Tax and Estate Planning for Divorce - Selected Issues

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I. INTRODUCTION

Marriage is a tax relationship with tax implications. Married individuals are permitted to combine all of their items of income, deduction and credit when filing a joint return. The losses of one may offset the income of the other. The tax rates applied to their combined incomes are lower than the rates that would have been applied if one unmarried individual had the same amount of taxable income. Additionally, they are allowed to make virtually unlimited transfers to each other free of federal estate and gift tax.[1]

On the other hand, if the two individuals both have income, the rate at which their income is taxed might be higher than the rates that would be applicable to their incomes if they were unmarried.[2] In addition, many provisions of the Code[3] have an adverse impact on married individuals.[4]

When a marriage is dissolved by divorce, the tax benefits and burdens of marriage are changed, and the property transfers that take place in connection with the dissolution are likely to have significant tax consequences of their own. This outline discusses the principal income,

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 Portions of this outline are derived from the manuscript of the forthcoming book CARLYN S. MCCAFFREY and JOHN C. MCCAFFREY, STRUCTURING THE TAX CONSEQUENCES OF MARRIAGE AND DIVORCE.

[1] Certain limitations apply to transfers to spouses who are not U.S. citizens.

[2] The Jobs and Growth Tax Relief Reconciliation Act of 2003, Pub. L. 108–27, 117 Stat. 752, reduced the impact of this so-called "marriage penalty" on married couples who file jointly. The Act equalized the standard deduction for singles and married couples and increased the amount of income subject to the 15% tax bracket for joint return filers. Once the couple's income reaches the 25% bracket the probability of a marriage penalty arises because the 25% bracket for joint filing is less than twice as large as the 25% bracket for singles. *See, e.g.* MARGOT L. CRANDALL-HOLLICK, CAROL A. PETTIT, MOLLY F. SHERLOCK, CONG. RESEARCH SERV., R43157, THE FEDERAL TAX TREATMENT OF MARRIED SAME-SEX COUPLES, 6 (July 30, 2015).

[3] References to the "Code" and "I.R.C." are to the Internal Revenue Code of 1986, as amended. References to "Section", "Code Sec." and "§" are to sections of the Code and references to "Treas. Reg. §" and "Temp. Reg. §" are to sections of the regulations and the temporary regulations promulgated under the Code. References to "IRS" are to the Internal Revenue Service.

[4] An example is the overall limitation on itemized deductions (I.R.C. §68), which exempts a larger portion of an unmarried individual's income than that of a married individual.

estate and gift tax consequences of divorce and the property settlements that generally accompany a divorce.

II. INCOME TAX TREATMENT OF PROPERTY SETTLEMENTS

A. IN GENERAL

Most states give each spouse interests in property acquired during marriage regardless of which spouse holds title to the property. When the marriage is dissolved, these rights are satisfied by a division of property. Property divisions may be accomplished by cash payments or by transfers of property other than cash. In some cases, the property transferred will be rights to receive income in the future such as the right to receive deferred compensation.

B. CASH TRANSFERS

Under current law, the payment of cash, unless it meets the requirements of taxable alimony under I.R.C. §71, will not be taxable to the payee spouse and will not be deductible by the payor spouse.

C. PRE-I.R.C. §1041 TRANSFERS OF PROPERTY OTHER THAN CASH

The tax consequences of property transfers other than cash are more complex. Before the enactment of I.R.C. §1041 as part of the Tax Reform Act of 1984, the transfer of property in satisfaction of marital rights was often a taxable event. This result stemmed from the 1962 Supreme Court decision in *United States v. Davis*.[5]

In the *Davis* case, the Court decided that a transfer of property by one spouse to the other in satisfaction of marital rights should be treated for tax purposes as a transfer of property in satisfaction of a legal obligation.[6] Because the value of the marital rights would be impossible to determine, the transfer was to be treated as a sale by the transferor to the transferee spouse for a price equal to the fair market value of the property transferred. If the transferor's basis in the property was less than its fair market value, the transferor would recognize capital gain, or in some circumstances, ordinary income. If the transferor's basis was higher than its fair market value, that person would recognize loss.[7]

The spouse to whom property was transferred in a transaction treated as a sale was treated as a purchaser. The transferee spouse received a tax basis equal to the fair market value of the property at the time of the transfer.

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[5] 370 U.S. 65 (1962).

[6] Curiously, the IRS never took the position that the release of marital rights was a recognition event for the releasing spouse. *See, e.g.,* Rev. Rul. 67-221, 1967-2 C.B. 63.

[7] I.R.C. §267 disallowed the deduction for the loss if the parties were married to each other at the time the transfer occurred.

D. TAX CONSEQUENCES OF APPLICATION OF I.R.C. §1041

1. NONRECOGNITION ON TRANSFER

Congress intended, and the Code reflects the goal, that "the tax laws [should be] as unintrusive as possible with respect to relations between spouses..."[8] Transfers to which I.R.C. §1041 applies do not result in the recognition of gain or loss.[9] The transferred property is treated as acquired by gift for income tax purposes.[10]

> Example - Addison owns real estate with a basis of $500,000 and a fair market value of $1,000,000 and cash of $1,000,000. Addison's spouse Bailey owns no property. Pursuant to their marital settlement agreement, Addison will transfer the real estate to Bailey in exchange for the release of Bailey's rights in all marital property. Addison will not recognize gain on the transfer.

2. BASIS

The basis in property acquired in an I.R.C. §1041 transaction is the same as the transferor's adjusted basis immediately prior to the transfer.[11]

There are two important differences between the basis rules of I.R.C. §1015, the rules that normally apply in the case of gifts, and I.R.C. §1041(b)(2).

i. The two sections have different rules for property that is transferred at a time when its basis exceeds its fair market value. Under I.R.C. §1015(a), if the basis of property is greater than its fair market value at the time of the gift, then for purposes of determining loss on a subsequent sale, the basis is limited to fair market value at the time of the gift. Under I.R.C. §1041(b)(2), the transferee takes the transferor's basis regardless of the relationship between value and basis at the time of the transfer.

ii. I.R.C. §1015(d) permits an increase in basis for gift tax paid in connection with a gift to the extent attributable to the excess of the value of the property at the time of the gift over the transferor's basis immediately before the gift. Because I.R.C. §1015 does not apply to transfers described in I.R.C. §1041(a), the basis adjustment for gift taxes paid will not be available to transfers described in I.R.C. §1041(a).[12]

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8 H.R. Rep. No. 432, 98 Cong. 1st Sess. 191-92 (1983).

9 I.R.C. §1041(a).

10 I.R.C. §1041(b)(1).

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

12 In most cases, transfers described in I.R.C. §1041(a) will not result in the payment of gift tax.

iii. If a transfer of property pursuant to a marital settlement agreement is in part to a spouse and in part to third parties such as the children of the marriage, the I.R.C. §1041(b)(2) basis rule should apply to the portion of the property transferred to the spouse and the I.R.C. §1015 basis rules should apply to the portion of the property transferred to the third parties.

3. HOLDING PERIOD

If the basis of property acquired by transfer is determined in whole or in part by reference to the transferor's basis, the holding period for the property includes the period of time the transferor held the property.[13]

4. OTHER CONSEQUENCES OF TREATMENT OF PROPERTY AS ACQUIRED BY GIFT

Gift treatment for income tax purposes causes the tax consequences discussed below.

a) DEPRECIABLE PROPERTY

Code Secs. 1245 and 1250, which require a transferor of depreciable property to include as ordinary income certain portions of the depreciation deductions the transferor has taken with respect to the transferred property, do not apply to gifts. Because I.R.C. §1041(b) treats the transferred property as having been acquired by gift, a transfer to which I.R.C. §1041(a) applies will not result in such inclusion. When the transferee spouse disposes of the property, however, the disposition may result in the application of these recapture provisions.

I.R.C. §1239 requires an individual who sells property which will be subject to depreciation in the hands of the purchaser to treat all gain on the transfer as ordinary income if the purchaser is a related entity or a trust in which the individual or the individual's spouse is a beneficiary (other than a beneficiary with a remote, contingent interest).[14] Because a sale or exchange of property with a trust for the benefit of a transferor's spouse is treated as a gift for income tax purposes under I.R.C. §1041(b), a transfer of I.R.C. §1239 property to a trust for the benefit of the transferor's spouse should not result in application of I.R.C. §1239.

b) LIFE INSURANCE

I.R.C. §101(a) provides an exclusion from gross income for proceeds received under a life insurance policy at the death of the insured. There is, however, an important exception to this rule. Section 101(a)(2), the so-called "transfer for value" rule, denies the exclusion to the transferee of a life insurance policy if the transferee has acquired the policy for "valuable consideration."

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[13] I.R.C. §1223(2).

[14] I.R.C. §1239(b)(2).

If I.R.C. §1041(b) applies to the transfer of a life insurance policy, this result will be avoided, because the policy will be treated as having been acquired by gift.

c) TERM INTERESTS

A transfer of property pursuant to a marital settlement agreement will sometimes be split between a spouse and third parties such as the transferor spouse's children. A typical example of a transfer of split interests is a transfer of a life estate in real estate to a spouse, followed by a remainder to the children. Life estates and other term interests (such as interests for a term of years) acquired by gift are subject to the following two significant tax disadvantages:

1) I.R.C. §273 prevents the donee of a term interest from claiming an amortization deduction to enable recovery of basis in the property.[15]

2) I.R.C. §1001(e) reduces an individual's basis in a term interest acquired by gift or inheritance to zero if the individual sells the interest. As a result, the full amount received in exchange for the interest will be taxable gain. There are two exceptions to this rule.

   (a) If the individual sells an interest in a transaction in which the entire interest in the trust property is transferred to another person, I.R.C. §1001(e)(3) will not apply.[16]

   (b) I.R.C. §1001(e) will not apply unless the individual's basis in the transferred term interest is a portion of the entire adjusted basis of the property. For example, if a taxpayer acquired a ten-year term interest by purchase from a parent, the taxpayer's basis in the term interest would be the cost of the interest, not a portion of the basis shared between the taxpayer and the seller. If the taxpayer transfers this term interest to the taxpayer's spouse, the spouse's basis in a subsequent sale will be the carryover basis under I.R.C. §1041(b)(2).

E. BASIS AS AN ELEMENT OF VALUATION

I.R.C. §1041 creates difficult valuation problems for those who give financial advice to divorcing spouses. As discussed above, I.R.C. §1041 provides for the non-recognition of gain on the sale or transfer of property to a spouse incident to divorce. The Code does not exempt such gains from taxation, but rather defers recognition until some future disposition. The distinction is critical to the negotiation of property settlements. Failure to consider the taxes that will be paid on the current or future disposition of an asset, and to adjust the value of the asset to reflect

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[15] *See* Jackson v. Commissioner, T.C. Memo 1996-481 (1996).

[16] *See* P.L.R. 7105110280A (May 11, 1971) and P.L.R. 7101070280A (January 7, 1971). The exception does not apply if the purchaser is the remainder person or the holder of the term interest. P.L.R. 8948023 (September 1, 1989) and P.L.R. 8448059 (August 28, 1984).

these taxes, will result in the potential overvaluation of low basis assets. These assets, subject to other variables, will generate more taxable gain relative to high basis assets.[17]

> Example - Caelan and Dana are married and own land worth $500,000 with a basis of $100,000. They also have $500,000 cash in their joint bank account. The total value of their marital property subject to division is $1,000,000. Caelan and Dana enter into a property settlement agreement and are divorced one year later. Their agreement provides that the land will be distributed to Caelan and that Dana will receive the cash. Section 1041 will protect both spouses from recognizing gain on this disposition. Six months later, Caelan sells the land for its fair market value, $500,000. Assuming a marginal tax rate of 15% applies to Caelan's gain of $400,000, Caelan will receive only $440,000 net of taxes. The result is an inequitable distribution because no consideration was given to the tax effect of this disposition when the agreement was negotiated.

The financial advisor to a spouse who plans to retain or acquire low-basis assets must assign some negative value to the tax liability inherent in a low basis. If the assets involved are expected to be sold in the near future, the task would not be difficult. For example, if 100 shares of the X corporation have a fair market value of $100,000 and a basis of $50,000, and if the party who will retain or acquire the shares plans to sell them within the current year in a taxable transaction, the value of the shares to the party is obviously not $100,000. Instead, it is $100,000 reduced by the estimated tax liability that will be incurred in connection with the sale.

In most cases, however, predicting the future will be more complicated. Assets may be retained for varying periods of time, and it may be impossible to predict when or whether they will ever be disposed of or what the seller's tax situation will be at the time of disposition. In some cases, the acquiring spouse may plan to retain the acquired asset until death, at which time, under current tax law, the acquiring spouse's estate will receive a basis in the asset equal to its then fair market value.[18] In this case, no income tax will be paid on the unrealized appreciation inherent in the asset at the time of the division of assets between the spouses. Even this result should not be viewed as a certainty. The individual may face changed circumstances that will compel disposition of the asset during lifetime. Moreover, even if the asset is held until death, there is no guarantee that Congress will not by then have adopted a carryover basis rule or perhaps a provision that would tax unrealized gains at death. Although few would suggest a

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[17] *See* Michael Asimow, *The Assault on Tax-Free Divorce: Carryover Basis and Assignment of Income*, 44 TAX L. REV. 65, 73-84 (1988). To the extent that the transferee spouse has unused losses, or if capital gains tax rates are lowered or repealed, the tax consequences of unrealized gains will be ameliorated.

[18] I.R.C. §1014. The basis adjustment, however, would not be available for an asset that consists of a deferred right to receive income in respect of a decedent under I.R.C. §691. I.R.C. §1014(c).

return to the *Davis* rule, the immediate tax burden imposed under the rule did have the virtue of providing certainty.[19]

Under the I.R.C. §1041 regime, some estimate of the present value of future tax costs must be made, despite the difficulty, so that the spouse who receives the lower basis assets is not inadequately compensated. Professor Michael Asimow, who has written thoughtfully and extensively about I.R.C. §1041, suggests that the estimate of future tax costs should be based on assumptions made as to: "(1) whether the asset will be disposed of in a taxable transaction, (2) when that will occur, (3) what the marginal tax rate will then be, and (4) what discount rate to employ in reducing that tax to present value."[20]

If it is possible to make these assumptions, Professor Asimow's approach can be implemented by using the formula below:

$$(U(1 + i)^n)(1\text{-}T)=X(1 +(i(1\text{-}T))^n$$

In this formula, "U" equals the amount of unrealized or untaxed income, "i" equals the annual rate of return expected to be achieved, "n" equals the number of years until the income is taxed, and "T" equals the expected rate of income tax. Solving the formula for "X" will produce the cash equivalent for any assumed value of "U," the amount of unrealized income.

The formula assumes: (1) that the property embodying the unrealized income will grow at a rate equal to the rate of return obtainable on an investment of the cash equivalent, (2) that the income earned or growth generated by the investment of the cash equivalent will be taxed annually, and (3) that such income and growth will be taxed at the same tax rate that the unrealized income will eventually be subjected to.

To the extent these assumptions are not correct, the formula can be adjusted. For example, if the rate of tax is likely to be different, the formula should be adjusted by changing the reference to the first "T" to "TA," the income tax rate that will be imposed on the unrealized appreciation, and the second "T" to "TB," the income tax rate that will be imposed on the spouse who is receiving the unappreciated asset. If the cash equivalent could be invested without subjecting the return to an annual tax (in a tax deferred annuity, for example) the formula might be as follows:

$$(U(1+i)^n)(1\text{-}T)=X(1+i)^n\text{-}(T((X(1+i)^n)\text{-}X))$$

To illustrate the use of the formula, assume the facts in the following example:

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[19] *But cf.* C. Garrison Lepow, *Tax Policy for Lovers and Cynics: How Divorce Settlement Became the Last Tax Shelter in America*, 62 NOTRE DAME L. REV. 32 (1986); William J. Brown, *Sexist Sleepers in Domestic Relations Provisions of the 1984 Tax Reform Act*, 30 N.Y.L. SCH. L. REV. 39 (1985); Katherine D. Podris and Gary J. Podris, *Section 1041 Was the Cure for U.S. v. Davis: Now How to Fix the Cure*, 68 TAXES 580 (August 1990). *But see also* Michael Asimow, *Section 1041 Needs No Cure*, 69 TAXES 37 (January 1991) (responding to Podris *supra*).

[20] Asimow, supra note 17, at 74.

> <u>Example</u> – Spouses Eddie and Frances have two assets, $500,000 cash in their joint bank account and jointly held securities. The securities are worth $500,000; the basis of the securities is zero. Eddie and Frances want to divide their assets equally between them. It is agreed that Frances will keep the bank account and that Eddie will keep the securities. The object is to determine how much of the cash in the bank account should be retained by Eddie to adjust for the taxes that will be paid when the securities are sold. They assume that the cash could be invested to achieve a 10% annual return, that each will pay a 20% tax on the return at the end of the investment period, and that Eddie will retain the securities for 5 years.

The second formula tells us that "X," the cash equivalent of the $500,000 worth of zero basis securities, is $432,814. This amount of cash, if invested at 10% for five years, would grow to $697,051 in five years. The tax on this amount would be 20% of $697,051 less $432,814, or $52,847. After paying this tax, Frances would have $644,204 left from the hypothetical investment.

Using the same assumptions, this amount is equal to what Eddie would retain, after income taxes. The $500,000 portion would grow to $805,255 over the five-year period. Eddie's income tax on this amount would be $161,051, leaving Frances with $644,204.

The formula suggests that Frances would receive $67,186 more value than Eddie if Frances keeps the cash and Eddie keeps the securities ($500,000 - $432,814). If Eddie and Frances intend that each should receive equal shares of their marital pie and if they agree with the various assumptions, Eddie should keep $33,543 (1/2 of $67,186) out of the bank account. This would equalize their shares.

The formulae suggested here must be used with care since they suggest a degree of analytical precision that is illusory. The formulae are no more accurate than the assumptions made as to their variables. And perfect accuracy as to the timing of future tax events, future rates of returns, and future tax rates is unlikely. Nevertheless, they may be helpful in the process of negotiation because they can help the parties to understand the boundaries of the range of economic results of their bargain.

F. TAX-IMPACTING PROPERTY DIVISIONS UNDER STATE LAW

The manner in which marital property is divided between spouses in connection with a divorce and the factors that must or may be taken into account in connection with that division are determined by state law. Unfortunately, there is no clear consensus among the various states as to whether the amount of future taxes that may be paid on the disposition or collection of a marital asset is a factor to be considered. Indeed, in some states, it may be difficult to find a common pattern among the various judicial decisions on this issue.

Many states specifically provide for consideration of the income tax consequences of the division of marital property when the taxes are not speculative and are a direct and necessarily incurred consequence of the property distribution.[21] For example, Oregon family law mandates that "[i]n arriving at a just and proper division of property, the court shall consider reasonable costs of sale of assets, taxes, and any other costs reasonably anticipated by the parties."[22]

Some state courts have allowed taxes to reduce the value of marital assets under circumstances in which there was a proper evidentiary basis that the taxes would be paid even though there was no showing that the taxes were required to be paid as a result of the property division and no indication that the taxes would be paid in the near future.[23] For example, if a property right to be allocated between the parties is the right to share in one spouse's pension, and the tax costs of withdrawing the funds in future years is certain, then such costs would be shared.[24]

Typically, state law will permit or require a trial court to ignore future taxes in valuing property or making an equitable distribution under circumstances indicating that the taxes are hypothetical, speculative, or not immediate and specific.[25] The California Supreme Court, for

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21 *See, e.g.*, 23 Pa.C.S.A. §3502(a)(10.1); Tenn. Code Ann. §36-4-121(c)(9); Ark. Stat. Ann. §9-12-315(a)(1)(A)(ix); S.C. Code Ann. §20-3-620(11); *see also* Maurer v. Maurer, 623 N.W.2d 604 (Minn. 2001); Innerbichler v. Innerbichler, 752 A.2d 291, 308 (Md. 2000); Hartog v. Hartog, 85 N.Y.2d 36, 647 N.E.2d 749, 623 N.Y.S.2d 537 (1995); Oberhansly v. Oberhansly, 798 P.2d 883 (Alaska 1990); Krage v. Krage, 329 N.W.2d 878 (S.D. 1983). *See also* 9 A.L.R. 5th 568, at §§8 and 19.

22 Ore. Rev. Stat. §107.105(1)(f)(G).

23 *See, e.g.*, Liddle v. Liddle, 140 Wis.2d 132, 410 N.W.2d 196 (1987) (in which disposition of a partnership interest was likely).

24 *See* Dodson v. Dodson, 955 P.2d 902 (Sup. Ct. Alaska, 1998) (401(k) plan); Laribee v. Laribee, 138 Wis.2d 46, 405 N.W.2d 679 (1987) (employee pension); Ashraf v. Ashraf, 134 Wis.2d 336, 397 N.W.2d 128 (Wis. App. 1986) (IRA and Keogh accounts); *but see* Fortson v. Fortson, 131 P.3d 451(Alaska 2006)("While *Dodson allows* the superior court to consider tax consequences to reach an equitable outcome, it does not mandate the credit, and <u>*Oberhansly*</u> requires the credit only where the tax effects are specific and immediate. Because the court did not require Jayne to sell the property, the tax effects were not specific and immediate, and the court did not abuse its discretion in denying Jayne a credit for possible tax effects and costs resulting from a sale." (emphasis in original)); *see also* Mattox v. Mattox, 105 N.M. 479, 734 P.2d 259 (1987) (the tax consequences of deferred pension payments were too speculative to consider due to the possibility of changing tax rates and income brackets). Similar results were reached in Calhoun v. Calhoun, 156 S.W.3d 410 (Mo. Ct. App. S.D. 2005); In re Marriage of Haberkern, 319 Mont. 393, 85 P.3d 743 (2004); Koutroumanos v. Tzeremes, 865 A.2d 1091 (R.I. 2005); Schuman v. Schuman, 265 Neb. 459, 658 N.W.2d 30 (2003).

25 Orgler v. Orgler, 237 N.J. Super. 342, 568 A.2d 67 (1989). Although the Court concluded that the tax the spouse would be required to pay on an asset distributed to him should not be deducted from the present value of the asset, it also concluded that the hypothetical tax

example, has held that a "trial court is not required to speculate on or consider such tax consequences in the absence of proof that a taxable event has occurred during the marriage or will occur in connection with the division of the community property."[26] A similar holding was reached in an Arizona case where the court ordered both parties in a divorce to share the capital gains tax on disposition of half their stock in a family corporation as was required to satisfy the property settlement, but did not consider the future tax liability of the other half of the stock not disposed of immediately.[27]

The possibility that future taxes may not be considered if a court, rather than the parties, makes the property division, does not mean that negotiating parties do not or should not take these tax considerations into account.[28] In fact, the possibility that future tax consequences would be ignored by a court puts extra pressure on the spouse who is likely to be left with the appreciated property to reach a negotiated settlement.

G. REQUIREMENTS FOR APPLICATION OF I.R.C. §1041

1. TRANSFERS TO SPOUSE

I.R.C. §1041 is applicable to any type of transfer between spouses, even if divorce or separation is never contemplated. It covers transfers of property intended as gifts and sales or exchanges of property between spouses acting at arm's length[29] as well as transfers that are made in connection with marital settlement agreements.

