of transfer is likely to accomplish an estate freeze. Four useful methods of avoiding § 2702 are discussed below.

1. Causing the Transferee Spouse's Interest to Be Treated as an Incomplete for Gift Tax Purposes

I.R.C. § 2702 does not apply if no portion of the gift would be treated as a completed gift without regard to any consideration received by the transferor.⁸¹

Consider the following example:

Example Waverly, in a transaction protected by § 2516, transfers \$1,000,000 to a trust to pay her husband Harlan income for life, remainder to their children. The application of § 2516 results in the treatment of the transfer of the income interest to Harlan as having been made for a full and adequate consideration in money or money's worth. Harlan has now acquired, within the meaning of the joint purchase rule, a term interest in property in the same transaction in which his children have acquired the remainder interest. As a result, he will be treated as having gifted the entire \$1,000,000 to his children with an offset for the value of the taxable gift to the children made by Waverly when she made the

⁸¹ Treas. Reg. § 25.2702-1(c)(1).

Vol. 27, 2014-2015 Trusts to Structure Divorce Settlements 55

actual transfer to the trust. If the actuarial value of Harlan's income interest were \$700,000 and the actuarial value of the children's interest were \$300,000, Harlan would be treated as having made a taxable gift to the children of \$700,000.

Suppose the trust instrument gave Harlan the power to determine how the children would share in the remainder interest of the trust. As a result, his deemed transfer is wholly incomplete for gift tax purposes. It is incomplete as to the income interest because the income interest is his. It is incomplete as to the remainder interest because he controls who will receive it.⁸²

If the approach described in the preceding example is used, care must be taken to ensure that the transferee spouse retains the power for life. Any lapse of the power during life would cause the deemed gift to be complete and would trigger the application of § 2702. Because § 2702 does not apply for estate tax purposes, the trust property should not be included in Harlan's gross estate for estate tax purposes if he dies possessing this power.

2. Delaying the Transfer

Section 2702 can also be avoided by delaying the transfer to the junior family members until after the divorce. In addition, the transfer to the children must be unrelated to the transfer to the spouse. If the two transfers were related they would likely be treated as a series of transactions in which the transferee spouse and the children acquired a term and a remainder interest, respectively. If the two transactions were treated as a series of transactions, the joint purchase rules discussed above would apply to treat the transferee spouse as the transferor of the children's interest.⁸³ The following is an example of a post-divorce transformation of an interspousal transfer into an estate freeze:

Example - Homer, pursuant to the terms of a marital settlement agreement entered into between him and his spouse, Wallis, transferred \$100,000 in trust to pay her income for life. At her death, the trustees were to return the principal to him. Homer's transfer to the trust was protected from gift tax by § 2516. The actuarial value of Wallis's interest in the trust was \$90,000. Two years after Homer's divorce from Wallis, he transferred his remainder interest, then worth \$11,000, to his daughters, Jenny and Kate. Section 2702 does not apply to Homer's

⁸² See Treas. Reg. § 25.2511-2(c).

⁸³ I.R.C. § 2702(c)(2).

56 *Journal of the American Academy of Matrimonial Lawyers*

transfer to Wallis since it was protected from the gift tax by § 2516 and because only he and Wallis had interests in the trust after his transfer to it. Because his later transfer to Jenny and Kate was made after his divorce when Wallis was no longer related to him, § 2702 does not apply to Homer's transfer. Section 2702 will not apply to Wallis because her acquisition of an income interest was not part of a series of transactions in which Jenny and Kate acquired an interest.

3. *Using a Qualified Annuity Interest*

In some cases, a spouse who is willing to accept a trust as part of a marital settlement wants to be assured of a fixed return and does not want to rely on trust income, the amount of which will depend to a large extent on the way the trustees choose to invest trust principal. This spouse may accept an annuity trust, one that pays him or her a fixed amount on specified dates each year. This kind of trust will escape the zero valuation rule of I.R.C. § 2702 if it meets certain requirements.