2. TRANSFERS TO FORMER SPOUSE

I.R.C. §1041 applies to the transfer of property between former spouses if the transfer is incident to divorce.[30] A transfer is incident to divorce if it occurs within one year after the date on which the marriage ceases,[31] or if it is related to the cessation of the marriage.[32] A transfer of

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consequences should be a factor to be considered in determining the distributive shares of each party.

[26] In re Marriage of Fonstein, 17 Cal.3d 738 (1976).

[27] Biddulph v. Biddulph, 147 Ariz. 571, 711 P.2d 1244 (1985); *see also* Hamroff v. Hamroff, 35 A.D.3d 365, 826 N.Y.S.2d 389 (2d Dept. 2006).

[28] *See* Asimow, *supra* note 17 at 77.

[29] Temp. Reg. §1.1041-1T(a) Q&A 2.

[30] I.R.C. §1041(a)(2). For this purpose, annulments and cessations of marriage that are void ab initio due to violations of state law constitute divorces. H. Rep't. No. 98-432, 98th Cong., 2d Sess. 1941 (1984) and Temp. Reg. §1.1041-1T(b) Q&A 8.

[31] I.R.C. §1041(c)(1) and Temp. Reg. §1.1041-1T(b) Q&A 6.

[32] *Id.*

property is related to the cessation of the marriage if the following two conditions are satisfied: (1) the transfer is pursuant to a divorce or separation instrument (including any modification or amendment to the instrument) as defined in I.R.C. §71(b)(2)[33] and (2) the transfer occurs within six years from the date on which the marriage ceases.[34] Transfers satisfying only one of the above two conditions are presumed to be not related to the cessation of the marriage. This presumption is rebuttable only upon a showing that the transfer was made to effect the division of property owned by the former spouse at the time the marriage was legally dissolved. The Temporary Regulations suggest that the presumption could be rebutted by showing that the transfer could not be made within the appropriate time limits due to legal or business impediments or disputes concerning the value of the property, provided the transfer takes place promptly after the impediment to transfer is removed.[35]

This provision was discussed in six Private Letter Rulings and in a 1999 Tax Court decision. In Letter Ruling 9235026[36] a marital settlement agreement approved by the court required one spouse to transfer certain property to the other. The actual transfer took place more than six years after the divorce because of a dispute as to the purchase price. The IRS concluded that the transfer was related to the cessation of the marriage because the transfer of the property was made in order to effect a division of property between the spouses, the delay was due to a dispute, and the transfer was made shortly after the dispute was resolved.

In Letter Ruling 9306015[37] there was an 8-year delay between the divorce and the transfer. The original judgment of divorce required that the parties' residence, which was owned jointly by the spouses, would be sold when the youngest child was emancipated and the proceeds would be divided equally between them. Instead, 8 years later, the parties amended the divorce instrument and, pursuant to that amendment, one former spouse sold the residence to the other. The IRS concluded that this transaction was not made to effect a division of property between them. That had already been accomplished by the original divorce judgment. Instead, this was an arm's-length transfer that was made between two individuals who were not married to each other.

In Letter Ruling 9348020[38] a marital settlement agreement between spouses who were divorced on December 26, 1990 provided that certain property held as tenants-in-common would

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33 In general, a divorce or separation instrument includes: (i) a decree of divorce or separate maintenance; (ii) a written instrument incident to a decree of divorce or separate maintenance; (iii) a written separation agreement; or (iv) a decree, other than a decree of divorce or separate maintenance that requires one spouse to make payments for the support or maintenance of the other spouse.

34 Temp. Reg. §1.1041-1T(b) Q&A 7.

35 Temp. Reg. §1.1041-1T(b) Q&A 7. *See* P.L.R. 9644053 (August 1, 1996).

36 P.L.R. 9235026 (May 29, 1992).

37 P.L.R. 9306015 (February 12, 1993).

38 P.L.R. 9348020 (September 1, 1993).

be sold to a third party unless the husband exercised his right of first refusal. The IRS concluded that the husband's purchase of the property would be a purchase pursuant to a divorce or separation instrument and that I.R.C. §1041(a)(1) would apply to any such sale if it took place before December 27, 1996.

In *Young v. Commissioner*,[39] there was a 4-year delay between the divorce and the transfer. In 1988, the parties divorced and in 1989 they entered into a settlement agreement under which one spouse gave a $1,500,000 promissory note to the other. The note provided for five annual payments to the payee. The payor spouse defaulted and the payee filed a collection suit. The parties settled the collection suit in 1992 and, pursuant to the settlement agreement, the payor transferred real property, not cash, to the payee. Although the property received was not cash, as originally bargained for, the court held that the 1992 agreement was "incident to" the divorce decree because the purpose of the transfer was to satisfy the payor's obligations arising from the cessation of the marriage. As a result, the property transfer was "related to the cessation of the marriage" and I.R.C. §1041 was applicable. This result seems clearly wrong.

The temporary regulation that tells us whether a transfer is incident to a divorce when it occurs more than one year after the divorce requires that the transfer be made pursuant to a divorce or separation instrument *and* within six years after the divorce. If both of these conditions are not satisfied, there is a presumption that the transfer is not incident to the divorce. In *Young*, the transfer was made within six years of the divorce but was not made pursuant to a divorce or separation instrument. It was made pursuant to the settlement of a suit for default on a promissory note. The temporary regulations require that the presumption can be overcome only if it can be shown that the transfer was made to effect the division of marital property. No such showing was made. In fact, all of the marital property had been divided four years earlier when the payee spouse accepted the payor's promise to make cash payments.[40]

In Letter Ruling 200221021,[41] the IRS concluded that a transfer of property from one spouse to the other after the 6-year period was related to the cessation of the marriage because it was made to effect the division of property owned by the spouses at the time of the divorce and there were compelling business reasons that caused the transfer to be delayed.

In Letter Ruling 200233022,[42] the IRS, citing *Young v. Commissioner*, treated a judicial amendment of an earlier decree as related to the cessation of the marriage. It concluded that the Temporary Regulation (Q&A 7) "specifically recognizes that a divorce or separation instrument includes a modification or amendment to such decree or instrument. Consequently, any order from the divorce court that specifically modifies an original divorce or separation instrument must be considered related to the cessation of the marriage, even if such order occurs many years after the divorce." This interpretation of the Temporary Regulation seems to eliminate the six

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39 Young v. Commissioner, 113 T.C. 152 (1999), *aff'd*, 240 F.3d 369 (4th Cir. 2001).

40 *See* Judge Wilkin's dissent in Young v. Commissioner, *supra*.

41 P.L.R. 200221021 (February 15, 2002).

42 P.L.R. 200233022 (May 15, 2002).

year requirement. Identical results were reached by the IRS in Letter Rulings 200709014 and 200442003.[43]

3. TRANSFERS OF SERVICES

I.R.C. §1041 applies to the transfer of any property whether or not it was owned or acquired during the marriage.[44] It does not apply to the transfer of services.

4. TRANSFERS OF PROPERTY FROM THIRD PARTIES

I.R.C. §1041 does not apply to transfers to a spouse from an entity, even if it is wholly-owned or controlled by the other spouse. As a result, a sale of property by a corporation of all of the shares which are owned by one individual to that individual's spouse is not protected by I.R.C. §1041.

If an individual wants to avoid the application of I.R.C. §1041 to a sale to his or her spouse, and if property of the kind to be transferred is owned by a controlled entity, the sale should be made by the entity rather than by the individual.

> Example - Gabriel owns appreciated real estate personally and through a wholly-owned corporation, Gabriel, Inc. Gabriel and Gabriel's spouse Harper have agreed that, as part of a marital settlement agreement, Gabriel will receive $100,000 in cash from Harper and Harper will receive $100,000 worth of real estate from Gabriel. If the agreement requires a transfer of real estate from Gabriel to Harper, I.R.C. §1041 will apply to the sale. If the agreement requires a transfer of real estate from Gabriel, Inc. to Harper and a transfer of cash from Harper to Gabriel, Inc., I.R.C. §1041 will not apply. Gabriel, Inc. will recognize gain or loss on the sale and Harper will have a $100,000 cost basis in that real estate.

If the property is transferred to a controlled entity as part of or immediately prior to the marital settlement agreement, the step-transaction doctrine would probably apply to recharacterize a sale between a spouse and the entity as a sale between spouses followed by a contribution of the purchase price to the entity by the shareholder.[45]

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43 P.L.R. 200709014 (March 2, 2007); P.L.R. 200442003 (October 15, 2004).

44 Temp. Reg. §1.1041-1T(a) Q&A 5.

45 Temp. Reg. §1.1041-1T(a), Q&A 2. Under the step-transaction doctrine, an integrated transaction may not be broken into separate and independent steps in order to alter its tax consequences. *See e.g.*, Commissioner v. Clark, 489 U.S. 726 (1989). In particular, "[a] sale by one person cannot be transformed for tax purposes into a sale by another by using the latter as a conduit through which to pass title." Commissioner v. Court Holding Co., 324 U.S. 331 (1945).

5. TRANSFERS OF PROPERTY TO THIRD PARTIES OTHER THAN TRUSTS

The Temporary Regulations provide that the transfer of property directly to a third party on behalf of a spouse or former spouse will qualify for non-recognition treatment under I.R.C. §1041 in three circumstances.[46] These circumstances are as follows:

i. Transfers required by a divorce or separation instrument;

ii. Transfers that are pursuant to the written request of the other spouse or former spouse; or

iii. Transfers as to which the transferor has received written consent or ratification of the transfer from the other spouse or former spouse. The consent or ratification must state, however, that both parties intend the transfer to be subject to I.R.C. §1041 and must be received by the transferor before filing the transferor's first tax return for the year of the transfer.

In each of the circumstances described above, the property is treated as having been transferred (i) directly to the transferee spouse or former spouse and (ii) immediately from the transferee spouse or former spouse to the third party. Only the deemed transfer to the transferee spouse or former spouse qualifies for non-recognition treatment under I.R.C. §1041.

The determination of whether a particular transfer was made "on behalf" of a spouse or is required by the terms of the divorce or separation instrument is sometimes an issue. For example, *Ingham v. United States*[47] focused on a divorce decree that transferred title of real property to one spouse, and required that she pay $404,102 to the transferor spouse upon sale of the real property but no later than five years after the divorce. The transferee spouse took the position in the tax case that her subsequent sale of the real property to a third party was required by the divorce decree and was made on behalf of her former spouse to the extent of the portion of the proceeds she was required to pay to him. The trial court granted summary judgment in favor of the IRS because the transferee spouse's sale did not satisfy any obligation imposed by the separation instrument.

6. EXCEPTION FOR NONRESIDENT NONCITIZEN SPOUSE

Transfers of property to a spouse or former spouse who is a nonresident noncitizen (or to a trust for the benefit of the nonresident noncitizen (an "NRA")) are not protected under the non-recognition rule of I.R.C. §1041.[48] As a result, transfers of property between a United States

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46 Temp. Reg. §1.1041-1T(c) Q&A 9.

47 96-1 USTC ¶ 50 (W.D. Wash. January 16, 1996), aff'd 167 F.3d 1240 (9^{th} Cir. 1999).

48 I.R.C. §1041(d). In its original form I.R.C. §1041(d) applied only to transfers to nonresident alien spouses and to transfers in trust for their benefit. Section 1018(l)(3)(B) of the Technical and Miscellaneous Revenue Act of 1988 extended it to transfers to former spouses (and to trusts for their benefit) effective for transfers after June 21, 1988.

person and the person's NRA spouse will be subject to the normal rules of taxation applicable to transfers to non-spouses. A sale of property to a nonresident noncitizen spouse, for example, will be a tax recognition event, and a transfer of property in satisfaction of marital rights will be treated as a sale under the authority of *United States v. Davis*.[49]

I.R.C. §1041 does apply to transfers from an NRA to the spouse of the NRA who is a United States person. From the standpoint of the NRA, the application of I.R.C. §1041 is not likely to be significant. Unless the property transferred is a United States real property interest, as defined in I.R.C. §897(c), or unless the NRA was present in the United States for more than 182 days during the year in which the transfer took place,[50] the property transfers would probably not have been subject to United States income tax even if I.R.C. §1041 did not apply.[51] The application of I.R.C. §1041 in this situation, however, will be significant to the United States person. Because I.R.C. §1041 applies, there will be a carry-over basis in the transferred property.

H. NOTICE AND RECORD KEEPING REQUIREMENTS

The Temporary Regulations provide that, at the time of the transfer, the transferor must supply the transferee with records sufficient to determine the adjusted basis, holding period and, where applicable, the amount and period of any investment tax credit recapture of the property.[52] However, the Temporary Regulations don't impose any penalties on a transferor for the failure to comply with the notice requirements.

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[49] 370 U.S. 65 (1962).

[50] I.R.C. §871(a)(2).

[51] In the case of a transfer of property subject to a debt in excess of basis from an NRA to a citizen or resident spouse, there may be some uncertainty as to whether §871 may apply to the transfer despite the provisions of §1041. Section 897 taxes the gain of an NRA from the disposition of a U.S. real property interest (a "USRPI"). The non-recognition rules of §1041 seem not to help because §897(e) says that the Code's non-recognition provisions do not apply to a §897 disposition unless there is an exchange of the USRPI for an interest the sale of which would be subject to tax under chapter 1 or except to the extent provided in regulations. There are no regulations on this issue. Arguably, because §1041 says that for purposes of all of subtitle A, any transfer of property described in §1041(a) is to be treated as acquired by the transferee by gift, the NRA should be treated as having received no consideration for the transfer. If the NRA receives no consideration for the transfer of a USRPI, there will be no gain and, therefore, no need to rely on a non-recognition provision to avoid §897.

[52] Temp. Reg. §1.1041-1T(e) Q&A 14.

I. I.R.C. §1041'S APPLICATION TO PARTICULAR KINDS OF TRANSFERS

1. TRANSFER OF PROPERTY SUBJECT TO LIABILITIES IN EXCESS OF BASIS

I.R.C. §1041(a) applies to transferred property subject to liabilities in excess of basis. The Temporary Regulations illustrate this principle in an example in which A owns property having a fair market value of $10,000 and an adjusted basis of $1,000. In contemplation of transferring the property pursuant to divorce, A borrows $5,000 securing the debt with the property. Notwithstanding that B assumes or takes subject to the liability, A's transfer to B does not result in gain recognition to A; B takes the property with an adjusted basis of $1,000.[53]

2. INSTALLMENT SALES

I.R.C. §453B(a) provides that if an individual disposes of an installment obligation, the individual will recognize gain or loss to the extent of the difference between (i) the amount realized or the fair market value of the obligation if the obligation is disposed of in a disposition other than a sale or exchange, and (ii) the individual's basis in the obligation. Section 453B(g) provides that the recognition rule of I.R.C. §453B(a) will not apply to a transfer described in I.R.C. §1041 other than a transfer to a trust for the benefit of the spouse. As a result, the transferee spouse will recognize gain when the transferee receives payments of principal or disposes of the obligation.

3. NONQUALIFIED DEFERRED COMPENSATION

The division of nonqualified deferred compensation benefits, such as stock options, deferred cash payments and nonqualified pensions, often play a significant role in the division of assets between spouses. Shortly after the enactment of I.R.C. §1041, the IRS took the position that the transfer of rights to these benefits in connection with a divorce was not protected by I.R.C. §1041. In Letter Ruling 8813023, for example, the IRS concluded that a spouse who relinquished her interest in her community property half of the military pension accrued by her spouse in exchange for payments by him of $42,000 recognized income to the full extent of the cash payments made to her.[54] The IRS reached this conclusion by calling on the assignment of income doctrine, reasoning that a taxpayer should not be able to escape the taxation of ordinary income by recharacterizing an assignment of the income as a nontaxable transfer of property under I.R.C. §1041.

The assignment of income doctrine is derived from a body of case law that prevents an individual from avoiding the payment of income tax on income already earned but not received

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[53] Temp. Reg. §1.1041-IT(d) Q&A 12. The nonrecognition rule does not apply to transfers in trust. I.R.C. §1041(e). In P.L.R. 9250031 (September 14, 1992) the IRS applied the nonrecognition rule to the transfer of a partnership interest when the transferring partner's share of partnership liability exceeded his basis in his partnership interest.

[54] P.L.R. 8813023 (December 29, 1987).

by transferring the right to receive the income before collection.[55] Examples of income subject to the rule include the right to collect compensation for services performed and the right to collect accrued interest.

The IRS's position in Letter Ruling 8813023 was rejected by the Tax Court.[56] In the *Balding* case, Judge Halpern concluded that the payments received by a payee spouse for the assignment of her community property interest in her payor spouse's pension constituted a nontaxable gift under I.R.C. §1041. In a footnote to his opinion, however, Judge Halpern left open the question of whether the payee spouse would be required to include in her gross income her share of the pension payments as they were made to her former spouse.

> "[W]e have no occasion to consider whether the assignment of income doctrine would require petitioner's share of those retirement payments to be taken into petitioner's income as paid by the Government to Balding, notwithstanding petitioner's lack of entitlement to such payments."[57]

What the Tax Court declined to consider was the subject of Letter Ruling 9340032.[58] In that ruling, the IRS considered the tax treatment to be afforded to payments under a deferred compensation plan that had been assigned to the employee's spouse pursuant to a divorce decree. The employee, a baseball player, participated in his employer's deferred compensation plan, which permitted him to defer a portion of his salary. A decree of divorce between the employee and his spouse gave her a percentage of his interest in the deferred compensation plan. The decree provided that if the IRS determined that the employee was taxable on payments made under the plan to his spouse, the spouse was to reimburse him for his tax liability on such payments.

The IRS did not renew the position it took in Letter Ruling 8813023. The theory of that ruling would have resulted in immediate taxation to the employee when the court assigned an interest in his deferred compensation plan to his spouse. If an assignment of deferred compensation in satisfaction of marital rights is not protected by I.R.C. §1041, under the rationale of *United States v. Davis*,[59] the assignment should cause recognition of income in the same manner as would an assignment of deferred compensation rights in exchange for a cash payment.

Instead, the IRS concluded that assignment of income principles require that the employee recognize income when his employer paid amounts under his deferred compensation plan to his spouse. This approach, if the IRS had continued to follow it, would have perpetuated

55 *See e.g.*, Helvering v. Horst, 311 U.S. 112 (1940); Lucas v. Earl, 281 U.S. 111 (1930).

56 Balding v. Commissioner, 98 T.C. 368 (1992).

57 *Id*. at footnote 8.

58 P.L.R. 9340032 (October 8, 1993).

59 370 U.S. 65 (1962).

the differences in tax consequences between marital settlements in common law and community property states. The nonemployee spouse in a community property state has rights under state law to the employee spouse's deferred compensation. No assignment is necessary. As a result, the assignment of income doctrine is not available.[60]

The IRS revived the position it took in Letter Ruling 8813023 in Field Service Advice 200005006.[61] The transferor spouse described in the Field Service Advice transferred compensatory stock options to his transferee spouse pursuant to a judgment of divorce. The IRS concluded that the transfer itself was a taxable disposition that resulted in compensation income to the transferor equal to the value of the options at the time of the transfer. It further concluded that the later disposition or exercise of the options by the transferee would not be taxable to the transferor but would produce capital gain (or loss) to the transferee.

The IRS substantially (but not entirely) reversed its position on this issue in Rev. Rul. 2002-22.[62] In that ruling, which dealt with the transfer of compensatory stock options and rights to nonqualified deferred compensation by an employee to his spouse in connection with a divorce, the IRS concluded that the transfer of rights to accrued ordinary income was the transfer of property within the meaning of I.R.C. §1041.

In addition, the IRS concluded that the assignment of income doctrine would not apply to tax the employee spouse when his or her spouse exercised the options or collected the deferred compensation. Instead, the spouse who exercised the options or received the deferred compensation is required to include the income attributable to the exercise or the amount received as deferred compensation in gross income. This part of the IRS's conclusion was not based directly on I.R.C. §1041. Instead, the IRS relied on a number of cases that have determined, in contexts other than divorce related transfers, that the assignment of income doctrine does not apply to every transfer of future income rights.[63] It concluded that transfers in connection with a divorce should also be excepted from the assignment of income doctrine

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60 *See e.g.*, Graham v. Commissioner, T.C. Memo 1996-512 (1996). *See also* P.L.R. 9647033 (November 22, 1996).

61 Field Service Advice 200005006 (February 4, 2000).

62 Rev. Rul. 2002-22, 2002-1 C.B. 849. A result similar to the result called for in Rev. Rul. 2002-22 was reached in *Pfister v. Commissioner*, 359 F.3d 352 (4th Cir. 2004). In that case, the marital settlement agreement provided that the transferee spouse was to be the owner of one-half of the transferor's retirement pay. The court concluded that the transfer of a one-half interest in his retirement pay was protected from tax by I.R.C. §1041, but that the transferee was required to report her receipt of each retirement payment as gross income. *See also* Chiarello v. Internal Revenue Service, 98 A.F.T.R.2d 2006-8325 (N.D. Tex.); PLR 200646003 (November 17, 2006); PLR 200519011 (May 13, 2005); PLR 200442003 (October 15, 2004).

63 *E.g.*, Hempt Bros, Inc. v. United States, 490 F.2d 1172 (3d Cir 1974), holding that the assignment of income doctrine does not apply to the transfer of receivables in a transaction to which I.R.C. §351(a) applies when there was a valid business purpose for the transfer.

because the application of the doctrine to these kinds of transfers would frustrate the purpose of I.R.C. §1041 with respect to divorcing spouses by imposing substantial burdens on marital property settlements involving such property. It also relied on a number of pre-I.R.C. §1041 cases in which courts had seemed to conclude that transfers of income rights between divorcing spouses were not voluntary assignments within the scope of the assignment of income doctrine.

In Rev. Rul. 2004-60[64] the IRS extended the principles of Rev. Rul. 2002-22 to the employer tax withholding rules under Code. Sec. 3402 and to the collection of social security taxes and Medicare taxes under the Federal Insurance Contributions Act ("FICA").[65] It concluded that the transferee spouse's options and deferred compensation are subject to these withholding taxes as if the employee spouse had exercised the options or collected the deferred compensation. The transferee spouse will be entitled to the credit for income taxes withheld but not for the FICA tax withheld.[66] In Letter Ruling 201016031[67] the IRS extended Rev. Rul. 2002-22 to apply to non-vested restricted shares.

There are two major aspects of the assignment of income issue as it pertains to employee stock options and deferred compensation that were specifically excluded from Rev. Rul. 2002-22. First, the ruling does not apply to transfers of property that are not made in connection with a divorce. This is curious because I.R.C. §1041, which is the statutory basis for the ruling, applies to transfers between spouses whether or not the transfer is in connection with a divorce. Second, the ruling does not apply to transfers of stock options or deferred compensation rights that are unvested at the time of transfer or are subject to substantial contingencies. This could mean that the IRS would treat a transfer of these rights between non-divorcing spouses or the transfer of nonvested or contingent rights between divorcing spouses as subject to the assignment of income doctrine requiring the transferor spouse either to recognize gain on transfer or later when the transferee spouse exercises the option.[68]

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64 Rev. Rul. 2004-60, 2004-1 C.B. 1051.

65 I.R.C. §§3101 and 3111.

66 P.L.R. 200646003 (November 17, 2006).

67 P.L.R. 201016031 (April 23, 2010).

68 When the spouse owning the right to receive income already earned does not actually transfer the property right but, instead, is obligated to make payments to the other spouse in an amount equal to (or a specific percentage or amount of) the amounts received as a result of holding that right, the assignment of income doctrine does not come into play because no assignment has been made. As a result, the spouse holding the right will continue to be taxed on receipt. Yankwich v. Commissioner, T.C. Memo 2002-37 (2002).

4. *INCENTIVE STOCK OPTIONS AND STOCK OPTIONS GRANTED UNDER EMPLOYEE STOCK PURCHASE PLANS ("STATUTORY OPTIONS")*

An incentive stock option (an "ISO") is an option granted by a corporation to an employee in connection with his or her employment to purchase stock in the corporation.[69] An employee stock purchase plan (an "ESPP") is a plan that grants options to all, with few exceptions, of a corporation's employees to purchase stock in the corporation.[70] ISOs and options issued under an ESPP, if the terms of the option or the plan meet a number of technical statutory requirements, referred to in the Regulations as "statutory options" qualify for special treatment under the Code.[71] An employee does not recognize income on the acquisition of a statutory option or when it is exercised.[72] Instead, the employee will have long term capital gain when the stock acquired through the exercise of the option is sold.

Three of the requirements are significant in the context of marital property settlements. First, the option, by its terms, may not be transferable except by will or by the laws of intestacy. Second, it must be exercisable only by the employee.[73] Third, if the employee exercises the option the stock must be retained for at least two years after receiving the option and for at least one year after receiving the stock. [74]

I.R.C. §1041 does not create an exception to the non-transferability rule for transfers to spouses or to the exclusive exercisability rule for a granting to a spouse of the right to exercise such an option. If, despite the prohibition against transfer, a statutory option is transferred incident to divorce, the option will cease to qualify as a statutory option.[75] It is unclear if these requirements can be circumvented by a divorce or separation instrument that leaves legal title to the options in the hands of the employee spouse, but confers beneficial interest on the other spouse and gives the latter the right to direct how and when the options will be exercised. There have been three letter rulings that sanction this kind of arrangement, but all of them involve

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69 I.R.C. §422.

70 I.R.C. §423(b).

71 Treas. Reg. §1.421-1(b).

72 I.R.C. §421(a)(1). However, the exercise of the option may create alternative minimum taxable income. I.R.C. §56(b)(3).

73 I.R.C. §§422(b)(5) and 423(b)(9).

74 I.R.C. §§422(a) and 423(a).

75 Treas. Reg. §1.421-1(b)(2); Rev. Rul. 2002-22, 2002-1 C.B 849. Treas. Reg. §1.421-1(b)(2) creates an exception for transfers to trusts that are treated as wholly owned by the transferor under I.R.C. §671 but only if the transferor is considered the sole beneficial owner of the option under local law.

statutory options that were community property.[76] In each case the non-employee spouse was awarded a 50% interest in the statutory options, but title was to remain in the employee spouse's name. The employee spouse was required to follow the non-employee spouse's directions with respect to the exercise of the options. Because the non-employee spouse already owned a ½ interest in the statutory options, under state law, the IRS's favorable conclusion in these three letter rulings may have been based on its conclusion that no transfer had taken place.

I.R.C. §424(c)(4) provides that for purposes of satisfying the no-disposition rule for the one and two year periods, a transfer between spouses that is described in I.R.C. §1041(a) will not be treated as a disposition.[77]

5. RETIREMENT PLANS AND THE RETIREMENT EQUITY ACT OF 1984

The Code provides a method for dividing qualified retirement plans between the employee and the employee's spouse in the case of a divorce. In the absence of a specific statutory provision permitting division, a division of qualified plan interests between an employee and the spouse would likely be prohibited by the spendthrift requirement for qualified plans.[78]

The Retirement Equity Act of 1984 ("REA") created an exception to the nonassignability rule for interests transferred pursuant to a qualified domestic relations order or "QDRO."[79] A QDRO is a domestic relations order made pursuant to a state domestic relations law that creates or recognizes the existence of an assignee's (or alternate payee's) right to receive all or a portion of a participant's interest in a plan. A domestic relations order is a judgment, decree or order (including approval of a property settlement agreement) which (1) relates to the provision of child or spousal support or marital property rights to a spouse, former spouse, child or other dependent of a participant and (2) is made pursuant to a State domestic relations law.[80]

A QDRO must also satisfy the following requirements:

(a) It must clearly specify the name and last known mailing address of the participant and the alternate payee, the amount or percentage of the benefits to be paid to the alternate

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[76] P.L.R. 200737009 (September 14, 2007); P.L.R. 200519011 (May 13, 2005); P.L.R. 8451031 (September 14, 1984).

[77] Treas. Reg. §1.424-1(c)(1)(iv).

[78] I.R.C. §401(a)(13)(A) and (B).

[79] I.R.C. §414(p).

[80] I.R.C. §414(p)(1). The requirement that a qualified domestic relations order must be made pursuant to a State domestic relations law seems to preclude the issuance of a qualified domestic relations order by a non-United States court.

payee[81] or the manner in which the amount or percentage is to be calculated, the number of payments or periods to which the order applies, and each plan to which the order applies.[82]

(b) It must not (i) require any type or form of benefit not otherwise provided by the plan, (ii) require the plan to provide increased benefits, or (iii) require the payment of benefits to an alternate payee that are required to be paid to another and prior alternate payee. A QDRO may, however, require payments to an alternate payee on the earliest day on which the participant attains his or her earliest retirement age under the plan.[83]

REA also provides an exception to the assignment of income doctrine by requiring that if the alternate payee is the spouse or former spouse of the participant, the alternate payee rather than the participant will be taxed on plan distributions made to him or her.[84]

When a transferee spouse receives a lump-sum distribution under a QDRO of the entire transferred interest in the transferor spouse's qualified retirement plan, the transferee can usually avoid immediate taxation on the distribution by transferring the amount received within sixty days of receipt to a qualified retirement plan.[85] For this purpose, the term "qualified retirement plan" means (1) an individual retirement account (described in I.R.C. §408(a)), (2) an individual

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81 The alternate payee must have the right to receive benefits directly from the plan. It is not sufficient, for example, if a domestic relations order directs the participant to withdraw funds from his or her qualified pension plan and pay the funds to the spouse or former spouse. *See e.g.*, Amarasinghe et al. v. Commissioner, T.C. Memo. 2007-333 (2007).

82 I.R.C. §414(p)(2). Although the statute seems to require absolute adherence to the requirements in order to qualify as a QDRO, this is not always the case. For example, in *Stewart v. Thorpe*, 207 F.3d 1143 (9th Cir. 2000), the failure to specifically state the alternate payee's mailing address was not a "fatal flaw" since the address was already known to the plan administrator.

83 I.R.C. §414(p)(3) and (4). *See Dickerson v. Dickerson*, 803 F. Supp. 127 (E.D. Tenn. 1992) in which the court denied qualified domestic relations order status to a domestic relations order that sought to require the pension plan to make a payment to an alternate payee prior to the earliest age on which the participant was eligible to begin receiving retirement benefits under the plan if he had retired.

84 I.R.C. §402(e)(1)(A). The statutory requirement that the alternate payee include the payments made pursuant to a QDRO in the alternate payee's gross income may not be changed by the terms of the QDRO. *See e.g.*, Clawson v. Commissioner, T.C. Memo 1996-446 (1996). Although I.R.C. §402(e)(1)(A) provides that the alternate payee, for purposes of subsection (a) of I.R.C. §§402 and 72 "shall be treated as the distributee of any distribution or payment made to the alternate payee under a qualified domestic relations order," the Tax Court has held that this provision is not broad enough to entitle the alternate payee of a disabled participant to take advantage of the exclusion from gross income under I.R.C. §104 that her participant spouse was entitled to use for the amount paid to him. Fernandez v. Commissioner, 138 T.C. 378 (2012).

85 I.R.C. §§402(e)(1)(B) and 402(c).

retirement annuity (described in I.R.C. §408(b)), (3) a qualified trust (described in I.R.C. §402(c)(8)(A)), or (4) an annuity plan (described in I.R.C. §403(a)).[86] The process by which funds are received from a qualified retirement plan and deposited in a qualified retirement plan is usually referred to as a "rollover."

The statutory requirements for a rollover must be followed with precision. A Tax Court decision described the consequences of failing to do so. The taxpayer in *Blatt v. Commissioner*[87] and her former spouse both had tax sheltered annuities with the Teachers Insurance and Annuity Association-College Retirement Equities Fund ("TIAA"). Pursuant to a QDRO, TIAA took $194,304.28 from the transferor spouse's annuity and deposited it in the taxpayer's annuity. The Tax Court concluded that the taxpayer had gross income because an annuity was not an eligible recipient of a rollover payment. If TIAA had paid the $194,305.28 directly to the taxpayer and if she had deposited it in an individual retirement account, the taxpayer would have avoided an immediate tax on this amount.

6. INDIVIDUAL RETIREMENT ACCOUNTS

I.R.C. §408(d)(6) permits an individual to transfer his or her interest in an individual retirement account (an "IRA") to the individual's spouse or former spouse under a divorce or separation instrument (as defined in I.R.C. §71(b)(2)(A)) without such transfer being treated as a taxable transfer. After the transfer, the IRA will be considered to be the IRA of the transferee spouse.

I.R.C. §71(b)(2)(A) defines the term "divorce or separation instrument" as a decree of divorce or separate maintenance or a written instrument incident to such a divorce, while I.R.C. §71(b)(2)(B) includes separation agreements whether or not related to a divorce or separate maintenance decree. The fact that I.R.C. §408(d)(6) refers only to I.R.C. §71(b)(2)(A) and not to I.R.C. §71(b)(2)(B) appears to limit the application of this provision to cases in which the parties are actually divorced or separated pursuant to a decree of separate maintenance. Case law under the prior version of I.R.C. §71 had determined that a written instrument would be treated as incident to a divorce if it were incident to the status of divorce, and that no actual relationship between the divorce decree and the written instrument would be required.[88] Thus, I.R.C. §408(d)(6) should apply to a transfer pursuant to a separation agreement if the separation agreement is entered into incident to an eventual divorce.

The requirement of an actual divorce or separate maintenance decree was confirmed by the IRS in Letter Ruling 9344027.[89] The spouses described in this letter ruling entered into a written separation agreement which stated that the transferor spouse's IRAs constituted

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[86] I.R.C. §402(c)(8).

[87] 66 T.C.M. 1409 (1993).

[88] *See e.g.*, Estate of Borax v. Commissioner, 349 F.2d 666 (2d Cir. 1965), *cert. denied*, 383 U.S. 935 (1966).

[89] P.L.R. 9344027 (November 5, 1993).

community property and required him to transfer one-half of the balance in all of the IRAs to his spouse who would then deposit such balance in her IRA. The spouses did not intend to divorce. The IRS concluded that I.R.C. §408(d)(6) would not protect the transferee spouse's transfer because their separation agreement was not incident to a divorce or separate maintenance decree. As a result, the transferor would be taxed on the distribution, and the transferee could not deposit the funds in her own IRA.

It is important to note that this exception applies only to transfers of interests in IRAs. It does not apply to the transfer of lump-sum distributions from one spouse's qualified plan to an IRA in the name of his or her spouse even if that transfer were incident to a divorce.[90]

7. CLOSELY-HELD CORPORATIONS

When one or both spouses own stock in a family corporation, the corporation may be an important source of funding for the satisfaction of one of the spouse's marital property rights. In some cases, both spouses own shares in the corporation before marital difficulties arise; in others, one of the spouses receives shares subject to the corporation's obligation to redeem as part of the marital settlement agreement. Typically, the corporation redeems the shares of one of the spouses.

Positions taken by the IRS and decisions reached by the courts in the past had made it virtually impossible to predict the tax consequences of these redemptions. There was uncertainty about the identity of the party whose interest was redeemed and as to whether the redemption of shares owned by one spouse satisfied an obligation of the other spouse. The IRS and the Tax Court seemed, until 2003, to treat the redemption as a redemption made by the spouse whose stock is actually redeemed. In contrast, the Ninth Circuit apparently treated it as a transfer of the stock to the corporation on behalf of the spouse whose interest in the corporation continues and a payment by the corporation on behalf of that spouse.

Resolution of this issue will determine not only the identity of the taxpayer but also the amount and character, and, in some cases, the timing of the recognition of the income arising from the redemption. If the spouse whose interest in the corporation is terminated is treated as the redeeming shareholder, the spouse will generally be able to treat the redemption as a sale or exchange under I.R.C. §302(a).[91] In contrast, if the spouse who will continue to own stock in the

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90 Rodoni v. Commissioner, 105 T.C. 29 (1995). The result of a lump-sum distribution followed by a transfer will be inclusion of the distribution in the transferor's gross income and the possibility of a 10% penalty for early distribution. *See e.g.*, Jones v. Commissioner, T.C. Memo. 2000-219 (2000), and Bunney v. Commissioner, 114 T.C. 259 (2000).

91 A redemption is treated as a sale or exchange if there has been a complete termination of interest in the corporation by the redeeming shareholder or in the case of certain disproportionate redemptions. I.R.C. §302(b). If, however, the redemption occurs before the divorce or if other family members, such as children, continue to own shares in the corporation, the family attribution rules of I.R.C. §318 may preclude satisfaction of this requirement. In some cases, I.R.C. §318 attribution can be avoided by complying with I.R.C. §302(c), which generally

corporation is treated as the redeeming shareholder, the owner will be treated as having received a distribution of property with respect to the stock to which I.R.C. §301 applies. To the extent the corporation has earnings and profits, the distribution will be treated as a dividend. Any excess will be treated as a return of capital or as a gain from the sale or exchange of property.

Treatment as a sale or exchange offers at least three advantages over treatment as a distribution with respect to stock (a "dividend"). First, it entitles the taxpayer to offset basis in the stock against the amount received. Second, if the stock has been held for at least twelve months, sale or exchange treatment results in characterization of the income as long-term capital gain rather than ordinary income. Although long-term capital gains and dividends are now subject to the same top tax rate of 23.8%,[92] this has not always been so. Until 2003, dividends were subject to the same top tax rate as other items of ordinary income, currently 43.4%. Finally, sale or exchange treatment entitles the taxpayer to defer recognition of gain under I.R.C. §453 until payment of the purchase price is made.[93]

a) REDEMPTION IF BOTH SPOUSES OWN ALL THE SHARES

If both spouses own shares in the closely-held corporation, and agree that the shares belonging to one of them will be redeemed, ordinarily, the redemption should be treated as a redemption of the shares of the spouse who is surrendering the shares. If, however, the redemption satisfies an obligation of the spouse who is not surrendering the shares, the redemption may be treated as a constructive dividend.

Under long-established corporate income tax principles, when two shareholders own all of the shares of a corporation, and the corporation redeems shares of one of them, the remaining shareholder is not taxed on the transaction despite the benefit of an increase in the shareholder's proportionate interest in the corporation.[94]

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requires the termination of all interests in the corporation (including interests as an employee, director, or officer but excluding interests as a creditor) for 10 years.

92 I.R.C. §1(h). The Patient Protection and Affordable Care Act imposes an additional 3.8% surtax on the lesser of net investment income or the amount by which a taxpayer's modified adjusted gross income exceeds the applicable threshold. 42 U.S.C. §18001 et seq. (2010).

93 I.R.C. §1(h).

94 *See, e. g.*, Edler v. Commissioner, 727 F.2d 857 (9th Cir. 1984), *aff'g* T.C. Memo 1982-67; Holsey v. Commissioner, 258 F.2d 865 (3d Cir. 1958); Wall v. United States, 164 F.2d 462 (4th Cir. 1947); Rev. Rul 69-608, 1969-2 C.B. 42. *See generally* Michael B. Lang, *Dividends Essentially Equivalent to Redemptions: The Taxation of Bootstrap Acquisitions*, 41 TAX L. REV. 309 (1986); Marvin A. Chirelstein, *Optional Redemptions and Optional Dividends: Taxing the Repurchase of Common Shares*, 78 YALE L.J. 739 (1969).

There is one principal exception to this general rule. If the redemption satisfies a primary, unconditional obligation of the nonredeeming spouse to purchase the redeemed shares, the redemption could be treated as a constructive dividend to the nonredeeming spouse.[95]

Marital settlement agreements often do obligate one spouse to purchase the shares of the other. This kind of agreement was the focus of the Tax Court in Hayes v. Commissioner.[96] In Hayes, the spouses, Jimmy and Mary Hayes, each owned shares in a corporation that operated a McDonald's franchise. McDonald's required that Mary, who owned a minority interest in the corporation, dispose of her stock in order for Jimmy to retain the franchise. The spouses executed a separation agreement which required Jimmy to purchase Mary's interest in the corporation. Several months later, Mary and the corporation executed a redemption agreement. Her shares were ultimately redeemed by the corporation.

The Tax Court agreed with the IRS's position that the redemption by the corporation of Mary's shares was a constructive dividend to the husband because it satisfied his primary and unconditional obligation to purchase his spouse's shares.

The Tax Court's conclusion in the Blatt case is confirmed by regulations issued by Treasury in January of 2003.[97] Under the final regulations, if a corporation redeems stock of one spouse in a redemption that is treated under normal tax principles (i.e., the primary and unconditional obligation standard discussed above) as a constructive distribution to the spouse who is the continuing shareholder, the redemption will be treated as a distribution to the spouse who continues as a shareholder. Section 1041 protects the redeemed spouse's deemed transfer of the stock to the continuing shareholder spouse. Conversely, I.R.C. §1041 does not protect the continuing shareholder spouse from tax on his or her deemed transfer of stock to the redeeming corporation.

A special rule in the regulations now permits the spouses, in cases in which the constructive distribution rule apples, to agree to treat the redemption as having been made by the spouse who is surrendering the shares rather than by the spouse who continues as a shareholder.[98] In order for the special rule to apply, the divorce or separation instrument or a valid written agreement between the spouses must provide that (i) the spouses intend that the redemption be treated for Federal income tax purposes as a redemption distribution to the spouse who is surrendering the shares and (ii) the instrument or agreement supersedes any other instrument or agreement concerning the stock that is the subject of the redemption.

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[95] *See e.g.*, Sullivan v. United States, 363 F.2d 724 (8th Cir. 1966), *cert. denied*, 387 U.S. 905 (1967); Wall v. United States, 164 F.2d 462 (4th Cir. 1947); Rev. Rul. 69-608, 1969-2 C.B. 43.

[96] 101 T.C. 593 (1993).

[97] T.D. 9035, 68 Fed. Reg. 1534 (January 13, 2003).

[98] Treas. Reg. §1.1041-2(c).

Curiously, the special rule does not permit the spouses to change the tax result if the continuing shareholder spouse does not have a primary and unconditional obligation to purchase the shares of the other spouse. As a result, despite any intention of the parties to the contrary, the tax burden attributable to the redemption will be borne by the spouse who surrenders shares.

Prior to the issuance of Treas. Reg. §1.1041-2 in 2003, a number of cases had held that when a marital settlement agreement required that the spouses cause the corporation to redeem the shares of one of the spouses, the spouse who surrendered shares to the corporation should be treated, within the meaning of Treas. Reg. §1.1041-1T(c) Q-9, as having transferred the shares to the corporation on behalf of the continuing shareholder spouse.[99] As a result, the spouse who actually transferred shares to the corporation was treated as having transferred them to the continuing shareholder spouse; the corporation was treated as having transferred the redemption price to the continuing shareholder spouse and the continuing shareholder spouse was treated as having paid the redemption price to the spouse who surrendered shares. Treas. Reg. §1.1041-2 has effectively overruled these cases.

b) REDEMPTION IF ONLY ONE SPOUSE OWNS ALL THE SHARES

If only one spouse owns shares in the closely-held corporation, funds held by the corporation may be needed to compensate the other spouse for a marital property interest in the shares or in other property. If the owner redeems a portion of the shares to obtain the necessary funds, the redemption would be treated as a distribution with the undesirable tax results described above.

Suppose, instead, that the owner-spouse first transferred the shares to the other spouse and the corporation then redeemed the shares from the spouse?

Outside the divorce context, the step-transaction doctrine would be likely to characterize this type of arrangement as a redemption from the original owner followed by the transfer of the redemption proceeds to the other spouse if (1) the transferee were legally obligated to surrender the stock for redemption,[100] or (2) there were an understanding that the stock would be redeemed and the original owner received something of value back from the transferee.[101] Treasury Regulation §1.1041-2 does not deal with redemptions of stock acquired by the redeeming stock in a transaction subject to the step-transaction doctrine.

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99 Craven v. United States, 215 F.3d 1201 (11th Cir. 2000); Arnes v. United States, 981 F.2d 456 (9th Cir. 1992); Read v. Commissioner, 114 T.C. 14 (2000).

100 In this case, the corporation's earnings and profits will be reduced by the amount of the distribution. I.R.C. §312(a).

101 *Cf.* Blake v. Commissioner, 697 F.2d 473 (2d Cir. 1982); Tech. Adv. Mem. 8552009 (September 25, 1985).

The IRS seems to have carved out an exception to the step-transaction doctrine for redemption of shares that are transferred from one spouse to the other pursuant to a marital settlement agreement. In Technical Advice Memorandum 9046004,[102] the IRS took the position that a redemption was a redemption by the spouse whose shares were actually redeemed despite the fact that she had received the shares pursuant to a divorce decree which required her to offer the shares for redemption by the corporation. The IRS recognized that the spouse's obligation to offer her shares for redemption would ordinarily require treating the original owner as the redeeming shareholder.

The IRS justified its conclusion in Tech. Adv. Mem. 9046004 with a surprisingly broad reading of I.R.C. §1041. It stated that:

> "[I.R.C. §1041 provides] taxpayers a mechanism for determining which of the two spouses will pay the tax on the ultimate disposition of the asset. The spouses are thus free to negotiate between themselves whether the "owner" spouse will first sell the asset, recognize the gain or loss and then transfer to the transferee spouse the proceeds from that sale, or whether the owner spouse will first transfer the asset to the transferee spouse who will then recognize gain or loss upon its subsequent sale."[103]

In Letter Ruling 9427009,[104] the IRS retreated from this broad reading of the Code. The marital settlement agreement described in the letter ruling required the spouse who owned the shares of a closely-held corporation to transfer a portion of the shares to the other spouse. It also stated that the transferee spouse intended to negotiate the redemption of the newly acquired shares by the corporation but that there was no obligation to do so. In fact, immediately after the transferee spouse received the shares, the corporation redeemed them. The letter ruling concluded that the gain was the gain of the transferee spouse but relied on the absence of any obligation on the part of the transferee spouse to offer her shares for redemption.