Section 2702's zero valuation rule does not apply to a trust in which the transferor retains a qualified interest.⁸⁴ The term "qualified interest" includes an interest "which consists of the right to receive fixed amounts payable not less frequently than annually."⁸⁵ The regulations impose several additional requirements. The annuity amount must be paid at least once each year.⁸⁶ The annuity amount payable each year must be fixed at the time the trust is created.⁸⁷ Although the trustees may be permitted to pay trust income in excess of the required annuity to the annuitant/beneficiary,⁸⁸ the annuity must be paid whether or not the trust income is sufficient to permit payment out of income. To the extent income is insufficient, it must be payable out of principal. The amount paid is not required to be the same each year, but the amount payable in any particular year may not exceed 120% of the amount payable in the preceding year.⁸⁹ The

⁸⁴ I.R.C. § 2702(a)(2).

⁸⁵ I.R.C. § 2702(b)(1). The term "qualified interest" also includes certain unitrust interests and certain noncontingent remainder interests. I.R.C. § 2702(b)(2)-(3). These interests are not discussed in the text because they do not present particularly attractive methods for structuring an estate freeze.

⁸⁶ Treas. Reg. § 25.2702-3(b)(1)(i).

⁸⁷ Treas. Reg. § 25.2702-3(b)(1)(ii).

⁸⁸ Treas. Reg. § 25.2702-3(b)(1)(iii) (stating the value of the right to receive excess income is not reflected in the value of the retained interest).

⁸⁹ Treas. Reg. § 25.2702-3(b)(1)(ii).

Vol. 27, 2014-2015 Trusts to Structure Divorce Settlements 57

trust instrument must prohibit payment to any person other than the annuitant/beneficiary until the expiration of the annuity term,⁹⁰ prepayment of the annuitant/beneficiary's term interest,⁹¹ and additions to the trust after its initial funding.⁹² The term may be for a fixed period of years, for the life of the annuitant/beneficiary or for the shorter of the two.⁹³ If all of these requirements are met, the value of the retained annuity will be determined using the normal valuation rules described in I.R.C. §7520. A qualified annuity trust may be a viable means of structuring a marital property settlement that both satisfies the transferee spouse's desire for a constant income and the transferor's estate freezing ambitions. Consider the following example:

Example - Whitney's fifty year old husband Howard has demanded alimony of \$50,000 per year for fifteen years or until his earlier death. Whitney is willing to provide him with this level of support only if he is willing to relinquish any personal claim against her and look only to a trust for payment. She has offered to fund this trust with \$625,000. Howard's investment advisors have told him that this amount should be sufficient to fund a fifteen year, \$50,000 annuity. Whitney wants the remainder interest in the trust to pass to their child Katy at the end of the fifteen year term.

If all the requirements set forth in the regulations are met, Howard's interest in the trust will be a qualified annuity interest. If the marital settlement agreement is protected by § 2516, Whitney's transfer to the trust will be subject to gift tax only to the extent of the excess of \$625,000 over the value of Howard's qualified annuity interest. Assuming a 2.2% discount rate, the value of his interest will be \$604,080.⁹⁴ Her taxable gift will be about \$20,920.

Because Howard's interest in the trust is a qualified interest, the joint purchase rule will credit him with the full \$604,080 in calculating the amount of his gift to Katy. Since this is the total amount of consideration he will be deemed to have furnished, he will not be treated as having made a taxable gift.

⁹⁰ Treas. Reg. § 25.2702-3(d)(3).

⁹¹ Treas. Reg. § 25.2702-3(d)(5).

⁹² Treas. Reg. § 25.2702-3(b)(5).

⁹³ Treas. Reg. § 25.2702-3(d)(4).

⁹⁴ This is the actuarial value of the right to receive a payment of \$50,000 per year for the shorter of fifteen years or the life of a fifty-year-old individual.

If the trustees invest the trust fund to achieve a 6% return, the trust will be worth \$334,050 when it passes to Katy. Whitney's estate freezing objective will have been accomplished.

If Whitney dies before the end of the annuity term, no portion of the trust will be included in her gross estate because she retained neither an interest in nor control over the trust. If Howard dies before the end of the fifteen year term no portion of the trust should be included in his gross estate because he made no transfer to it. The IRS may challenge the second result on the grounds that he is the real transferor of the trust because of his relinquishment of marital rights. There is some support for such a challenge in the *Gradow v. United States* decision.⁹⁵ In that case, the court held that the bona fide sale exception in I.R.C. § 2036 required that the transferor receive consideration equal to the entire value of the property in the trust.⁹⁶ *Gradow* may be inapplicable to a situation in which the decedent did not transfer any property to a trust but simply purchased a term interest.