8. CHARITABLE REMAINDER TRUSTS

A charitable remainder trust (a "CRT") is a trust that pays an annuity or a unitrust amount to one or more persons for a period of years or for the life or lives of such persons. At the end of its term, its remaining assets are paid to one or more charities. There are two principal types of CRTs, a charitable remainder annuity trust (a "CRAT") and a charitable remainder unitrust (a "CRUT"). A CRAT pays a fixed amount at least annually to its non-charitable beneficiaries; a CRUT pays a unitrust amount, an amount equal to a fixed percentage of the annually determined value of the trust assets, at least annually, to its non-charitable beneficiaries. If the CRT is structured and administered to comply with a number of technical rules set forth in I.R.C. §664

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102 Tech. Adv. Mem. 9046004 (November 16, 1990).

103 Id.

104 P.L.R. 9427009 (July 8, 1994).

and the regulations issued under that section,[105] transfers to the CRT are not income tax realization events, the transferor is entitled to gift and income tax deductions for the actuarial value of charity's interests at the inception of the trust, and the trust pays no income tax on its income except on its unrelated business taxable income.

A CRT can be a substantial marital asset of one or both spouses that has to be accounted for on separation or divorce. CRTs created by both spouses during marriage are generally structured to pay an annuity or unitrust amount in equal shares to both spouses during their joint lives and then to pay the entire annuity or unitrust amount to the surviving spouse for life (a "joint CRT"). If only one spouse creates a CRT, it is generally structured to pay the entire annuity or unitrust amount to the creator for life and then, if applicable, to the surviving spouse for life (a "survivor CRT").

Marital settlement agreements sometimes require that a CRT be divided into two separate trusts to make separate payments to each spouse. In the case of joint CRTs, a division is generally desirable so that each spouse's economic interest in the CRT is separated from the other's, avoiding the necessity of consulting with each other as to trust investments, the selection of the ultimate charitable beneficiaries, and the like. In the case of survivor CRTs the division is often called for in order to give each spouse a current, equal economic interest in the CRT.

These divisions raise questions as to whether they should be treated as tax realization events to the spouses because, as a result of the divisions, each spouse receives interests in the charitable remainder trusts that are materially different from the interest each had before or to the trusts involved, because after the division each new trust holds different interests in assets than the original trust held before the division.[106]

Over the past 18 years, the IRS has issued at least 20 private letter rulings dealing with divisions of joint CRTs and survivor CRTs in the context of divorce. In some cases, each of the CRT's assets was divided equally between the two new CRTs; in other cases, the assets were divided equally between the two new trusts by value, but each trust received some assets in their entirety. In each private letter ruling that considered the income tax consequences to the spouses and to the trusts, the IRS reached the conclusion that the division should not be subject to tax

105 Treas. Reg. §§1.664-1 through 1.664-3.

106 Cottage Savings Association v. Commissioner, 499 U.S. 554 (1991). The division of a CRT raises additional questions that are beyond the scope of this outline such as: (1) will such a division cause the trust or the two new, separate trusts to fail to qualify as a CRT, (2) will such a division terminate the trust's status as a trust described in I.R.C. §4947(a)(2), thereby subjecting it to tax under I.R.C. §507(c), (3) does such a division constitute an act of self-dealing under I.R.C. §4941, (4) does such a division constitute a taxable expenditure under I.R.C. §4945, or (5) does the payment of expenses incurred in connection with such a division constitute a taxable expenditure? These issues seem to have been resolved in favor of the taxpayer in Rev. Rul. 2008-41, 2008-30 I.R.B. 170.

either because it was protected under I.R.C. §1041 or because it was a nontaxable partition of property between joint owners.[107]

The IRS's first approach to this issue in a published ruling appeared in Rev. Rul. 2008-41.[108] In that ruling, the IRS focused on a joint CRT that paid an annuity or unitrust amount in equal shares to the two spouses. On the death of the first of them to die, the survivor was to receive the entire annuity or unitrust amount for the rest of his of her life. In connection with their divorce, the CRT was to be split into two equal trusts, each one funded with an equal share of each asset held by the original trust. The terms of the new trusts were to be the same as the terms of the original trust except that (1) one trust would pay its entire annuity or unitrust amount to one of the spouses, and (2) each trust would terminate on the death of its beneficiary. The ruling concludes that the division will not cause the CRT to lose its status as a CRT under I.R.C. §664 and that the division will not be treated as a "sale, exchange, or other disposition producing gain or loss." No rationale is given for the latter conclusion. The conclusion, however, is clearly correct because after the division each spouse had no interest in any trust asset that he or she did not have an interest in before the division. The only economic change caused by the division was the relinquishment by each of them of his or her previously held right to receive both annuity or unitrust amounts if he or she survived the other.

Rev. Rul. 2008-41 is not helpful in the more common case in which CRT assets are not divided equally asset by asset, but, instead are divided on a pro rata basis with each new trust receiving assets with an equal aggregate value. It is also not helpful in the case of a survivor CRT when one spouse created the CRT and was its original annuitant or unitrust recipient and the marital settlement agreement requires a division of the trust between the spouses.

In either case, if I.R.C. §1041 applies to the division, it should provide complete protection from income tax. Even if the division results in conferring materially different interests in trust assets on each spouse, I.R.C. §1041 shields inter-spousal transfers from treatment as tax realization events.[109]

If I.R.C. §1041 does not apply to the division, and if the CRT being divided is one in which each spouse had an equal interest, it should also be protected from income tax by Rev. Rul. 81-292.[110] In that ruling, which predated the enactment of I.R.C. §1041, the IRS concluded that an approximately equal division of the total value of jointly owned property under a divorce settlement agreement that provides for transferring some jointly held assets in their entirety to

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107 *See e.g.*, P.L.R. 201029002 (July 23, 2010); P.L.R. 200814003 (April 4, 2008); P.L.R. 200728026 (July 13, 2007); P.L.R. 200616008 (April 21, 2006); P.L.R. 200539008 (September 30, 2005); P.L.R. 200524013 (June 17, 2005)

108 2008-30 I.R.B. 170.

109 *See e.g.*, P.L.R. 200539008 (September 30, 2005).

110 1981-2 C.B. 158.

one spouse and other jointly held assets to the other, is a nontaxable division of property that does not result in the realization of gain or loss.[111]

J. PRINCIPAL RESIDENCE ISSUES

1. IN GENERAL

The principal residence of two spouses is likely to be one of their most significant assets. When the marriage dissolves, its disposition presents some potential tax issues involving the interaction between I.R.C. §1041 and the principal residence exclusion of gain provision of I.R.C. §121.

For sales of principal residences occurring after May 6, 1997,[112] I.R.C. §121 provides that homeowners of any age may avoid tax on gains of up to $250,000 (or $500,000 if married filing a joint return) that are recognized on the sale of a principal residence, regardless of whether they purchase another principal residence with the profits. In order to be eligible for this exclusion, the home must have been occupied as a principal residence for at least two of the five years prior to the sale.[113] Taxpayers can take advantage of this exclusion as frequently as once every two years.[114]

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111 *See also* Rev. Rul. 76-83, 1976-1 C.B. 213, reaching the same conclusion as to the equal division of community property under a divorce settlement agreement.

112 Under prior law, I.R.C. §121 permitted a taxpayer to exclude from income tax the first $125,000 of gain recognized on the sale of her principal residence if the sale occurred on or after her 55th birthday, but only if she had both owned and used the home as her principal residence for periods aggregating 3 years or more during the 5 year period ending on the date of sale. Old I.R.C. §1034 also allowed homeowners to defer income tax by rolling over gains from the sale of their principal residence into a new principal residence (a “replacement residence”) within two years of the sale. The Taxpayer Relief Act of 1997 eliminated both of these provisions.

113 The holding period of a taxpayer who acquired a principal residence from a spouse or former spouse under I.R.C. §1041(a) includes the period in which the transferor owned the property. I.R.C. 121(d)(3)(A). In addition, a taxpayer is treated as using property as a principal residence during any period of ownership while a spouse or former spouse is granted use of the property under a divorce or separation agreement defined in I.R.C. §71(b)(2). I.R.C. 121(d)(3)(B).

114 I.R.C. §121(b)(3).

2. *TRANSFER OF PRINCIPAL RESIDENCE FROM ONE SPOUSE TO THE OTHER*

a) RECOGNITION OF GAIN

If one spouse transfers an interest in the principal residence to the other spouse, I.R.C. §1041 will protect the transferor spouse from recognition of gain even if the transferee spouse transfers property in exchange.[115]

b) DEDUCTIBILITY OF INTEREST

If one spouse transfers an interest in the principal residence to the other spouse for a note for the purchase price and the note requires the payment of interest, the interest on the note should be deductible as qualified residence interest within the limits set forth in I.R.C. §163(h) if the note is secured by a mortgage on the residence. This is so whether the transferor spouse holds actual title to the residence or has only a community property interest in it.[116]

It is unclear, however, whether this conclusion would apply if the transferee spouse already held legal title to the residence and was paying the other spouse for marital rights (other than a community property interest) in the residence. A transfer of a note in satisfaction of marital property rights in a residence that is owned by the note issuer may not be treated as an acquisition for purposes of I.R.C. §163(h).

If the transferee spouse gives the other spouse a note that does not call for interest payments, will the imputed interest rules of Code Secs. 483, 1274, or 7872 apply? The answer is

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[115] The transfer may, however, be subject to local transfer taxes. For example, the transfer of New York City real estate between spouses pursuant to the terms of a separation agreement is subject to both the New York State and New York City Transfer Tax. The consideration received for the transferred property, which includes the relinquishment of marital rights, is presumed to be equal to the fair market value of the property transferred. 20 N.Y.C.R.R. §575.11(a) and N.Y.C. Regs. Title II, Art. 23.03(d). *See also* In the Matter of Tobjy, NYC Tax Appeals Tribunal, Administrative Law Judge Division, No. TAT(H) 93-2128 (RP), 1995 WL 405581 (June 29, 1995). New York State will impose transfer taxes of .4% on the transfer (N.Y. Tax Law §1402) and New York City will impose transfer taxes of 1.425% on the transfers of houses with three or less units and individual condominium units the value of which is more than $500,000 (N.Y.C. Admin. Code §11-2102(9)). In addition, if the consideration for the entire conveyance of residential real property or interest therein exceeds $1 million, there is an additional 1% tax. N.Y. Tax Law §1402-a.

[116] *See* P.L.R. 8928010 (July 14, 1989) (dealing with the acquisition of the other spouse's community property interest in a residence) and I.R.S. Notice 88-74, 1988-2 C.B. 385. I.R.C. §163(h) limits the amount of the debt on which interest is deductible to $1,000,000 for debt incurred to acquire, construct or substantially improve the residence. *See also* Armacost v. Commissioner, T.C. Memo 1998-150 (1998).

probably no. These provisions seem not to apply to transactions to which I.R.C. §1041 applies.[117]

c) ISSUES UNDER I.R.C. §121 UPON THE TRANSFER OF THE RESIDENCE

If the transfer of a residence from one spouse to the other is an I.R.C. §1041 transaction, I.R.C. §121 will not be needed, since the transferor spouse has not recognized any gain to be excluded.

A potential problem should be considered, however. When the transferee spouse (who now owns the entire residence) eventually sells the residence, only the first $250,000 of gain under I.R.C. §121 will be protected (provided there is not a new spouse who satisfies the requirements of I.R.C. §121). If the couple had sold the residence while they were still married, together they could have excluded up to $500,000 of gain. This will place the transferee spouse in a less desirable position than had the transferee owned only half of the residence when it was sold.

In cases in which the residence is transferred pursuant to a divorce decree, the time during which the spouse or former spouse owned the residence is added to the transferee's period of ownership. In addition, if pursuant to a divorce decree, one spouse is permitted to use the residence for a period of time, for purposes of I.R.C. §121 the other spouse may be deemed to have used such residence as a primary residence during such period.[118] The result is that a spouse who vacates the marital residence prior to its sale may nevertheless be eligible for the I.R.C. §121 gain exclusion.

d) ISSUES RELATING TO SALE OF RESIDENCE TO THIRD PARTIES

Some property settlement agreements require the sale of a co-owned marital residence to a third party and provide that the proceeds are to be divided between the parties other than in proportion to their respective percentage ownership in the residence. Such an agreement is not likely to change the manner in which the parties will be taxed on any gain recognized as a result of the sale. The gain should be allocated between the parties in the same percentages as their percentage ownership in the residence.[119]

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117 See discussion below in K.

118 I.R.C. §121(d)(3)(A).

119 Urbauer v. Commissioner, T.C. Memo 1997-227 (1997). *Cf.* Walker v. Commissioner, T.C. Memo 2003-335 (2003); *But see, Friscone v. Commissioner*, T.C. Memo 1996-193 (1996) in which the court held that the spouse to whom the court awarded 55% of the sale proceeds was required to pay tax on 55% of the gain. In this case, title to the property did not pass to the third party until after the divorce.

K. DEFERRED PAYMENTS IN CONNECTION WITH PROPERTY SETTLEMENTS

In some cases, one spouse is willing to purchase assets owned by the other or to compensate the other for the relinquishment of rights to marital property but wants to make payments over a period of time rather than immediately. If the obligation to make deferred payments does not include interest, interest will not be imputed.[120] If, however, deferred payments are structured with actual interest to be paid, the IRS takes the position that the spouse who receives the interest will be required to include it in gross income. The Tax Court agrees.[121]

Whether the spouse paying the interest will be entitled to deduct the payments depends on the reason for the payments. If, for example, the spouse has purchased investment assets that were titled in the other spouse, it is likely that the interest will be investment interest and, therefore, deductible under I.R.C. §163(h).[122] On the other hand, if the payments are to compensate the spouse for relinquishing marital rights, the interest will probably be characterized as personal interest and will be nondeductible.

If there is any question as to the deductibility of interest to be paid by one spouse to the other, it would be preferable to restructure the arrangement so that the payments are nonincludible alimony to the spouse who would otherwise have received the interest. If this is done, the receiving spouse will not be required to include the payments and should be willing to accept smaller payments to reflect the economic advantage of not paying income tax. If the payments are structured without interest, Code Secs. 483 and 1274 arguably could be applied to the transaction. The regulations under Code Secs. 483 and 1274, however, specifically provide that the original issue discount rules do not apply to I.R.C. §1041 Transfers.[123] Care must be taken in structuring such an arrangement to avoid any provision in the obligation that could be characterized as interest. In a private letter ruling, for example, the IRS imputed interest in the case of a non-interest bearing note because the principal of the note was to be adjusted for inflation.[124]

If the spouse receiving the payments is in a sufficiently low tax bracket so that nonincludibility will not produce an advantage, the payments should be structured as includible

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[120] Treas. Reg. §1.1274-1(b)(3)(iii); Craven v. United States, 215 F.3d 1201 (11th Cir. 2000).

[121] Yankwich v Commissioner, T.C. Memo 2002-37 (2002); Gibbs v. Commissioner, T.C. Memo 1997-196 (1997).

[122] Seymour v. Commissioner, 109 T.C. 279 (1997); Armacost v. Commissioner, TC Memo 1998-150 (1998).

[123] Reg. §§1.483-1(c)(3); 1.1274-1(b)(3)(iii). *See also* Craven v. United States, 215 F.3d 1201 (11th Cir. 2000), Fox v. United States, 510 F.2d 1330 (3d Cir. 1975) and P.L.R. 9644053 (November 1, 1996).

[124] Tech. Adv. Mem. 200624065 (June 16, 2006).

alimony rather than interest. The interest will then be taxable to the receiving spouse and deductible by the payor spouse. In order to satisfy I.R.C. §71's requirement that the payments terminate on the death of the receiving spouse without changing the economic consequences of the arrangement to the receiving spouse, the payor spouse should increase the payments to the receiving spouse by an amount necessary to enable the receiving spouse to acquire a life insurance policy in an amount sufficient to compensate him or her for the loss of the substitute interest payments if the receiving spouse dies before all the installments have been paid.

L. TAX CARRYOVERS

1. IN GENERAL

The Code generally permits taxpayers who are unable to use fully certain deductions in one year to use these deductions in future years. The right to take future tax deductions is a valuable right that should be taken into account in negotiating a marital settlement agreement.

2. CHARITABLE CONTRIBUTIONS

A taxpayer may deduct the value of certain gifts to charity, subject to certain limitations based on the amount of adjusted gross income in the year of the gift.[125] When the value of a taxpayer's charitable gifts in one year exceeds the appropriate income limitation, the taxpayer is able to carry the unused deduction forward and use it over the next five year period.[126] When a deduction for a charitable gift is originally claimed on a joint income tax return and the spouses divorce (or file separate returns for other reasons), the carryforward charitable deductions are allocated between them based on the ratio between the amounts that each of them would have carried forward if they had filed separate returns in the year in which the excess charitable contributions were made.[127]

Because the regulations do not permit taxpayers to adopt their own pattern of allocation of charitable contribution carryforwards, when the required allocation pattern is not consistent with the manner in which the parties agree to divide their marital property, it may be appropriate for the taxpayer who receives the disproportionate share of the charitable contribution carryforward to compensate the other taxpayer for the loss. If it seems clear that the carryforward will be usable within the five-year period, the appropriate amount of compensation is presumably the present value to the taxpayer who can claim its carry forward of the expected future tax savings. The Supreme Court of New Hampshire has approved such an approach.[128]

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[125] I.R.C. §170(a) and (b).

[126] I.R.C. §170(d).

[127] Treas. Reg. §1.170A-10(d)(4)(i)(b).

[128] Dombrowski v. Dombrowski, 131 N.H. 654 (1989).

3. CAPITAL LOSSES

A taxpayer may deduct capital losses from the sale of investment property to the extent of the amount of realized capital gains in the year of sale. If capital losses exceed capital gains, $3,000 of the losses can be deducted against ordinary income and can carry over the balance for life until it has been fully used.[129]

As is the case with charitable contribution carryforwards, the regulations do not permit taxpayers whose excess capital losses were incurred in a year in which they filed joint returns to decide how best to allocate those excess losses between them in future years when they will be filing separate returns. Instead, the regulations require that the losses be allocated between them on the basis of their individual net losses that gave rise to the carryover.[130]

Because the regulations do not permit taxpayers to adopt their own pattern of allocation of capital loss carryovers, when the required pattern is not consistent with the manner in which marital property is to be divided, it may be appropriate for the taxpayer who receives a disproportionate share of the carryovers to compensate the other for the excess value. Several state courts have treated capital loss carryovers as marital assets, subject to equitable division.[131]

III. INCOME TAX ASPECTS OF THE USE OF TRUSTS IN CONNECTION WITH MARITAL SETTLEMENT AGREEMENTS

A. 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 alternative to both spouses.

The transferee spouse will generally prefer to look to a trustee for payment rather than to a 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 the assets. But, if the transferee spouse is demanding a lump sum property settlement as well as support payments, a transfer of property to

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129 I.R.C. §1211(b).

130 Treas. Reg. §1.1212-1(c)(iii).

131 *See e.g.,* Haley v. Haley, 936 So.2d 1136 (Fl Ct of Appeal 2006); Finkelstein v. Finkelstein, 268 A.D. 2d 273 (NY Sup Ct. App Div 1st Dept 2000); Mills v. Mills, 663 S.W.2d 369 (Mo.Ct. App. 1983); Denton v. Rose, 2004 WL 2315114 (Ky. Ct. App. 2004) (unpublished opinion); Magee v. Garry-Magee, 833 N.E. 2d 1083 (Ind. Ct. App. 2005). *See also,* Wayne P. Kerr, *Tax Carryovers: Important Assets to Consider in High Income and High Asset Divorce Cases or Valuation Nightmare*, 17 J. AM. ACAD. MATRIM. LAW. 361 (2001)

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 be assured that the transferred funds will be professionally managed. It will also give the transferor spouse the assurance that transferred property (except to the extent consumed during the transferee spouse's lifetime) will ultimately pass to certain children (or other appropriate designees) at the death of the transferee spouse. In addition, if the separation has been acrimonious, the transferor may welcome the separation from the former spouse the trustee provides.

B. INCOME TAX CONSEQUENCES OF TRANSFERS TO TRUST

1. IN GENERAL

As discussed above, 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 the divorce, to a trust for the benefit of a former spouse. This will be so even if the transfer is in satisfaction of the transferor spouse's support obligations, other marital obligations or any other obligations.

When a transferee acquires property in a transfer to which I.R.C. §1041(a) applies, the basis in the transferred property is the same as the adjusted basis in the hands of the transferor immediately before the transfer.[132] 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.[133]

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 I.R.C. §1041.

Arguably, such transfers should be treated as gifts for gift tax purposes, but this may not always be the result. Such a transfer may cause recognition to the transferor spouse if the transfer to the trust discharges an obligation to support children or if the transfer is to provide a reasonable allowance for the support of minor issue of the marriage within the meaning of §2516.[134] 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.[135]

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

133 Compare §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).

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

135 I.R.C. §1012. *See, e.g.*, St. Joseph Bank & Trust Co. v. United States, 716 F.2d 1180 (7th Cir. 1983); Spruance v. Commissioner, 60 T.C. 141 (1973), *aff'd mem*, 505 F.2d 731 (3d Cir. 1974).

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 in order for §1041 to apply. The Temporary Regulations offer no clarification.

Until this issue is clearly resolved, it remains a possibility that the IRS may require a bifurcation of a transfer to a multiple beneficiary trust into two segments - one equal in value to the value of the transferee spouse's interest in the trust, and the other equal in value to the other interests in the trust. The portion allocable to the spouse's interest in the trust would be subject to §1041. The balance of the transfer would be subject to the rules for determining recognition, basis and the status of transferred property received by gift, or to the rules for determining recognition, basis and the status of transferred property acquired by purchase. If the transferee spouse can be shown to have furnished the consideration for the balance of the transfer, the balance might be treated in the same manner as other transfers to third parties on behalf of the spouse.[136]

2. NEGATIVE BASIS PROPERTY

I.R.C. §1041(e) makes subsection (a) of I.R.C. §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.[137]

I.R.C. §1041(e) is limited to I.R.C. §1041(a). It does not prevent the application of I.R.C. §1041(b). Thus, 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 I.R.C. §1041 rather than I.R.C. §1015, adjusted to reflect the amount of gain recognized by the transferor as a result of the transfer.

<u>Example</u> – Al owns property having a fair market value of $1,000,000 and an adjusted basis of $10,000. Al borrows $500,000 using the property as security in contemplation of transferring this property incident to a divorce from Quinn. Al 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), Al recognizes gain of $490,000 on the transfer of the property and Quinn's basis in the property is $500,000.

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

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136 The transfer would be treated as a transfer from the transferor spouse to the transferee spouse followed by an immediate transfer by the transferee spouse to the trust. The second transfer would not be protected by I.R.C. §1041. Temp. Reg. §1.1041-1T(c) Q&A 9.

137 I.R.C. §1041(e).

meaning of I.R.C. §671), the transfer would not result in recognition of gain. This is so because the transferor will continue to be treated as the owner of the transferred property after the transfer.[138] When the trust ceases to be a grantor trust because of the termination of the spouse's interest or upon the spouse's death,[139] the transferor will be treated as having transferred ownership of the interest to a different taxable entity.[140] At that time, the transferor will be treated as having disposed of the interest.[141]

3. INSTALLMENT NOTES

I.R.C. §453B(g) provides that the nonrecognition provision of I.R.C. §1041, which was made generally applicable to the disposition of installment obligations by I.R.C. §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 I.R.C. §453B.[142]

Unlike I.R.C. §1041(e), discussed above, no provision of I.R.C. §1041 or I.R.C. §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 I.R.C. §1015 seems to provide the necessary adjustment. Section 1015 indicates that the transferee's basis will "be the same as it would be in the hands of the [transferor]."[143] The IRS has ruled that this language requires that the transferor's basis take into account the gain resulting from the transfer because if the transferor held the note after the disposition, the transferor's basis would have been increased by the amount of such gain.[144]

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138 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.

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

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

141 *See id.*; Madorin v. Commissioner, 84 T.C. 667 (1985); Rev. Rul. 79-84, 1979-1 C.B. 223; Rev. Rul. 77-402, 1977-2 C.B. 222 (1977).

142 I.R.C. §453B(a), (g)(1).

143 I.R.C. §1015(a).

144 Rev. Rul. 79-371, 1979-2 C.B. 294.

I.R.C. §1041(b), however, not I.R.C. §1015(a), applies to a transfer of an installment note to a trust for the benefit of the transferor's spouse. The language of I.R.C. §1041(b) states only that the "basis of the transferee shall be the adjusted basis of the transferor." Unlike I.R.C. §1015, it does not suggest a test that looks to see what the transferor's basis would be if a transfer had not occurred. In order to avoid a double tax on the same gain, the Treasury Regulations should construe I.R.C. §1041(b) to require the same test as I.R.C. §1015.[145]

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.[146] 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.

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.[147]

C. TAXATION OF TRUST INCOME

1. IN GENERAL

There are two principal tax types of trusts that are likely to be used in connection with a property settlement agreement: (1) a standard trust and (2) 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 outline. Nevertheless, 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.[148]

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145 *Cf.* Rev. Rul. 87-112, 1987-2 C.B. 207 (in which the Internal Revenue Service allowed the transferee spouse of E bonds to increase his or her basis by the amount of income the transferor spouse recognized on the transfer).

146 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.

147 *See* Treas. Reg. §1.1001-2(c), Ex. (5); Madorin v. Commissioner, 84 T.C. 667 (1985); Rev. Rul. 79-84, 1979-1 C.B. 223; Rev. Rul. 77-402, 1977-2 C.B. 222.

148 For a comprehensive discussion of this subject, *see* BYRLE M. ABBIN, INCOME TAXATION OF FIDUCIARIES AND BENEFICIARIES (CCH 2014).

2. *STANDARD TRUSTS*

a) 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 six 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 $12,300.[149]

In addition, the net investment income of trusts is subject to the I.R.C. §1411 Medicare Tax at income levels above $12,300.[150]

b) 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.

c) 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 Code §§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.[151] In each case the deduction is limited to the amount of the trust's "distributable net income" ("DNI")[152] regardless of the actual amount of the deduction.[153] 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:[154]

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149 I.R.C. §1(f) requires Treasury to prescribe new tables annually to reflect increases in the cost of living. The $12,150 taxable income level was established in Rev. Proc. 2014-61, 2014-47 I.R.B. 860.

150 I.R.C. §1411(a)(2)(B)(ii).

151 I.R.C. §§651, 652, 661 and 662.

152 I.R.C. §643(a).

153 I.R.C. §§651 and 661.

154 I.R.C. §643(a).

1) 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."[155] Capital losses are also not taken into account except to the extent that they reduce the amount of gains included under the preceding sentence.[156] 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.[157]

2) 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).[158]

3) A trust's distribution deduction, discussed below, is added back to taxable income.[159]

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.[160] 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.[161]

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.[162] The distributions have the same tax character in the hands of the beneficiaries as they had in the hands of the trustee.[163]

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

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155 I.R.C. §643(a)(3); Treas. Reg. §1.643(a)-3.

156 *Id.*

157 *Id.*

158 I.R.C. §643(a)(5).

159 I.R.C. §643(a)(1).

160 I.R.C. §§651(b) and 661(c).

161 *Id.*

162 I.R.C. §§652(a) and 662(a). DNI is computed without the deduction allowed under I.R.C. §642(c) for payments to charities. See I.R.C. §§651(a)(2) and 662(b).

163 I.R.C. §§652(b) and 662(b).

treated as a distribution of trust income.[164] 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.[165]

3. GRANTOR TRUSTS

a) IN GENERAL

The term "grantor trust" is used to describe a trust which is treated as "owned" by its creator, the grantor, or, in some cases, by another individual. The rules governing grantor trusts are set forth in Code Secs. 671 through 679.

b) CONSEQUENCES OF GRANTOR TRUST TREATMENT

The primary tax consequence of grantor trust treatment is that the deemed owner of the trust will calculate annual taxable income and credits by including the trust's income, deductions, and credits.[166] 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 far 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.[167]

An individual may be the deemed owner of an entire trust or only a portion of the trust.[168] 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

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164 I.R.C. §663(a).

165 Treas. Reg. §1.663(a)-1(b)(2).

166 I.R.C. §671. Because a single individual does not reach the highest income tax bracket until realizing taxable income of $413,200 (§1(c); Rev. Proc. 2014-61), grantor trust status can sometimes result in income tax savings.

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

168 I.R.C. §671(a).

the individual's taxable income.[169] 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.[170]

c) WHEN THE RULES APPLY

(1) IN GENERAL

The grantor trust rules apply when the grantor or a nonadverse party 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 grantors 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 the grantor 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 the individual is "any person having a substantial beneficial interest in the trust which would be adversely affected by the exercise or nonexercise of the power…respecting the trust."[171]

(2) 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 the grantor 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.

(3) 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.[172] The most significant exception is in I.R.C. §675(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 I.R.C. §672(e) imputes to the grantor any power held by the grantor's spouse, it is likely that this exception does not apply if the grantor's spouse is a trustee with any power to control beneficial enjoyment.

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169 Treas. Reg. §1.671-3(a).

170 *Id.*

171 I.R.C. §672(a).

172 I.R.C. §674(b)-(d).

(4) 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,[173] 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.[174]

(5) 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 the grantor or any nonadverse party has the power to revert title to such portion in the grantor.

(6) POWER TO DISTRIBUTE OR ACCUMULATE INCOME TO OR FOR THE GRANTOR OR THE GRANTOR'S SPOUSE

I.R.C. §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. Section 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 to be treated as a

[173] 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 I.R.C. §672(c). I.R.C. §675(3).

[174] I.R.C. §675(4).

distribution within the meaning of I.R.C. §661(a)(2) and is to be taxed to the grantor under I.R.C. §662.[175]

(7) 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 the individual has the unilateral right to withdraw the corpus or the income.[176] The individual will also be treated as the owner of a partially released or modified power, if after such partial release or modification the individual 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 the individual had been the grantor.[177]

4. 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 in connection with a divorce or separation, the taxation of that trust and of the transferee spouse would generally follow the rules reviewed above.[178] Taxability will depend on the particular characteristics of the trust. If the trust is a standard trust, it and the transferee spouse would be taxed in the manner discussed above. The spouse rather than the trust would be taxed on trust income to the extent distributed.

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 reversion the actuarial value of which was more than five percent at the inception of the trust.[179] 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 certain children will share in the trust property at the death or remarriage of the transferee spouse.[180]

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175 I.R.C. §677(b).

176 I.R.C. §678(a)(1).

177 I.R.C. §678(a)(2).

178 *See supra* text accompanying notes 148 through 165.

179 I.R.C. §673(a).

180 I.R.C. §674(a).

If the transferor spouse's transfer to the trust does not, under state law, completely terminate an 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 or could be accumulated for future distribution to the transferee spouse.[181] Such payments would be treated as having been made for the transferor spouse's benefit since they would discharge a continuing legal obligation.[182]

If the transferor spouse and the transferee spouse are 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 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 I.R.C. §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.[183] 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 I.R.C. §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.[184] I.R.C. §672(e) does not cease to operate after the grantor and spouse are divorced.

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181 *See* Helvering v. Leonard, 310 U.S. 80 (1940). *See generally*, Comment, *Tax Aspects of Alimony Trusts*, 66 YALE L.J. 881 (1957). *But cf.* John L. Peschel, *Income Taxation of Alimony Payments Attributable to Transferred Property: Congressional Confusion*, 44 TUL. L. REV. 223 n. 94 (1970)("This comment contains some useful discussion of income tax planning for alimony trusts but is marred by a failure to consider all of the relevant authorities on the legal issues and the non-recognition of the relationship between alimony trusts and other transferred property situations.")

182 I.R.C. §677(b).

183 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 I.R.C. §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).

184 I.R.C. §672(e) also applies 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 date of the marriage.

If I.R.C. §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 the grantor held the interest or power held by the spouse.

> Example - Jamie created a trust to pay a child Kaden income for 15 years, remainder to Jamie's spouse Lake. The actuarial value of Lake's interest in the trust corpus at the inception of the trust was 10%. Since Jamie is treated as owning the reversionary interest held by Lake and since that reversionary interest is worth more than 5%, Jamie will be treated as the owner of 100% of the trust under I.R.C. §673(a).

The result in the preceding example will not change if Jamie and Lake 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 I.R.C. §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), I.R.C. §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 I.R.C. §672(e), then that status would continue to be attributed to the grantor after a divorce and would result in grantor trust status.

> Example - Max, pursuant to the requirements of a marital settlement agreement, transferred $500,000 to a trust to pay Max's spouse Pat income for life. The independent trustee had discretion to distribute principal to Pat if the independent trustee deemed it advisable. At Pat's death, the remainder was to be paid to Max's children. The transfer was made prior to Max's divorce from Pat. Section 677(a) applies to treat Max 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.[185] It will be partially, but not completely, avoided in most cases by the operation of I.R.C. §682(c), which is discussed below.

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185 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 I.R.C. §677 because of the trustee's power to distribute income to a former spouse, after the couple divorces. This regulation seems incorrect for two reasons. First it is misreading I.R.C. §682. Section 682 does not eliminate grantor trust

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 Max for Pat described above might have been an inter vivos qualified terminable interest property trust 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.

5. 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 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.[186] I.R.C. §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 I.R.C. §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 I.R.C. §71. Under I.R.C. §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 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 I.R.C. §71

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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 I.R.C. §677 fails to take into account the fact that the spouse's beneficial interest is attributed to the grantor under I.R.C. §672(e) even after divorce. It is true that the trust is no longer a grantor trust under I.R.C. §677 because of the possible distributions to the former spouse, but under I.R.C. §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 I.R.C. §677 after divorce.

186 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 I.R.C. §682 will cause the termination of the grantor trust status of an inter vivos qualified terminable interest property when the grantor and the beneficiary spouse divorce. A similar conclusion is reached in PLR 9235032 (August 28, 1992). The conclusions seem clearly wrong. Nothing in I.R.C. §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.

specifically required gross income inclusion of payments attributable to property transferred in trust.[187]

I.R.C. §682(a) was not needed to protect the transferor spouse from tax because the former version of I.R.C. §71 expressly excluded from one spouse's gross income the income from transferred property that I.R.C. §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 I.R.C. §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 I.R.C. §71(b) are met.[188] As a result, if a divorce or separation instrument requires the establishment of a trust to make payments for life to one spouse, I.R.C. §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.[189]

To avoid this result, it is advisable to draft a provision in the divorce or separation instrument stating that the distributions to the transferee spouse are not to be included in gross income under I.R.C. §71(a). The use of this simple statement will prevent the operation of I.R.C. §71(a)'s inclusion rule.[190]

c) TAX TREATMENT OF TRANSFEREE SPOUSE UNDER I.R.C. §682(a)

The spouse who receives or is entitled to receive the income from a Section 682 Trust is treated as a beneficiary of the trust for purposes of the rules governing the taxation of

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187 Treas. Reg. §§1.71-1(c)(2) and 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. Commissioner, 9 T.C. 195 (1947).

188 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. Rep. 432, 98th Cong., 2d Sess. 1491, 1492 (1984).

189 In that event, the transferor spouse, if 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).

190 I.R.C. §71(b)(1)(B).

standard trusts and their beneficiaries.[191] This means that the transferee spouse must include in gross income the amounts allocated 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, I.R.C. §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 I.R.C. §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 18, 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 to be allocated first to the child support portion of the amount paid to the transferee spouse.[192]

If a Section 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 gross income. Whether or not this is the correct result is unclear because neither I.R.C. §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, contain two conflicting definitions of "income." Section 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 local law are to be disregarded.[193] 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 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.[194]

Applying the grantor trust definition of income to I.R.C. §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 I.R.C. §682(a) applies, be taxed to the transferor, a distribution to the transferee spouse in excess of trust accounting income would be taxed to the transferee spouse to

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191 I.R.C. §682(b).

192 I.R.C. §682(a).

193 Treas. Reg. §1.643(b)-1.

194 Treas. Reg. §1.671-2(b).

the extent of the trust's capital gain income. Because the primary function of I.R.C. §682(a) is to override the grantor trust rules, these rules are probably the proper source for the definition.[195]

d) TAX TREATMENT OF TRANSFEROR SPOUSE UNDER I.R.C. §682(A)

The tax treatment of the transferor spouse depends upon whether the transferor is deemed to own the trust under the grantor trust rules.[196] 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.[197]

If the trust is treated as owned by the transferor spouse, the transferor will be taxed, under the grantor trust rules, on all trust income not distributed to the transferee spouse.[198] Defining what that income is presents the same issue discussed above in connection with determining the transferee spouse's income.

Until this issue is resolved, drafters of trusts that will be subject to I.R.C. §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 to be responsible for the tax on capital gain income to the extent of distributions in excess of ordinary income. In order 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 gross income of the amount of income the parties had expected to be taxed to the transferor spouse. Additionally, in order to protect the reimbursement payments from treatment as income under I.R.C. §71(a), the

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195 In P.L.R. 9235032 (May 29, 1992) the IRS concluded that the transferee spouse would be taxed under I.R.C. §682 on trust distributions to the extent of the trust's DNI. Because the trust instrument required the allocation of capital gain income to income, it also concluded that DNI would include capital gain income. Surprisingly, without any stated rationale, the IRS determined that §682 protected the transferor spouse from income taxation on any portion of the trust income whether or not it was distributed to the transferee spouse. There seems to be no basis in §682 for this conclusion. P.L.R. 200408015 (February 2, 2004) takes a contrary position, one that seems more consistent with the text of §682. It concluded that §682 will not protect the grantor spouse from being taxed on the capital gain income of a trust all of the income of which, in the absence of §682, would be taxed to the grantor under I.R.C. §675 because the terms of the trust instrument provided that capital gains are not included in distributions to the spouse.

196 I.R.C. §671(a).

197 I.R.C. §682(a).

198 I.R.C. §671(a).

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.[199]

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, such portion will be included in the transferor spouse's income.[200]

IV. TRANSFER TAXES

A. IN GENERAL

The application of the gift tax and the estate tax does not depend upon the existence of a subjective, donative intent. As a result, although divorcing spouses do not usually intend to make gifts to each other, their marital settlement agreements and the transfers made under the agreements may be subject to federal gift or estate tax.

The gift tax law creates an objective standard for determining whether a gift has occurred. It treats transfers of property and payments of cash by one individual to another as taxable gifts (unless protected by the gift tax marital deduction or the annual gift tax exclusion) except to the extent that the transferor actually receives or is treated as having received adequate and full consideration in money or money's worth.[201]

The estate tax law does the same. It does not permit obligations that are based on agreements, including marital settlement agreements, to be deducted in the calculation of a decedent's taxable estate except to the extent that the transferor actually received or is deemed to have received adequate and full consideration in money or money's worth.

Property transferred during a decedent's lifetime will be included in the decedent's gross estate for federal estate tax purposes if the decedent retained certain rights over or interests in the property. There is an exception to this rule for transfers that are bona fide sales for an adequate and full consideration in money or money's worth. The relinquishment of certain kinds of marital rights will not always be treated as consideration in money or money's worth for purposes of the gift and estate tax.[202]

B. THE GIFT TAX

1. IN GENERAL

I.R.C. §2512(b) contains the following definition of a gift for gift tax purposes.

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199 I.R.C. §71(b)(1)(B).

200 Treas. Reg. §1.682(a)-1(b).

201 I.R.C. §2512(b).

202 I.R.C. §2043(b).

> "Where property is transferred for less than an adequate and full consideration in money or money's worth, then the amount by which the value of the property exceeded the value of the consideration shall be deemed to be a gift."

Marital settlement agreements usually have one or more of the following as consideration:

a) relinquishment of support rights;

b) relinquishment of rights to an equitable or equal division of marital or community property;

c) relinquishment of rights to dower, curtesy, or similar statutory rights in the estate of the other; and

d) relinquishment of rights under federal law to an interest in certain pension and profit sharing plans.

2. EXCEPTIONS

To protect a marital settlement agreement and the transfers required by such agreement from the gift tax, the parties might rely on the marital deduction provided under I.R.C. §2523. If the marital deduction is not available, the parties will need to rely on one of four other rules under which such agreements or transfers are either treated as made for adequate consideration in money or money's worth or are excepted from the consideration requirement:

a) the deemed consideration rule of I.R.C. §2516;

b) the treatment of the relinquishment of support rights as consideration in money or money's worth;

c) the treatment of the relinquishment of other immediately enforceable rights arising upon the dissolution of a marriage as consideration in money or money's worth; and

d) the exception for transfers based on a decree.

3. THE MARITAL DEDUCTION

If the transfers are effective for gift tax purposes while the spouses are married to each other, they may be eligible for the marital deduction. The marital deduction is available for outright transfers of property. It is not available for transfers of certain terminable property interests.[203]

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[203] I.R.C. §2523 (b). The marital deduction is also not available for transfers to a spouse who is not a citizen of the United States. I.R.C. §2523(i). Instead, the annual gift tax exclusion

If the transferor spouse wants to assure that property being transferred will pass at the death of the transferee spouse to the children of the marriage, a transfer in trust may be an appropriate solution. The transferor spouse could transfer property to a qualified terminable interest property trust, usually referred to as a QTIP trust.[204] Transfers to this type of trust are eligible for the marital deduction despite the fact that the transferee spouse's interest in the trust is terminable - i.e., the interest usually ends at death.

A QTIP trust is a trust that must pay all of its income currently to the transferee spouse and that prohibits any payments during the spouse's life to anyone other than the spouse. In order to qualify for the QTIP treatment, the transferor spouse must elect to have the trust property treated as qualified terminable interest property. The election must be made on or before the time for filing a gift tax return under I.R.C. §6075(b).

When the marital deduction is used, the transferee spouse's interest in the transferred property will be sufficient to require its inclusion in gross estate for federal estate tax purposes on death. The transferee spouse should adjust the estate plan to take this into account. If the interest one spouse is willing to transfer is an interest in a qualified terminable interest property trust, before agreeing to accept this interest, the transferee spouse should make sure that local law will permit the estate to recover from the trust the full amount of the incremental state inheritance or estate tax that will be imposed on the estate.[205]

The existence of a gift from one spouse to the other is a threshold requirement for the application of the marital deduction. As a result, if one spouse transfers property in a transaction that is protected from gift tax by I.R.C. §2516 or by the relinquishment of rights that are deemed to be consideration in money or money's worth, the gift tax marital deduction will not be available. To the extent that the transfer is made to the spouse, the lack of availability of the marital deduction will not be a problem. The difficulty arises if the transfer consists in part of a transfer to another individual, such as a transfer to a trust to pay the spouse income for life and then to pay the remainder to a child.

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permitted for gifts to such a spouse is currently $145,000, adjusted periodically for inflation. Rev. Proc. 2013-35, 2013-47 I.R.B. 537.

[204] The requirements for a QTIP trust are described in I.R.C. §2056(b)(7). In the case of a transfer to a spouse who is not a citizen of the United States, the QTIP Trust is unavailable. Instead, a Qualified Domestic Trust, described in I.R.C. §2056A, should be used.

[205] I.R.C. §2207A(a) will give the transferee spouse's estate the right to recover from the qualified terminable interest property trust an amount equal to (1) the federal estate taxes imposed on the surviving spouse's estate reduced by (2) the federal estate taxes that would have been imposed on the surviving spouse's estate if the trust had not been included in the gross estate. Some states have similar tax reimbursement rules. *See, e. g.*, New York Estates, Powers and Trusts Law, §2-1.8. Some state statutes may require only reimbursement of a pro rata amount of the estate tax.

4. I.R.C. §2516 TRANSFERS

I.R.C. §2516 provides that a transfer will be deemed to have been made for an adequate and full consideration in money or money's worth if the transfer is made:

a) From one spouse to the other in settlement of marital or property rights or to provide a reasonable allowance for the support of issue of the marriage during minority; and

b) Pursuant to a written agreement relating to marital and property rights that was executed within a period of three years beginning two years before and ending one year after the parties are divorced.[206]

Transfers made pursuant to an agreement protected by I.R.C. §2516 may be made at any time. There is no requirement that such payments be made within two years before or one year after the divorce.

The I.R.C. §2516 exception will apply only if the parties are actually divorced[207] and only if the divorce occurs within the prescribed time period. In some circumstances the timing requirement may preclude reliance on the I.R.C. §2516 exception.

If the transfer is made in settlement of a spouse's marital or property rights, I.R.C. §2516 applies only if the transfer is made to the spouse.

A transfer to a trust for the benefit of a spouse will be treated as having been made to the spouse, but only to the extent the value of the transferred interest in the trust can be determined.[208] If the trustee has discretion as to the amount of the distributions to be made to or for the benefit of the spouse, the amount of the transfer to the trust that is protected by I.R.C. §2516 will be limited to the actuarial value of the minimum amount the trustee is required to distribute.[209]

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206 For this purpose, an agreement includes a subsequent modification of an agreement. Estate of Kahanic, T.C. Memo 2012-81.

207 In Estate of Hundley v. Commissioner, 52 T.C. 495 (1969), *aff'd*, 435 F.2d 1311 (4th Cir. 1971), the Tax Court concluded that a separation agreement coupled with an actual separation did not satisfy the divorce requirement of I.R.C. §2516. The Tax Court declined to decide whether under some circumstances I.R.C. §2516 might operate without an actual divorce although it suggested that it was inclined to this view.

208 *See e.g.*, Rev. Rul. 79-363, 1979-2 C.B. 345, Rev. Rul. 75-73, 1975-1 C.B. 313, Rev. Rul. 57-506, 1957-2 C.B. 65.

209 For example, in Rev. Rul. 75-73, 1975-1 C.B. 313, the taxpayer, pursuant to a marital settlement agreement, had transferred property to a trust for his spouse. The terms of the trust required that the trustee distribute all of the income to the spouse during her life unless she became incompetent. If she became incompetent, the trustee had the power to accumulate the

If a taxpayer makes a transfer that the taxpayer believes will be protected by I.R.C. §2516, but the divorce has not become final by the due date for the gift tax return for gifts made on the date a transfer is made pursuant to the agreement, Treas. Reg. §25.6019-3(b) provides that the taxpayer must report the transfer on the gift tax return and attach a copy of the separation agreement. Within 60 days after the divorce becomes final, the taxpayer must submit a certified copy of the divorce decree to the District Director.