4. *Using a Qualified Personal Residence Trust*

In some cases, one of the spouses will want to retain the use of the marital residence or a family vacation home for a period of time. The qualified personal residence trust may be a useful tool in these cases.

Suppose, for example, that one spouse agrees to let the other retain the marital residence for a period of years, after which the residence will be sold, and the proceeds divided be-

⁹⁵ *Gradow v. United States*, 11 Cl. Ct. 808 (1987), *aff'd*, 897 F.2d 516 (1990).

⁹⁶ *Id.* at 814. In both *Estate of D'Ambrosio v. Comm'r*, 101 F.3d 309 (3d Cir.), *cert. denied*, 520 U.S. 1230 (1997), and *Wheeler v. United States*, 116 F.3d 749 (5th Cir. 1997), on the other hand, it was held that adequate and full consideration under I.R.C. § 2036(a) is determined with reference to the value of the remainder interest transferred, not the value of the full fee simple interest in the underlying property. The Court in *D'Ambrosio* opined that under the *Gradow* analysis it would be virtually impossible to sell a remainder interest because "the transferor [would] have to find an arms-length buyer willing to pay a fee simple price for a future interest." *D'Ambrosio*, at 316. In Letter Ruling 200408015 (Nov. 12, 2003), the IRS concluded that a trust created to pay an annuity to a former wife of the settlor would not be included in her gross estate at her death because "[w]ife will have no interest that she can transmit to others, upon her death."

tween them. If one or both of them are interested in simultaneously making a gift to their children, this could be accomplished by using a qualified personal residence trust (“QPRT”). The terms of the trust would give one spouse the right to use the residence for the agreed upon period. At the end of the period, all, or a portion of the property, could be distributed to the parties’ children. Consider the following example:

Example - Wendy and Hank own their marital residence jointly. Their marital settlement agreement gives Wendy the right to live in the marital residence for the rest of her life. At that time, the residence is to be sold. Wendy’s estate will receive one-half of the proceeds. Hank would like the other one-half to be paid to their children. The residence is worth \$500,000. The § 7520 rate is 4.8%. Wendy is fifty-five years old. Hank’s transfer of the right to use his one-half of the residence to Wendy for her life will be protected from gift tax by § 2516. His transfer of the future interest in one-half of the residence to his children will be a taxable gift, but the amount of the gift will be only \$89,208 rather than \$250,000.

As discussed above, the joint purchase rules of I.R.C. § 2702, would make Wendy the transferor of Hank’s entire one-half of the residence, with an offset only for the value of his \$89,208 gift to the children. If, however, the transfer is structured as a QPRT, § 2702 can be avoided.

To qualify for the QPRT exception to § 2702, the trust instrument must meet several governing instrument requirements described in the regulations.⁹⁷ For example, it must require the distribution of all trust income to the term holder at least annually and must prohibit principal distributions to anyone other than the term holder during the trust term.⁹⁸ With a few exceptions, the trust instrument must prohibit the trust from holding any asset other than the residence.⁹⁹ The trust instrument must prohibit commutation, *i.e.*, the prepayment of the term holder’s interest at its actuarial value at the date of prepayment.¹⁰⁰ The trust instrument must provide that if the residence held by the trust ceases to be a personal residence of the term holder, the trust ceases to be a QPRT¹⁰¹ and, within thirty days of the trust’s

⁹⁷ Treas. Reg. § 25.2702-5.

⁹⁸ Treas. Reg. § 25.2702-5(c)(3) and (4).

⁹⁹ Treas. Reg. § 25.2702-5(c)(5)(i).

¹⁰⁰ Treas. Reg. § 25.2702-5(c)(6).

¹⁰¹ Treas. Reg. § 25.2702-5(c)(7).

60 *Journal of the American Academy of Matrimonial Lawyers*

ceasing to be a QPRT with respect to any assets, those assets must be (i) distributed to the term interest holder, or (ii) held for the balance of the term in a separate share of the trust that meets the requirements of a qualified annuity interest within the meaning of Treas. Reg. § 25.2702-3.¹⁰² The regulations state that the trust instrument can direct either of these results or leave the decision to the discretion of the trustee.

¹⁰² Treas. Reg. § 25.2702-5(c)(8)(i).