5. RELEASE OF SUPPORT RIGHTS

The laws of most states impose mutual obligations of support on spouses. Similarly, if two married individuals have minor children, the law of their domicile probably imposes on them an obligation to support these children. Payments made by one spouse in discharge of these obligations are not treated as gifts. This is so because the payments are viewed as made in satisfaction of an obligation imposed by local law. The satisfaction of the obligation provides the consideration.

These support obligations do not disappear when spouses are separated or divorced. The marital settlement agreement generally will require a series of support payments or a property transfer intended to provide a source of funds for support. The IRS ruled in 1946 that the release of support rights, in contrast to the release of other marital rights, did constitute consideration in money or money's worth.[210]

As a result, transfers made for this purpose are treated as made for consideration in money or money's worth to the extent of the value of the support rights relinquished in exchange for the transfer.[211]

It is often difficult to quantify the transferor's support obligation to a spouse and to specific children. The amount of the obligation and its duration are determined under the laws of the state that imposes the obligation. These laws generally do not provide any objective standards for determining the amount[212] although they usually do provide a fairly clear standard for determining the duration of the obligation.

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income not necessary for her support or to distribute such income to the taxpayer's adult children. Since it was impossible to determine whether or when the spouse would become incompetent, the Internal Revenue Service concluded that for purposes of determining the amount of the transfer protected by I.R.C. §2516, the interest passing to the spouse would be valued as if she were incompetent from the date of the transfer. As a result, the amount protected was limited to the actuarial value of the amount of income estimated to be necessary for support rather than the actuarial value of the entire income stream.

210 1946-2 C.B. 166 (US), 1946 WL 63274.

211 Rev. Rul. 77-314, 1977-2 C.B. 349; Rev. Rul. 68-379, 1968-2 C.B. 414; superseding 1946-2 C.B. 166 (US), 1946 WL 63274.

212 The numerical child support guidelines that have recently been enacted in virtually all states in response to Pub. L. 100-485, §103, amending §467(b) of the Social Security Act,

The valuation process must take into account the factors that a state court would take into account in determining the amount and duration of alimony or child support. These factors include the obligor's financial resources and the pre-separation standard of living of the parties.[213] Since state law will usually terminate an alimony obligation on the death or remarriage of the transferee spouse and on the death of the transferor spouse, the probability of the transferee spouse's remarriage, and the life expectancies of the parties must be taken into account. Since state law will usually terminate a child support obligation when the child reaches majority or is otherwise emancipated, or on the death of the transferor spouse, the age of the child and the life expectancies of the transferor spouse also must be taken into account.

Once the amount and the duration of the obligation have been determined, the present value of the right to receive such payments over the period of the obligation must be determined. In the case of an obligation to pay support to a spouse, the calculation must take into account the life expectancies of both parties, the possibility of the transferee spouse's remarriage, and an assumed rate of interest. Life expectancies and assumed interest rates can be obtained from the tables published by the IRS under I.R.C. §7520. Remarriage factors are generally obtained from the American Remarriage Table.

In some cases, courts have resolved the valuation issue by applying the presumption of equal value that the Court of Claims used for income tax purposes in *United States v. Davis*.[214] In *Davis* the Supreme Court determined that properties exchanged pursuant to negotiated agreements are presumed to be of equal value.[215]

6. TRANSFERS IN EXCHANGE FOR RELEASE OF IMMEDIATELY ENFORCEABLE RIGHTS IN PROPERTY

The laws of most states give one spouse a right to a portion of the other spouse's property on divorce. In some cases, the spouse may be entitled to a fixed percentage of the property acquired during the marriage; in others, the spouse may be entitled to such portion as a court deems equitable. Although a divorce will terminate each spouse's rights to receive a share of the other's estate on death, the kind of rights each acquires in the other's property on divorce is not a simple substitute for the termination of rights in the other's estate. There are frequently differences in amount, the type of property in which the rights accrue, and the form of property interests that can be used to satisfy the claim.

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provide some objective guidance for measuring the value of an individual's child support obligation. *See* New York Domestic Relations Law §240.

[213] Estate of Fenton v. Commissioner, 70 T.C. 263 (1978); Rev. Rul. 71-67, 1971-1 C.B. 271. *See also* Kosow v. Commissioner, 45 F.3d 1524 (11th Cir. 1995).

[214] 370 U.S. 65, 72 (1962).

[215] *Id. See e.g,* Carly v. Commissioner, 84 T.C. 649 (1985).

In New York, for example, a surviving spouse is entitled to a one-third share of the deceased spouse's property regardless of when acquired.[216] In contrast, on divorce, each spouse has a right to receive outright an equitable share of the marital property acquired during the marriage regardless of in whose name the property was acquired.[217]

It is unclear whether the release of rights to a portion of a spouse's property on divorce is the release of another "marital right" within the meaning of I.R.C. §2043(b)(1) or is properly treated as consideration in money or money's worth. The Tax Court and the Fourth Circuit have both decided this issue in favor of the taxpayer.

In the *Glen* case, the Tax Court treated the release of a wife's immediately enforceable right under the laws of Scotland to a one-third interest in her husband's assets on divorce as consideration in money or money's worth.[218] The court's decision was based on (1) the doctrine of *ejusdem generis*, (2) its analysis of the purpose of I.R.C. §2043(b)(1), and (3) the similarity between this type of right and support rights.[219]

In the *Waters* case, the Fourth Circuit treated the release of a former spouse's interests in her former spouse's property, under North Carolina law, as consideration in money or money's worth.[220] North Carolina's marital property law creates a system of deferred community property law. During a marriage, common law principles apply to the marital property of spouses. On divorce, however, unless the parties have agreed otherwise prior to the divorce, each spouse acquires a "vested, present ownership interest in one-half of the marital property." The Fourth Circuit concluded that these kinds of rights are of an entirely different character than the "other marital rights" referred to in I.R.C. §2043(b)(1) and that I.R.C. §2043(b)(1) applies only to rights that the parties have when they are still married to each other. It is unclear from the opinion in *Waters* whether the Fourth Circuit would have reached the same conclusion if the parties had agreed to divide their property prior to the divorce. In theory, if they had done so, no community property interests would have arisen.

Most states now give each spouse a right either to a fixed percentage of property acquired during marriage or an "equitable" portion of such property. The rationale used by the Tax Court in the *Glen* case and by the Fourth Circuit in *Waters* could be used to protect most transfers intended to satisfy these rights from the gift tax. The *Glen* case, however, was decided more than 40 years ago and has not yet been so applied. Thus, its possible application to the various equitable distribution rights of the different states is uncertain.[221] Reliance on *Waters* may be

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[216] New York Estates, Powers and Trusts Laws, §5-1.1-A.

[217] New York Domestic Relations Law, §236.

[218] Estate of Glen v. Commissioner, 45 T.C. 323 (1966).

[219] *Id.* at 340-41.

[220] Estate of Waters v. Commissioner, 48 F.3d 838 (4th Cir. 1995).

[221] *See also* Taurog v. Commissioner, 11 T.C. 1016 (1948); McLean v. Commissioner, 11 T.C. 543 (1948).

precarious unless the applicable state law creates a kind of property right similar to community property. Dicta in the Second Circuit's opinion in *Herrmann v. Commissioner*,[222] provides some additional support for the position taken by the Tax Court in the *Glen* case. In *Herrmann*, the court said that the relinquishment of "rights a spouse may have by virtue of the marriage in the other spouse's property during their joint lives" can constitute consideration in money or money's worth.

7. TRANSFERS PURSUANT TO DECREE - THE "HARRIS" RULE

The Supreme Court held in *Harris v. Commissioner*[223] that if a divorce decree rather than an agreement between the spouses is the basis for an obligation to make a transfer, the transfer does not have to be supported by consideration to avoid the gift tax because the transfer is not founded on a promise or agreement. This conclusion is based on I.R.C. §2053, an estate tax provision which permits a deduction for estate tax purposes of all claims regardless of the existence of consideration so long as they are not based on a promise or agreement. *Harris* imports this provision into the gift tax law and concludes that the gift tax does not require the existence of consideration unless the transfer is voluntary or is based on a promise or agreement.

The *Harris* rule is sometimes difficult to apply because, in most cases, spouses will have negotiated a marital settlement agreement before going to court for a divorce. The difficulty with relying on the *Harris* rule when an agreement exists is the lack of clear standards for determining whether a transfer is based on an agreement or on a decree.

The IRS has taken the position in Revenue Ruling 60-160 that a transfer from one spouse to the other that is required by the terms of a marital settlement agreement will be deemed to be based on a decree rather than the agreement only if a court that "has [the] power to decree a settlement of all property rights or to vary the terms of a prior settlement agreement" actually approves the agreement.[224]

The Second Circuit's opinion in *Natchez v. United States*[225] creates an alternative to the IRS's requirement that the court have the power to vary the terms of the agreement. In the *Natchez* case, the parties, residents of New York, executed a marital settlement agreement and then obtained a divorce in Chihuahua, Mexico. The Chihuahua court did not have the power to vary the terms of the parties' agreement. It did, however, have the power to adopt and incorporate the terms of the agreement as part of its decree. Under the law of New York at the time the agreement was entered into, the agreement would not have been enforceable. The adoption of the agreement by the Chihuahua court made the agreement enforceable under New York law. The Second Circuit held that the "essential judicial power for our purposes is the

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222 85 F.3d 1032 (2d Cir. 1996).

223 340 U.S. 106 (1950). *See also* Commissioner v. Converse, 163 F.2d 131 (2d Cir. 1947). The *Harris* doctrine was applied by the IRS in P.L.R. 201029002 (July 23, 2010).

224 Rev. Rul. 60-160, 1960-1 C.B. 374.

225 705 F.2d 671 (2d Cir. 1983).

court's power to approve the separation agreement and incorporate it in the decree . . . . The fact that the court has or lacks the additional power to modify the separation agreement is immaterial . . . ." [226] It is unclear whether the Second Circuit would apply this reasoning to a situation in which the marital settlement agreement did not depend on the decree for its enforceability.

In most cases, any transfer that would be protected from gift tax by the *Harris* decree exception would also be protected by I.R.C. §2516. For gift tax purposes, therefore, the exception is likely to be important only under the following circumstances:

a) The parties are unable to secure a divorce within the time limits required by I.R.C. §2516. Unless a divorce occurs virtually simultaneously with the execution of the marital settlement agreement, the possibility that the divorce will not be obtained in time will always be a risk. The death of one of the parties before the divorce is obtained will usually prevent the survivor from obtaining a divorce. This would prevent the application of I.R.C. §2516.

b) Local law permits the court to direct a payment or transfer to an adult child. This might be permitted, for example, in a state which requires parents to support disabled children regardless of their ages.

c) The parties are not able to negotiate a marital settlement agreement, and a court is required to determine their respective property and support rights.

8. GIFT TAX PROBLEMS UNDER I.R.C. §2702

I.R.C. §2702, which was added to the Code in 1990 as part of new Chapter 14, may present significant difficulties for many typical marital settlement patterns.[227] Section 2702 was designed to attack the ordinary method of valuing term interests in property as described above. Transferors were permitted to use Treasury valuation tables, which assumed 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. Since it could not be sure that a retained income interest would have any particular value, Congress decided to give it a

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[226] *Id.* at 675.

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

value of zero when a remainder interest is transferred to certain family members.[228] As a result, the transferor's taxable gift would be the full value of the transferred property.[229]

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 member[230] retains an interest in the transferred property. Unless 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 I.R.C. §2702 if the transferor retains the remainder.

> <u>Example</u> - Ray transfers $100,000 in trust to pay spouse, Sage, income for 10 years, and then to pay back the trust principal. The actuarial value of Ray'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 I.R.C. §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:

> <u>Example</u> - Tanner and Val own their home as joint tenants. Their marital settlement agreement gives Tanner the right to live in it for 5 years. At the end of the 5 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 Tanner's retained interest in the residence will be deemed to be zero.

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

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[228] 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. I.R.C. §2702(e); I.R.C. §2704(c)(2).

[229] I.R.C. §2702(a)(2)(A).

[230] 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); I.R.C. §2702(a)(1).

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 I.R.C. §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 will 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 acquire an interest in the trust. Thus, if a remainder interest in a trust is to pass to the children, which is not uncommon in an I.R.C. §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 I.R.C. §2702 does not reach the transfer unless the grantor retains an interest in the trust. If a transferor transfers a term interest to a spouse and a remainder interest to their children, I.R.C. §2702 will not apply to the transfer because neither the transferor nor an applicable family member has retained an interest.

> <u>Example</u> - West transferred $100,000 in trust to pay spouse Adrian income for 10 years and then to pay the trust principal to West's children. The value of the income interest is $55,000. In exchange, Adrian relinquished the right to be supported by West. The support rights were worth $55,000. West has retained no interest in the trust. West's gift to the children will be $45,000. Adrian is an applicable family member as to West but has "acquired" rather than "retained" an interest in the trust.[231]

The joint purchase rule of I.R.C. §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 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 the family member had acquired the entire property and then transferred to the other family member the interest acquired.[232]

> <u>Example</u> - Bay and child Campbell acquired Blackacre from Bay's father Dakota for a total purchase price of $100,000. Bay acquired a 10-year term interest and Campbell acquired the remainder. Bay paid Dakota $55,000 for the interest, an amount equal to the actuarial value of the 10-year interest, and Campbell paid Dakota $45,000. Bay 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

[231] Treas. Reg. §25.2702-2(c)(3) defines "retained" for any individual other than the transferor as "held by the same individual both before and after the transfer in trust."

[232] I.R.C. §2702(c)(2).

interest to Campbell for $45,000. Because the value of Bay's retained interest in Blackacre is zero, the net result is a taxable gift to Campbell by Bay 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 I.R.C. §2516 as a taxable gift 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.

> <u>Example</u> - Eli and Frankie entered into a marital settlement agreement that required Frankie transfer $100,000 into a trust to pay income to Eli for 15 years and then to pay the remaining trust principal to their adult children. In exchange, Eli relinquished marital rights. Eli and Frankie were divorced within 2 years of the date of the agreement. The actuarial value of Eli's interest in the trust is $68,500; the actuarial value of the children's interest, $31,500. Frankie's transfer to the trust was protected from gift tax, to the extent of Eli's interest, by I.R.C. §2516. Frankie paid a gift tax on the value of the children's remainder interest. Eli will be caught by the joint purchase rule. Eli will be treated as having acquired the full $100,000 interest in the trust and then as having transferred it in trust to pay income for 15 years, remainder to the children. The value of the retained interest in the trust is zero but the consideration 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 Frankie's transfer to the children had also been protected by I.R.C. §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 Frankie, since that person was the one who made the actual transfer. For I.R.C. §2516 to apply to Eli, the deemed transfer would also have to be treated as having been made for the support of the children. Since the portion of the deemed transfer that consists of the value of the retained interest is clearly not intended for the support of the children, I.R.C. §2516 seems to be unavailable.

There are several ways of avoiding the impact of I.R.C. §2702 on an I.R.C. §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, I.R.C. §2702 can be avoided, if I.R.C. §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 I.R.C. §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 the transferee such a power, the gift would be deemed to have made, by application of the joint purchase rule, an incomplete gift. The IRS dealt with such a transfer in Letter Ruling 201116006.[233] 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 transferor spouse's transfer to the trust was protected from gift tax by I.R.C. §2516. The IRS concluded, without any analysis of the joint purchase rule, that the transferee spouse had not made a transfer within the meaning of I.R.C. §2702. The 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.

C. THE ESTATE TAX

1. IN GENERAL

Three principal questions arise under the estate tax law in connection with transfers required by marital settlement agreements.

[i] Will payments or property transfers required to be made after the death of the transferor spouse be deductible from the gross estate for estate tax purposes?

[ii] Will a trust created by the transferor spouse pursuant to a marital settlement agreement or other property transferred by the transferor spouse, such as life insurance, be included in the gross estate for estate tax purposes and if so, will a deduction be available?

[iii]Will a trust created for a transferee spouse be included in the transferee spouse's gross estate for estate tax purposes?

2. DEDUCTIBILITY OF TRANSFERS REQUIRED BY MARITAL SETTLEMENT AGREEMENT OR DECREE

a) IN GENERAL

Marital settlement agreements often require that one spouse make or provide for certain payments to be made after his or her death to the other spouse or to the children of the marriage. The three most typical provisions of this kind are:

(1) A provision requiring the transferor spouse's estate to continue alimony or child support payments after death,

(2) A provision requiring the transferor spouse to bequeath a certain amount or a certain portion of the estate to the surviving spouse or to their children, and

233 P.L.R. 201116006 (April 22, 2011).

(3) A provision requiring the transferor spouse to become and continue to be insured by a life insurance policy for the benefit of the surviving spouse or their children.

Obligations imposed by a marital settlement agreement may be allowable deductions either under I.R.C. §2053(a), which permits a deduction for certain debts, or I.R.C. §2056, which permits a deduction for certain property passing to the surviving spouse of a decedent. The two relevant parts of I.R.C. §2053(a) are I.R.C. §2053(a)(3) and I.R.C. §2053(a)(4). I.R.C. §2053(a)(3) permits a deduction for claims against the estate, and I.R.C. §2053(a)(4) permits a deduction for indebtedness to which property included in the gross estate is subject if the estate is not liable for the debt.

In some cases, obligations imposed by a marital settlement agreement are satisfied during the transferor spouse's life by the transfer of property or by the designation of the transferee spouse as a beneficiary of a life insurance policy. In these cases, the transferor spouse's estate will not be entitled to a deduction under I.R.C. §2053(a)(3) because of the lack of liability at death. If the transferred property is included in the transferor spouse's gross estate under Code Secs. 2036 through 2038 or if the life insurance policy is included in the transferor's gross estate under I.R.C. §2041, a deduction may be allowed under I.R.C. §2043(a)(4).[234]

I.R.C. §2053(c)(1)(A) prohibits a deduction for a debt founded on a promise or agreement if the promise or agreement is not based on adequate and full consideration in money or money's worth. The kind of consideration usually furnished in connection with a marital settlement agreement is the relinquishment of some kind of marital right. I.R.C. §2043(b)(1) generally provides that the relinquishment of marital rights does not constitute consideration in money or money's worth.

The deductibility of transfers required by a marital settlement agreement depends on the application of one of four rules under which the obligations imposed by such agreements are treated as made for adequate consideration in money or money's worth or are excepted from the consideration requirement. Each of these rules is discussed below.

b) I.R.C. §2516

The requirements for the application of I.R.C. §2516 are discussed at IV. B. 4. above. The Tax Court and the Second Circuit have disagreed on the extent to which the deemed consideration rule of I.R.C. §2516 applies to the estate tax. The Tax Court in *Estate of Satz v. Commissioner*[235] concluded that I.R.C. §2516 does not apply to the estate tax.

The Second Circuit in *Natchez v. United States*[236] concluded that I.R.C. §2516 should apply to I.R.C. §2053(c)(1)(A) because: (1) I.R.C. §2516 contains no language limiting its

234 *See e.g.*, Estate of Robinson, 63 T.C. 717 (1975); Estate of Kahanic, T.C. Memo 2012-81; Rev. Rul. 1976-113, 1976-1 C.B. 276.

235 78 T.C. 1172 (1982). *See also* Estate of Fenton v. Commissioner, 70 T.C. 263 (1978); Estate of Glen v. Commissioner, 45 T.C. 323 (1966).

236 705 F.2d 671, 675-76 (1983).

application to the gift tax law; (2) I.R.C. §7806(b) provides that no "inference, implication, or presumption of legislative construction" is to be drawn from the location of any particular provision of the Code; and (3) the Supreme Court has consistently ruled that the estate tax and gift tax should be construed in _pari_ _materia_.

Congress partially resolved this issue by the enactment of I.R.C. §2043(b)(2) as part of the Tax Reform Act of 1984. I.R.C. §2043(b)(2) provides that "[f]or purposes of section 2053 (relating to expenses, indebtedness, and taxes), a transfer of property which satisfies the requirements of paragraph (1) of section 2516 (relating to certain property settlements) will be considered to be made for an adequate and full consideration in money or money's worth."

This provision imports only part of I.R.C. §2516 into the estate tax law. It applies for purposes of the I.R.C. §2053 deduction and ignores the sections providing for inclusion of property in the decedent's gross estate. Under these inclusion sections, property may be included in a transferor's gross estate if the transferor has transferred the property during life other than in a bona fide sale for adequate and full consideration in money or money's worth.

Additionally, it does not extend any protection to transfers made to provide a reasonable allowance for the support of issue of the marriage during their minority.

Since Congress has finally addressed the application of I.R.C. §2516 to the estate tax law and has provided only limited applicability, it is likely that the courts will be reluctant to extend it further. Accordingly, I.R.C. §2516 should not be relied upon as a basis for deducting post-death child support payments or any other transfers designed to provide child support. To the extent possible, marital settlement agreements that provide for post-death payments should avoid post-death child support payments and should substitute a larger post-death payment to the surviving spouse as a payment in settlement of marital or property rights. Alternatively, the marital settlement agreement could provide for larger child support payments during the transferor's life time with the understanding that the larger payments would be used to pay premiums on a life insurance policy on the transferor spouse's life. So long as the transferor had no incidents of ownership in the policy within the meaning of I.R.C. §2042, the proceeds would pass free of estate tax at death.

c) TRANSFERS IN EXCHANGE FOR RELEASE OF SUPPORT RIGHTS

As discussed at IV. B. 5. above in connection with the gift tax, the relinquishment of support rights is treated as consideration in money or money's worth for purposes of the gift tax.[237] The IRS has concluded that this principle also applies to the estate tax.[238]

Reliance on the relinquishment of support rights presents particularly difficult valuation problems. An individual's obligation to support a spouse and children generally ends on death. Thus, the consideration for the post-death payment or payments is limited to that portion of the

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237 *See e.g.*, Rev. Rul. 68-379, 1968-2 C.B. 414.

238 Rev. Rul. 71-67, 1971-1 C.B. 271.

value of the individual's pre-death support obligation that was not satisfied by pre-death payments.

The payments to be made at death do not have to be payable to the transferee spouse in order to be deductible. It is sufficient that the transferee spouse bargained for the payment and relinquished rights in exchange. In the *Leopold* case, for example, the transferee spouse released a portion of her support rights in exchange for the transferor's promise to bequeath a certain sum to their daughter. The Ninth Circuit held that the transferor's estate's obligation was deductible under I.R.C. §2053(a).[239]

If the transferor spouse expects that the estate will have to rely on the value of relinquished support rights as the basis for a deduction under I.R.C. §2053(a), the marital settlement agreement should specifically allocate each of the promised transfers against each of the rights being relinquished.

d) TRANSFERS IN EXCHANGE FOR RELEASE OF IMMEDIATELY ENFORCEABLE RIGHTS IN PROPERTY

The release of presently enforceable rights in a spouse's property may be treated as consideration in money or money's worth. As discussed more fully above, the extent to which such a release may be relied on has not been settled.

Since the law is not clear on this issue, if a marital settlement agreement requires transfers of property or payments to be made after the death of the transferor spouse, an attempt should be made to protect the transfers or payments under I.R.C. §2516 or under the decree exception discussed below.

e) TRANSFERS PURSUANT TO DECREE

I.R.C. §2053(a)(3) permits the deduction of debts without the necessity of establishing consideration in money or money's worth if the debt is based on a decree rather than on a promise or agreement.[240] As discussed above in connection with the gift tax, it is difficult to rely on this rule if a marital settlement agreement has been executed because of the lack of clear standards for determining whether a transfer is based on the agreement or on the decree.

In most instances, any obligation that would be deductible because of the *Harris* decree exception would also be protected by the portion of I.R.C. §2516 that has been imported into the estate tax law if a marital settlement agreement had been executed. For purposes of determining whether an obligation is deductible for estate tax purposes, therefore, the exception is likely to be important only under the following circumstances:

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239 Leopold v. United States, 510 F.2d 617 (9th Cir. 1975). *See also*, Kosow v. Commissioner, 45 F.3d 1524 (11th Cir. 1995); Bowes v. United States, 77-2 USTC ¶ 13,212 (N.D. Ill. 1977); Chemical Bank New York Trust Co. v. United States, 249 F. Supp. 450 (S.D.N.Y. 1966); Estate of Glen v. Commissioner, 45 T.C. 323 (1966).

240 Rev. Rul. 76-113, 1976-1 C.B. 2 76

(1) The parties do not obtain a divorce within the time limits required by I.R.C. §2516. Unless a divorce occurs virtually simultaneously with the execution of the marital settlement agreement, the possibility that the divorce will not be obtained in time will always be a risk. The death of one of the parties before the divorce is obtained will usually prevent the survivor from obtaining a divorce. This would prevent the application of I.R.C. §2516.

(2) Local law permits the court to direct payments or transfers to an adult child or for the support of a minor child. Payments for this purpose are not protected by the portion of I.R.C. §2516 imported into the estate tax law.

In some cases, an obligation that would be deductible under the *Harris* decree exception would also be deductible under the rule that treats the release of support rights as consideration in money or money's worth. The *Harris* rule may permit a deduction that would otherwise be disallowed because of an inability to calculate the value of the released support rights.

f) TIMING AND AMOUNT OF DEDUCTION

Claims that are deductible under I.R.C. §2053 must be valued in order to calculate the amount of the deduction. If the obligation is one to pay a fixed amount or to transfer particular property at death or shortly after death, the valuation of the claim is generally straightforward. An obligation to pay a fixed amount should permit a deduction equal to the amount required to be paid. An obligation to transfer a particular item of property should be valued by using the normal valuation rules set forth in Treas. Reg. §20.2031.

Obligations to make future payments, particularly those that will cease on the occurrence of a particular event after the transferor spouse's death present special valuation problems.

Consider the following example:

> Example: Glenn and Hayden's Marital Settlement Agreement required Glenn's estate to pay Hayden $100,000 per year until death. The actuarial value of the right to receive $100,000 per year for Hayden's life measured on the date of Glenn's death is $1,000,000. Hayden dies six months after Glenn's death. Before death, Glenn's estate had paid $100,000. Should Glenn's estate be able to deduct the full value of its obligation to Hayden as of the date of death, or should it be limited to $100,000, the amount actually paid?

The issue is whether post-death events should be taken into account in determining the amount of the deduction. There is no clear answer to this question. The Fifth Circuit,[241] the

[241] Estate of Smith v. Commissioner, 198 F.3d 515 (5th Cir. 1999) *but see* Estate of Hagmann v. Commissioner, 60 T.C. 465, 1973 WL 2507 (1975), *aff'd per curium*, 492 F.2d 796 (5th Cir.1974).

Ninth Circuit[242], the Tenth Circuit,[243] the Eleventh Circuit,[244] and the Tax Court[245] have all supported the date of death valuation approach based on the Supreme Court's decision in *Ithaca Trust Co. v. United States*.[246] In the *Ithaca* case, the Supreme Court established the method for valuing a charitable deduction for a remainder interest in a trust when the individual who had a life interest preceding the charitable interest died before the estate tax return was filed. The court determined that the individual's death should not be taken into account in valuing the charitable remainder stating,

> The estate so far as may be is settled as of the date of the testator's death. The tax is on the act of the testator not on the receipt of the property by the legatees. Therefore the value of the thing to be taxed must be estimated as of the time when the act is done.

The First Circuit,[247] Second Circuit,[248] Eighth Circuit[249] and the Court of Claims[250] have taken the position that *Ithaca Trust* is not determinative in the context of I.R.C. §2053(a)(3).

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[242] Estate of Van Horne v. Commissioner, 720 F.2d 1114 (9th Cir. 1983), *aff'g* 78 T.C. 728 (1982), *cert denied*, 466 U.S. 980 (1984), Popstra v. United States, 680 F.2d 1248 (9th Cir.1982). Note that *Estate of Saunders v. C.I.R.* 136 T.C. 406 (2011), in a case determined under 9th Circuit law, expressed that whether or not post death events could be considered was an issue that "the [Tax] Court expressed an interest in avoiding the necessity of deciding" due to their understanding that the 9th Circuit case law was inconsistent. 136 T.C. 419-20.

[243] Estate of McMorris v. Commissioner, 243 F. 3d 1254 (10th Cir. 2001).

[244] Estate of O'Neal v. Commissioner, 258 F.3d 1265 (11th Cir. 2001).

[245] Estate of Van Horne v. Commissioner, 78 T.C. 728 (1982); Estate of Lester v. Commissioner, 57 T.C. 503 (1972); Estate of Maresi v. Commissioner, 6 T.C. 582 (1946); Estate of Shively v. Commissioner, T.C. Memo 1958-196; *but see* Estate of Kyle v. Commissioner, 94 T.C. 829 (1990) (disallowing an estate's deduction because estate won case six years after decedent's death); Estate of Hagmann v. Commissioner, 60 T.C. 465 (1975), *aff'd per curiam*, 492 F.2d 796 (5th Cir.1974) (disallowing an estate's deduction for debts which became unenforceable because the creditors did not file claim for such debts against the estate).

[246] Ithaca Trust Co. v. United States, 279 U.S. 151 (1929).

[247] Commissioner v. State Street Trust Co., 128 F.2d 618 (1st Cir. 1942).

[248] Commissioner v. Estate of Shively, 276 F.2d 372 (2d Cir. 1960), rejecting without discussing an earlier Second Circuit decision to the contrary, *Commissioner v. Maresi*, 156 F.2d 929 (2d Cir 1946).

[249] Jacobs v. Commissioner, 34 F.2d 233 (8th Cir. 1929); Estate of Sachs v. Commissioner, 856 F.2d 1158 (8th Cir. 1988).

[250] Estate of Chesterton v. United States, 551 F.2d 278, *cert. denied*, 434 U.S. 835 (1977). This case dealt with the obligation of a decedent's estate to make annual payments to his former

They have concluded that I.R.C. §2053(a)(3) allows a deduction only for claims allowed by state law. In the view of these courts, when state law would take such post-death events into account, the I.R.C. §2053(a)(3) deduction must also reflect post-death events.

Another issue that arises in connection with post-death payments is the proper valuation approach. It is unclear from the code and the regulations whether an obligation to make payments in the future should be valued as an annuity or as a series of notes. Longstanding judicial and administrative practices seem to require the use of the regulations under I.R.C. §7520 to value obligations that are to be satisfied with periodic future payments.[251] But I.R.C. §7520 itself does not purport to dictate how obligations to make payments should be valued under I.R.C. §2053. The two different valuation approaches may result in substantially different values. The lower interest rates generally applicable to the valuation of a loan rather than a stream of annuity payments will usually produce a higher value for the loan.

Some marital settlement agreements provide for future payments of alimony until the supported spouse dies or is remarried. Traditionally, the IRS has taken the position that the factor to be used to reflect the possibility of a spouse's remarriage should be determined under a table known as the American Remarriage Table.[252]

Regulations, which became effective for estates of decedents who die after October 19, 2009, have seemingly resolved this issue. The regulations take the position that claims against the estate are not deductible unless actually paid or unless the unpaid amount is ascertainable with reasonable certainty and will be paid.[253] In determining whether an amount to be paid is ascertainable, the IRS is to take into account post-death events, but only if such events occur prior to the expiration of the statute of limitations on assessment prescribed in I.R.C. §6501 or if a determination is being made in connection with a claim for refund, within the time prescribed in I.R.C. §6511(a).[254]

Recurring payments that the estate is obligated to make will be deemed to satisfy the "ascertainable with reasonable certainty" requirement even if the obligation is to cease on the death or remarriage of the claimant.[255] The amount of the claim is to be determined according to actuarial principles, using factors set forth in the transfer tax regulations or otherwise provided by the IRS. The transfer tax regulations provide factors for determining the probability of the

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spouse until her death or remarriage. The former spouse remarried after 9 months after the decedent's death, prior to the date the estate filed the tax return. The estate's deduction was limited to the amount actually paid to the former spouse.

251 *See e.g.*, Estate of Lester v. Commissioner, 57 T.C. 503 (1972).

252 Rev. Rul. 71-67, 1971-1C.B. 271.

253 Treas. Reg. §25.2553-4(a)(1).

254 Treas. Reg. §25.2553-1(d)(2).

255 Treas. Reg. §25.2553-4(d)(2).

claimant's death but not as to the probability of remarriage. Presumably the IRS will have to provide, on a case by case basis, the appropriate factor for the probability of remarriage.

There is an important difference between this new regulation as it applies to post-death support payments or other payments that are to terminate on the death or remarriage of a former spouse and the law as it was commonly understood prior to the effective date of the regulation. Prior law limited the amount of such a deduction to the present value, measured as of the date of death, of the recurring stream of payments. Under the regulation, no present value discounting is required. The preamble to the final regulations states that the IRS will give further consideration to the issue of the appropriate use of present value calculations to determine the amount of a deduction for noncontingent recurring payments.

g) THE MARITAL DEDUCTION

If the property that is to be transferred to the surviving party under a marital settlement agreement is eligible for I.R.C. §2056's marital deduction, it will be protected completely from the estate tax. Eligibility requires essentially the same elements that are required for eligibility for the gift tax marital deduction as discussed above. They are as follows:

(1) The parties must be married to each other at the death of the transferor spouse.[256]

(2) The transferee spouse must be a citizen of the United States unless the property passes to a qualified domestic trust.[257]

(3) The property interest transferred must not be a nondeductible interest in property.

The estate tax marital deduction generally will not be available to protect property that is to pass at the death of the transferor spouse, since, unless the transferor spouse dies unexpectedly, the parties will usually be divorced when the transferor spouse dies. Accordingly, the marital deduction should not be relied upon as a planning tool. Nevertheless, in those unusual cases where the parties remain married to each other after the execution of a marital settlement agreement, the marital deduction may provide the basis for deductibility of amounts due at the death of the first spouse to die.

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256 I.R.C. §2056(a).

257 I.R.C. §§2056(d) and 2056A.

3. INCLUDIBILITY OF TRANSFERRED PROPERTY IN THE GROSS ESTATE OF THE TRANSFEROR SPOUSE

a) CODE SECS. 2035 THROUGH 2038 AND 2042

(1) IN GENERAL

If an individual transfers property pursuant to a marital settlement agreement and retains or possesses at death the kind of power over or interest in the property that is described in Code Secs. 2036, 2037, or 2038, or if the transferor releases any of these retained powers or interests within three years of death as provided in I.R.C. §2035, the transferred property may be included in the transferor's gross estate. The following two kinds of transfers sometimes required by marital settlement agreements may be vulnerable to one of these provisions:

(a) A transfer to a trust for the benefit of the transferee spouse and children that can be amended or revoked by the transferor, usually with the consent of the transferee spouse.

(b) A transfer of property to the transferee spouse in which the transferor spouse has retained the right to possession of or income from for some period of time that does not end before death. This would include, for example, a trust that was created to provide support payments to a former spouse when the transferor spouse continues to be liable for the support payments if payments from the trust are insufficient or a transferred life insurance policy if an amount equal to the policy proceeds would be an obligation of the transferor spouse's estate if the transferor failed to pay the premiums necessary to keep the policy in force.[258]

Marital settlement agreements often require one spouse to maintain a life insurance policy for the benefit of the other spouse or a trust of which the other spouse is a beneficiary. The insured spouse often retains the right to receive the proceeds of the policy if the beneficiary spouse remarries or dies before the death of the insured spouse. The possibility that the proceeds will be paid to the insured or the estate is a reversionary interest that will cause the inclusion of the proceeds in the insured's gross estate under I.R.C. §2042(2).

(2) EXCEPTIONS

a) IN GENERAL

Each of Code sections 2035 through 2038 contains a clause excepting a "bona fide sale for an adequate and full consideration in money or money's worth" from the general inclusion rule. If the estate can show the receipt of such consideration, the transferred property will be excluded from the decedent's gross estate despite the extent of the decedent's interest in or control over it. If the decedent received some consideration in money or money's worth but not

[258] *See e.g.*, P.L.R. 9235032 (May 29, 1992).

adequate and full consideration, the amount of the consideration received offsets the value of the property to be included under I.R.C. §§2035 through 2038.[259]

b) APPLICATION OF THE "BONA FIDE SALE" EXCEPTION AND THE EXCLUSION FOR CONSIDERATION RECEIVED

Neither the exception nor the exclusion will be available unless the consideration received by the transferor spouse was consideration in money or money's worth. The kind of consideration usually furnished in connection with a marital settlement agreement is the relinquishment of some kind of marital right. Section 2043(b)(1) generally provides that the relinquishment of marital rights does not constitute consideration in money or money's worth. Nevertheless, one of the following four rules under which the obligations imposed by such agreements are treated as made for adequate consideration in money or money's worth or are excepted from the consideration requirement may apply:

(i) The deemed consideration rule of I.R.C. §2516;

(ii) The treatment of the relinquishment of support rights as consideration in money or money's worth;

(iii) The treatment of the relinquishment of other immediately enforceable rights arising upon the dissolution of a marriage as consideration in money or money's worth; and

(iv) The exception to the requirement of consideration for transfers based on a decree, rather than on an agreement.

(3) I.R.C. §2516

The requirements for the application of I.R.C. §2516 are discussed above. I.R.C. §2043(b)(2), discussed above, does not import I.R.C. §2516 into the estate tax for any purpose other than I.R.C. §2053. Thus, it cannot be relied upon to satisfy the bona fide sale's and I.R.C. §2043(a)'s requirement for consideration in money or money's worth.

I.R.C. §2516 will apply for this purpose only if the courts decide to import it into the estate tax. As discussed above, there has been judicial disagreement on this issue. Since Congress has recently considered the issue and has provided only limited applicability, it is unlikely that the courts will expand its applicability beyond I.R.C. §2053(c)(3). Accordingly, I.R.C. §2516 should not be relied upon to prevent or to limit inclusion under I.R.C. §§2035 through 2036.

[259] I.R.C. §2043(a).

(4) TRANSFERS IN EXCHANGE FOR RELEASE OF SUPPORT RIGHTS

As discussed more fully above, the relinquishment of support rights is treated as consideration in money or money's worth for purposes of I.R.C. §2053(a)(3). This principle also applies to the bona fide sale rule and to I.R.C. §2043(a).[260]

(5) TRANSFERS IN EXCHANGE FOR RELEASE OF IMMEDIATELY ENFORCEABLE RIGHTS IN PROPERTY

The release of presently enforceable rights in a spouse's property may be treated as consideration in money or money's worth as discussed more fully above.

(6) TRANSFERS PURSUANT TO DECREE

If the requirements of the Harris decree rule, as described above, are met, transfers made pursuant to the decree are deemed to have been made for adequate and full consideration in money or money's worth for purposes of the bona fide sale rule and I.R.C. §2043(a).[261]

(7) THE MARITAL DEDUCTION

If the transferred property is in a form eligible for I.R.C. §2056's marital deduction, it will be protected completely from the estate tax if the spouses are still married to each other at the time of the death of the transferor spouse. In most cases, however, the parties will be divorced before the death of the transferor spouse.

(8) TRANSFERS FOR LESS THAN FULL CONSIDERATION

When property includible in a decedent's gross estate under Code Secs. 2035 through 2038 has been transferred in exchange for some consideration in money or money's worth, but less than full consideration, the proper way to measure the amount to be included is unclear.

I.R.C. §2043(a) requires the inclusion of (1) the excess of the value of the transferred property at the time of death over (2) the value of the consideration received measured at the time of receipt.[262] This mismatching of valuation dates has the effect of shifting all of the post-transfer appreciation to the included amount and reducing the included amount by all post-transfer depreciation.

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260 *See e.g.*, Commissioner v. Nelson, 396 F.2d 519 (2d Cir. 1968); Estate of Davis v. Commissioner, 51 T.C. 269 (1968), *rev'd on other grounds*, 440 F.2d 896 (3d Cir. 1971).

261 *See e.g.*, Estate of Robinson, 63 T.C. 717 (1975). Estate of O'Nan v. Commissioner, 47 T.C. 648 (1967).

262 Estate of Davis v. Commissioner, 51 T.C. 269 (1968).

The Tax Court has suggested an alternate approach referred to as the "fragmented approach." This method requires an initial division of the property interests created by the trust and an appropriate assignment of the consideration received between the interests. If the transferor received full consideration for one of the interests, the value of that interest will be excluded from the transferor's estate under I.R.C. §2043(a) regardless of its value on the date of the transferor's death. The other interest will be included to the extent its value on the date of death exceeds the consideration received for its creation.[263]

c) OBSERVATION

There are difficult and unanswered questions that arise in connection with the transfer of property under a marital settlement agreement if the transferor retains certain interests in or powers over the property. In contrast, the rules that permit a deduction under I.R.C. §2053(a)(3) for post-death transfers, particularly since the importation of I.R.C. §2516 into I.R.C. §2053(a)(3) by I.R.C. §2043(b)(2), provide greater certainty for protection of transfers from the estate tax.

Where possible, obligations under marital settlement agreements should be structured so that a deduction under I.R.C. §2053(a)(3) is available for property interests to be enjoyed by the transferee spouse after the transferor's death.

For example, suppose the transferee spouse has asked for the creation of a trust. To maintain flexibility the transferee would like the trust to be amendable with the consent of the transferor spouse. To avoid possible inclusion of the trust in the gross estate of the transferor, the marital settlement agreement could provide: (1) that the trust for the transferee would terminate if the transferor died before the transferee, (2) that the trust property would be returned to transferor's estate, (3) that the transferor's will would create a trust to be funded with an amount equal to the value of the terminated trust's property on the date of his death with terms similar to the terminated trust, and (4) that all of these terms are modifiable by the spouses. The actuarial value of the transferee's interest should be deductible under I.R.C. §2053(a)(3) since, under I.R.C. §2043(b)(2), the transferor will be deemed to have received full consideration in money or money's worth for the promise to create it.

4. INCLUDIBILITY OF TRANSFERRED PROPERTY IN THE GROSS ESTATE OF THE TRANSFEREE SPOUSE

a) IN GENERAL

A transfer to a spouse pursuant to a marital settlement agreement might result in the inclusion of property in the transferee spouse's gross estate for one of the two following reasons:

(A) The transfer was to a trust that qualified for the marital deduction; or

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[263] Estate of Nelson v. Commissioner, 47 T.C. 279 (1966), rev'd, 396 F.2d 519 (2d Cir. 1968).

(B) The transferee spouse is treated as the real transferor of the trust.

If a marital settlement agreement requires a transfer to a trust eligible for the marital deduction, the trust property will be included in the transferee spouse's gross estate either because the remainder is payable to the transferee's estate (the so-called "estate trust"), the transferee has a general power of appointment over the trust within the meaning of I.R.C. §2041, or the interest is included under I.R.C. §2044 because the trust is a qualified terminable interest property trust.

If the trust is to be included in the transferee spouse's gross estate, the transferee's will ought to reflect the intentions with respect to the sharing of the burden of estate taxes between the estate and the trust. In the case of a trust included under I.R.C. §2044, it may not be possible to shift the entire burden of the estate taxes caused by inclusion unless the state has a statute similar to I.R.C. §2207A.

The IRS takes the position that a transferee spouse who does not receive full value for support rights has made a gift either to the transferor spouse or to a third party such as the couple's children, if there was a bargain for such a benefit.[264] If such a spouse is treated as having made a gift for gift tax purposes, the spouse could be treated as having made a donative transfer for estate tax purposes as well.

In view of the many areas of uncertainty as to the vulnerability of post-death transfers and property interests to the estate tax, drafters of marital settlement agreements should approach these issues with caution. If any provision creates the possibility of inclusion in the gross estate of one of the spouses, the marital settlement agreement should make provision for the payment of estate taxes as the parties intend. For example, if a transferee spouse is the beneficiary of a trust that might be included in the spouse's gross estate if the spouse dies before the transferee, the marital settlement agreement should allocate the responsibility for the payment of any estate taxes.

D. DIVORCE RELATED ESTATE FREEZES

1. 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 Code Secs. 2701 and 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, or other intended beneficiaries.

One of the most common types of such transfers is discussed above in connection with I.R.C. §2516 - a transfer of a term interest and a remainder interest in a trust. Section 2702 is

[264] Rev. Rul. 77-314, 1977-2 C.B. 349.

potentially applicable to this type of transfer. Another common type of freeze transaction involves the transfer of common stock and preferred stock in the same corporation. Section 2701 makes these types of transfers difficult to accomplish.

Section 2701 applies generally to the transfer of a junior interest in an entity, such as common stock in a corporation, to a spouse or to a child or more remote descendant, if immediately after the transfer, the transferor or an applicable family member, such as a spouse,[265] holds a senior interest, such as preferred stock.[266]

2. AVOIDING I.R.C. §2702

a) IN GENERAL

I.R.C. §2702 potentially applies to a transfer of an interest in trust or a transfer of property with respect to which there are one or more term interests to a family member if the transferor or any applicable family member retains an interest in the trust.[267] If, for example, a transferor transfers property to a trust the terms of which provide that the transferor is to receive all trust income for a period of years or for life with the remainder to pass to certain children, the transfer will be subject to I.R.C. §2702.

When I.R.C. §2702 applies to a transfer, it values the transferred interest by treating the value of any retained interest has having a zero value.

The term "retained" means "held by the same individual both before and after the transfer, and in the case of the transferor, any interest held by him or her immediately after the transfer."[268] As a result of the way in which the term "retained" is defined, a transferor who transfers property to a trust to pay income for a period of years or for life to a spouse with the remainder to pass to the transferor's children will not be subject to I.R.C. §2702 even if the transfer of the income interest is protected from gift tax by I.R.C. §2516.[269]

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[265] I.R.C. §2701(e)(2) defines "applicable family member" in the same way as for purposes of I.R.C. §2702.

[266] Similar rules apply to the transfer of partnership interests. *See* I.R.C. §2701(a)(1).

[267] For purposes of I.R.C. §2702, the transferor's spouse, ancestors and spouses of ancestors, issue and spouses of issue and siblings and spouses of siblings are family members and the transferor's spouse, ancestors and spouses of ancestors are applicable family members. There is an exception to the application of I.R.C. §2702 in the case of a transfer of an interest in a trust to a spouse that is protected by the application of I.R.C. §2516 if the only remaining interests in the trust are retained by the other spouse. Treas. Reg. §25.2702-1(c)(7).

[268] Treas. Reg. §25.2702-2(a)(3).

[269] P.L.R. 200408015 (February 20, 2003).

The transferee spouse, however, may be subject to I.R.C. §2702 because of the application of the so-called "joint purchase rule." This rule states that if two or more members of the same family acquire interests in any property as to which there are one or more term interests in the same transaction or in a series of transactions, the person who acquires the term interest will be treated as having acquired the entire property and then as having transferred the remainder interest to the family members who actually acquire the remainder interests.[270]

> Example –Jean, in a transaction protected by I.R.C. §2516, transfers $1,000,000 to a trust to pay spouse Kelly income for life, remainder to certain children. The application of I.R.C. §2516 results in the treatment of the transfer of the income interest to Kelly as having been made for a full and adequate consideration in money or money's worth. Kelly has now acquired, within the meaning of the joint purchase rule, a term interest in property in the same transaction in which the children have acquired the remainder interest. As a result, Kelly will be treated as having gifted the entire $1,000,000 to the children with an offset for the value of the taxable gift to the children made by Jean when Jean made the actual transfer to the trust. If the actuarial value of Kelly's income interest were $700,000 and the actuarial value of the children's interest were $300,000, Kelly would be treated as having made a taxable gift to the children of $700,000.

b) CAUSING THE TRANSFEREE SPOUSE'S INTEREST TO BE TREATED AS 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.[271]

> Example – The trust described in the preceding example gave Kelly the power to determine how the children would share in the remainder interest of the trust. As a result, Kelly's deemed transfer is wholly incomplete for gift tax purposes. It is incomplete as to the income interest because the income interest is Kelly's. It is incomplete as to the remainder interest because Kelly controls who will receive it.[272]

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 I.R.C. §2702. Because I.R.C. §2702 does not apply for estate tax purposes, the trust property should not be included in Kelly's gross estate for estate tax purposes if Kelly dies possessing this power.

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[270] I.R.C. §2702(c)(2). The facts described in P.L.R. 200408015, referred to in the preceding footnote, presented this joint purchase issue. Because no ruling was requested as to the application of I.R.C. §2702 to the transferee spouse, the IRS did not discuss it.

[271] Treas. Reg. §25.2702-1(c)(1)

[272] *See* Treas. Reg. §25.2511-2(c).

c) DELAYING THE TRANSFER

I.R.C. §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.[273] The following is an example of a post-divorce transformation of an interspousal transfer into an estate freeze:

> Example - Logan, pursuant to the terms of a marital settlement agreement entered into with spouse, Morgan, transferred $100,000 in trust to pay Morgan income for life. At Morgan's death, the trustees were to return the principal to Logan. Logan's transfer to the trust was protected from gift tax by I.R.C. §2516. The actuarial value of Morgan's interest in the trust was $90,000. Two years after Logan's divorce from Morgan, Logan transferred his remainder interest, then worth $11,000, to children, Peyton and Reed. Section 2702 does not apply to Logan's transfer to Morgan since it was protected from the gift tax by I.R.C. §2516 and because only Logan and Morgan had interests in the trust after the transfer to it. Since the later transfer to Peyton and Reed was made after the divorce when Morgan was no longer related to Logan, I.R.C. §2702 does not apply to Logan's transfer. Section 2702 will not apply to Morgan because Morgan's acquisition of an income interest was not part of a series of transactions in which Peyton and Reed acquired an interest.

d) 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 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.

I.R.C. §2702's zero valuation rule does not apply to a trust in which the transferor retains a qualified interest.[274] The term "qualified interest" includes an interest "which consists of the right to receive fixed amounts payable not less frequently than annually."[275] The regulations

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[273] I.R.C. §2702(c)(2).

[274] I.R.C. §2702(a)(2).

[275] 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 since they do not present particularly attractive methods for structuring an estate freeze.

impose several additional requirements. The annuity amount must be paid at least once each year.[276] The annuity amount payable each year must be fixed at the time the trust is created.[277] Although the trustees may be permitted to pay trust income in excess of the required annuity to the annuitant/beneficiary,[278] 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.[279] The trust instrument must prohibit payment to any person other than the annuitant/beneficiary until the expiration of the annuity term,[280] prepayment of the annuitant/beneficiary's term interest,[281] and additions to the trust after its initial funding.[282] The term may be for a fixed period of years, for the life of the annuitant/beneficiary or for the shorter of the two.[283] If all of these requirements are met, the value of the retained annuity will be determined using the normal valuation rules described in §7520.

A qualified annuity trust may be a viable means of structuring a martial property settlement that both satisfies the transferee spouse's desire for a constant income and the transferor's estate freezing ambitions.

> <u>Example</u> - Sam's 50 year old spouse Taylor has demanded alimony of $50,000 per year for 15 years or until death. Sam is willing to provide Taylor with this level of support only if Taylor is willing to relinquish any personal claim against Sam and look only to a trust for payment. Sam has offered to fund this trust with $625,000. Taylor's investment advisors have advised that this amount should be sufficient to fund a 15 year, $50,000 annuity. Sam wants the remainder interest in the trust to pass to their child Winter at the end of the 15 year term.

If all the requirements set forth in the regulations are met, Taylor's interest in the trust will be a qualified annuity interest. If the marital settlement agreement is protected by I.R.C. §2516, Sam's transfer to the trust will be subject to gift tax only to the extent of the excess of

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[276] Treas. Reg. §25.2702-3(b)(1)(i).

[277] Treas. Reg. §25.2702-3(b)(1)(ii).

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

[279] Treas. Reg. §25.2702-3(b)(1)(ii).

[280] Treas. Reg. §25.2702-3(d)(3).

[281] Treas. Reg. §25.2702-3(d)(5).

[282] Treas. Reg. §25.2702-3(b)(5).

[283] Treas. Reg. §25.2702-3(d)(4).

$625,000 over the value of Taylor's qualified annuity interest. Assuming a 2.2% discount rate, the value of Taylor's interest will be $604,080.[284] Sam's taxable gift will be $20,920.

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

If the trustees invest the trust fund to achieve a 6% return, the trust will be worth $334,050 when it passes to Winter. If the trustees are able to invest to secure a higher return, the trust will then be worth more. In either event, the excess will pass to Winter free of further gift tax. Sam's estate freezing objective will have been accomplished.

If Sam dies before the end of the annuity term, no portion of the trust will be included in the gross estate because Sam retained neither an interest in nor control over the trust. If Taylor dies before the end of the 15 year term no portion of the trust should be included in the gross estate because Taylor made no transfer to it. The IRS may challenge the second result on the grounds that Taylor is the real transferor of the trust because of the relinquishment of marital rights. There is some support for such a challenge in the *Gradow* decision.[285] 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.[286] *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.

e) USING A QUALIFIED PERSONAL RESIDENCE TRUST

In some cases, one of the spouses will wish 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.

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284 This is the actuarial value of the right to receive a payment of $50,000 per year for the shorter of 15 years or the life of a 50 year old individual.

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

286 In both *Estate of D'Ambrosio v. Commissioner*, 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 P.L.R. 200408015 (February 20, 2003), the IRS concluded that a trust created to pay an annuity to a former spouse of the settlor would not be included in her gross estate at her death because the "[w]ife will have no interest that she can transmit to others, upon her death."

Suppose, for example, that one spouse agrees to let the other retain the marital residence for a period of years, after which the residence is to be sold, and the proceeds divided between 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. 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 - Ainsley and Blaine own their marital residence jointly. Their marital settlement agreement gives Ainsley the right to live in the marital residence for life. At that time, the residence is to be sold. Ainsley's estate is to receive one-half of the proceeds. Blaine would like the other one-half to be paid to their children. The residence is worth $500,000. The I.R.C. §7520 rate is 4.8%. Ainsley is 55 years old. Blaine's transfer of the right to use one-half of the residence to Ainsley for life will be protected from gift tax by I.R.C. §2516. The transfer of the future interest in one-half of the residence to the 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 Ainsley the transferor of Blaine'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 qualified personal residence trust, I.R.C. §2702 can be avoided.

To qualify for the qualified personal residence trust exception to I.R.C. §2702, the trust instrument must meet several governing instrument requirements described in the regulations.[287] 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.[288] With a few exceptions, the trust instrument must prohibit the trust from holding any asset other than the residence.[289] 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.[290] 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 QPRT[291] and, within 30 days of the trust's 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.[292]

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287 Treas. Reg. §25.2702-5.

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

289 Treas. Reg. §25.2702-5(c)(5)(i).

290 Treas. Reg. §25.2702-5(c)(6).

291 Treas. Reg. §25.2702-5(c)(7).

292 Treas. Reg. §25.2702-5(c)(8)(i).

The regulations state that the trust instrument can direct either of these results or leave the decision to the discretion of the trustee.

3. AVOIDING I.R.C. §2701

I.R.C. §2701 potentially applies to a transfer of a junior equity interest in an entity such as a partnership or corporation to a family member if the transferor or an applicable family member holds a senior equity interest in that entity immediately after the transfer. [293] When I.R.C. §2701 applies to a transfer, it values the transferred interest by including the value of the retained senior interests except those that consist of certain nondiscretionary rights such as the right to a cumulative annual dividend.

> Example – Carroll owns all of the preferred and common stock of Bookworks, Inc. The preferred stock has a noncumulative dividend. The aggregate fair market value of all of the shares of Bookworks, Inc. is $1,000,000. She Carroll transfers all preferred stock to spouse Dale and all common stock to their child Elliott. The transfer to Elliott is subject to I.R.C. §2701. As a result, Carroll will be treated as having made a gift of $1,000,000 to Elliott.

Because I.R.C. §2701 applies only if an applicable family member holds a senior equity interest after a transfer of a junior equity interest, transfers that are made in connection with a divorce can easily avoid it. All that is required is a delay in the transfer of the junior equity interest until after the spouses have divorced. After the divorce the former spouse will no longer be either an applicable family member or a family member.

In some states it is difficult for one spouse to obtain a divorce without the consent of the other spouse until a marital settlement agreement has been negotiated. The spouse who expects to be the transferee spouse generally is unwilling to consent to a divorce until he or she is sure of the financial terms of the dissolution of the marriage. The technique of delay is likely to be practical only in states where one spouse can obtain a divorce without the consent of the other and before a settlement has been reached.

> Example – Carroll, the transferor described in the preceding example, obtains a divorce from Dale. After her divorce, Carroll and Dale negotiate a marital settlement agreement. The agreement required Carroll to transfer all preferred stock in Bookworks, Inc. to Dale and all of the common stock to their child Elliott. The transfer to Dale is not subject to I.R.C. §2701, both because Dale is no longer related to Carroll and because the transfer was a transfer of a senior equity interest. The later transfer to Elliott escapes I.R.C. §2701 because immediately after the transfer only Dale, who is no longer related to Carroll, will hold the senior equity interest.

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[293] For purposes of I.R.C. §2701, the transferor's spouse, issue and spouses of issue are family members and the transferor's spouse, ancestors and spouses of ancestors are applicable family members.

If the transfer to Elliott is not required by the marital settlement agreement, the same estate planning result can be achieved even if the transfer to Dale is bargained for or effected prior to the divorce. The transfer to Dale will not be subject to I.R.C. §2701 because it is a transfer of a senior equity interest, not a junior equity interest. If the transfer to Elliott is delayed until after the divorce, it will not be subject to I.R.C. §2701 because Dale is no longer Carroll's spouse, and, therefore, not an applicable family member.[294]

V. TAX CONSEQUENCES OF PAYMENTS UNDER PREMARITAL AGREEMENTS

A. IN GENERAL

The Code provides specific protections and advantages to payments made in connection with divorce or separation instruments or pursuant to marital settlement agreements. Each of these provisions is discussed below. None of them is effective to protect payments made under premarital agreements.

B. TAXABLE AND DEDUCTIBLE POST DIVORCE OR POST SEPARATION SUPPORT PAYMENTS

Premarital agreements often require a stream of payments from one party to the other in the event of a divorce in order to provide a temporary or permanent source of support to the receiving party.

I.R.C. §215 permits a taxpayer who makes certain cash payments, such as alimony or maintenance, to a spouse or former spouse to deduct those payments from gross income. Section 71 requires the spouse who receives the payments to include them in gross income. In order to be deductible, a number of requirements described in I.R.C. §71 must be satisfied. One of these requirements is a requirement that the payments must be made under a divorce or separation instrument. The term "divorce or separation instrument" is defined as a decree of divorce or separate maintenance, a written separation agreement, or a decree requiring a spouse to make payments for the support of the transferee spouse. Payments made under a premarital agreement will generally not satisfy this requirement.

There is a possibility that the IRS could argue that the payments made under a premarital agreement are income to the receiving spouse under I.R.C. §61. This section requires gross inclusion in gross income of income from all sources. A good argument could be made, however, based on the Supreme Court's decision in *Gould v. Gould*,[295] that support payments required to be made under a premarital agreement by an individual to a spouse or former spouse as support payments should not be treated as income. In *Gould*, which predated §71, the Supreme Court concluded that because alimony payments are made in lieu of ongoing spousal support and represent a portion of the payor spouse's assets to which the payee spouse is equitable entitled, they should not be subject to income tax. Arguably, the support payments

[294] I.R.C. §2701(e)(2).

[295] 245 U.S. 151 (1917). *See also* Douglas v. Wilcuts, 296 U.S. 1 (1935).

required to be made under a premarital agreement are made in lieu of the support payments that the state would otherwise require to be made.[296]

C. INCOME TAX TREATMENT OF PROPERTY SETTLEMENTS MADE ON DIVORCE PURSUANT TO PREMARITAL AGREEMENTS

Some premarital agreements require the transfer of certain properties from one party to the other in the event of a divorce or separation. The income tax treatment of these transfers is discussed in Part II of this outline. If the property required to be transferred is appreciated or if a required cash payment is satisfied with appreciated property, there is a risk that the transfer will be treated as a tax recognition event under the rationale of the Supreme Court's decision in *United States v. Davis*.[297] When a transfer of property is treated as a tax recognition event, the transferring taxpayer will generally pay income tax on the gain, and the receiving taxpayer will receive a tax basis equal to the fair market value on the date of transfer.

The enactment of I.R.C. §1041 in 1984 was intended to avoid this result in most cases. Section 1041 provides that transfers of property between spouses are treated as gifts for income tax purposes. The rule applies to former spouses, however, only if the transfer is incident to their divorce. A transfer is treated as incident to a divorce if it occurs not more than one year after the divorce regardless of the reason for the transfer. If however, it occurs more than one year after the divorce, I.R.C. §1041 will apply only if the transfer is related to the cessation of the marriage. A transfer is treated as related to the cessation of the marriage for purposes of I.R.C. §1041 only if the transfer is made pursuant to a divorce or separation instrument and the transfer takes place not more than six years after the termination of the marriage. Transfers that take place pursuant to the terms of a premarital agreement will not satisfy the "related to the cessation of the marriage requirement."

D. GIFT TAX TREATMENT OF PROPERTY SETTLEMENTS MADE PURSUANT TO PREMARITAL AGREEMENTS

The gift tax treatment of transfers pursuant to marital settlement agreements that are negotiated in connection with a divorce or separation are discussed in Part IV. B. of this outline. If a transfer between spouses is made under a premarital agreement rather than a marital settlement agreement, the only way of assuring that the transfer will not be subject to the gift tax is to make sure that the transfer takes place before the divorce and that the form of the transfer is one that is eligible for the gift tax marital deduction.[298]

The deemed consideration rule of I.R.C. §2516 will normally not apply to payments made under a premarital agreement because it requires a written agreement relating to marital or property rights that is entered into within a three year period beginning two years before and

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[296] *See also*, Taylor v. Commissioner, 55 T.C. 1134 (1971); GCM 37571 (6/15/1978).

[297] 370 U.S. 65 (1962).

[298] The gift tax marital deduction will not be available to protect transfers to a spouse who is not a U.S. citizen. I.R.C. §2523(i).

ending one year after the spouses are divorced. As a result, a premarital agreement will be protected by I.R.C. §2516 only if the spouses are divorced within two years of its execution.

The "release of support rights" or the "release of other immediately enforceable rights" are unlikely to serve as consideration for a transfer made pursuant to a premarital agreement if the effect of the agreement was to prevent the creation of such rights when the parties married. Similarly, the *Harris* decree rule is unlikely to apply because the property transfer will be made pursuant to the premarital agreement rather than the court decree.

E. ESTATE TAX TREATMENT OF POST-DEATH TRANSFERS MADE PURSUANT TO PREMARITAL AGREEMENTS

The estate tax treatment of certain lifetime and post death transfers pursuant to marital settlement agreements that are negotiated in connection with a divorce or separation are discussed in Part IV. C. of this outline. If a property transfer during a transferor spouse's lifetime that is required to be included in the gross estate is made pursuant to a premarital agreement rather than a marital settlement agreement, the only way of achieving estate tax protection is to structure the transfer in a manner that satisfies the marital deduction and to remain married until death. Similarly, if a post-death payment is required to be made from the estate of one spouse to the surviving spouse, the only protection available is the estate tax marital deduction.[299]

The deemed consideration rule of I.R.C. §2516, as imported into the estate tax by I.R.C. §2043(b), will normally not be applicable because it requires a written agreement relating to marital or property rights that is entered into within a three year period beginning two years before and ending one year after the spouses are divorced. As a result, a premarital agreement will be protected by I.R.C. §2516 only if the spouses are divorced within two years of its execution.

As is the case with the gift tax, the "release of support rights" or the "release of other immediately enforceable rights" are unlikely to serve as consideration for a transfer made pursuant to a premarital agreement if the effect of the agreement was to prevent the creation of such rights when the parties married. Similarly, the *Harris* decree rule is unlikely to apply because the property transfer will be made pursuant to the premarital agreement rather than the court decree.

F. INCORPORATING THE TERMS OF A PREMARITAL AGREEMENT IN A MARITAL SETTLEMENT AGREEMENT OR DECREE

Each of Code §§ 71, 215, 1041, and 2516 requires similar documents in order to access the tax treatment afforded by the sections. Sections 71 and 215 require a divorce or separation instrument. Section 1041 requires a divorce or separation instrument if a property transfer takes

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[299] The estate tax marital deduction will be available to protect transfers to a spouse who is not a U.S. citizen only if the transfer is made to a qualified domestic trust within the meaning of I.R.C. §2056A or if, in the case of a payment made directly to the surviving spouse, the surviving spouse transfers the property to a qualified domestic trust before the estate tax return is filed. I.R.C. §2056(d).

place more than one year after the divorce. Section 2516 requires a written agreement relating to marital or property rights that is entered into at a time near the divorce. And sections 2053 (a)(3) and (4) require a written agreement that satisfies I.R.C. §2516, a decree, or a relinquishment of support rights or other presently enforceable rights. As discussed above, a premarital agreement is unlikely to satisfy any of these requirements.

The best method of assuring that the spouse who is required to make transfers pursuant to a premarital agreement will be able to claim the benefits of these sections is to include a provision in the premarital agreement that requires, as a precondition for any spousal support payment intended to be treated as taxable alimony and as a precondition for any property transfer that is to be made after a divorce that the requirement to make the payments or other transfers be incorporated into a marital settlement agreement.

For example, a premarital agreement requiring taxable support payments could include a provision similar to the following:

> We understand that if the monthly support payments that section ___ of this agreement requires Spouse 1 to make to Spouse 2 in the event of the occurrence of an Event of Marital Discord are not made under a divorce or separation instrument, the payments will not be includable in the gross income of Spouse 2 and will not be deductible by Spouse 1 for income tax purposes. In order to assure that these payments will receive the income tax treatment we have agreed to, we agree that Spouse 1 shall have no obligation to begin monthly payments to Spouse 2 until we sign a separation agreement that incorporates all of the obligations we will owe to each other under this Agreement in the event of the occurrence of an Event of Marital Discord ("our Marital Discord Obligations"), including the obligation of Spouse 1 to make these payments to Spouse 2 or until Spouse 1's obligation to make these payments is incorporated in a court order. Each of us agrees to sign a separation agreement that incorporates all of our Marital Discord Obligations promptly after the occurrence of an Event of Marital Discord if requested to do so by the other.[300]

The regulations issued under the prior version of I.R.C. §71 contain an example that supports the validity of this approach. Former I.R.C. §71 required inclusion of certain support payments in the gross income of the recipient spouse if the payments were made pursuant to a decree of divorce or separate maintenance, pursuant to a separation agreement, or pursuant to a decree for support. The spouses in the example in the regulations had entered into a premarital agreement that required one spouse to make monthly payments to the other for support. The example concludes that these payments would not be included in the gross income of the transferee spouse under I.R.C. §71 because they would not be made under a separation agreement or a divorce decree. The regulation observes that inclusion would have been required if the parties' written separation agreement had incorporated the requirement to make these payments, if the divorce decree contained a reference to the premarital agreement or if the parties

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[300] For a similar form, *see* LINDA J. RAVDIN, PREMARITAL AGREEMENTS: DRAFTING AND NEGOTIATION (American Bar Association 2011) at 265.

had referred to it in a written instrument incident to the divorce status.[301] The regulations under the present version of I.R.C. §71 confirm that the term "divorce or separation instruments" for purposes of the new law include the instruments described in old I.R.C. §71.[302]

A premarital agreement requiring any post-divorce or post-death transfers could include a provision similar to the following:

> We understand that if Spouse 1 makes the transfer of property to Spouse 2 that is required to be made under section ___ of this agreement after our divorce, Spouse 1 could be treated for federal gift tax purposes as having made a taxable gift to Spouse 2 and, for federal income tax purposes, as having made a taxable sale of the transferred property. Similarly, we understand that if the estate of Spouse 1 makes the post-death payment Spouse 1's estate is required to make to Spouse 2 under section ___ of this agreement and if we are no longer married when Spouse 1 dies, the estate of Spouse 1 may not be able to deduct the amount of the obligation from the gross estate for federal estate tax purposes. In order to protect the required transfers from income tax and from gift tax and to secure an estate tax deduction for them in the event payments are made after the death of Spouse 1, we agree that the obligation of Spouse 1 to make all of the payments and other transfers that Spouse 1 is required to make to Spouse 2 in the event of the occurrence of an Event of Marital Discord shall be incorporated in a written agreement between us relative to our martial rights entered into during the three year period that begins two years before our divorce and ends one year after our divorce or in our decree of divorce.

The regulations issued under I.R.C. §1041 support his approach. They say that the term "divorce or separation instrument" has the same meaning under I.R.C. §1041 as it does under I.R.C. §71(b)(2).[303]

There seems to be no specific authority confirming that an agreement made in connection with a divorce (a "divorce related agreement") that incorporates the terms of a premarital agreement are made under the divorce related agreement rather than the premarital agreement. Nevertheless, if the premarital agreement provides that its provisions can be implemented only if incorporated in a marital settlement agreement, a conclusion that the payments are made under the marital settlement agreement seems supportable.

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301 Treas. Reg. §1.71-1(b)(6), Example (2),

302 Treas. Reg. §1.71-1T Q&A 4.

303 Treas. Reg. §1.1041-1T Q&A 7.

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