PLENARY:

*Love, Sex, Money, Marriage and Death: Estate Planning Aspects of Divorce*

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Introduction

I. Statistics indicate that 40% to 50% of first marriages, 60% of second marriages and 73% of third marriages end in divorce.

Review Estate Plan for Needed Changes

II. State law may revoke the will or certain provisions in favor of the former spouse e.g. executor/personal representative, attorney-in-fact under a durable power of attorney, health care agent under a health care proxy, trustee of a trust, beneficiary of retirement plan assets, beneficiary of life insurance policy.
   i. If new beneficiary of life insurance or retirement plan assets is a minor child, consider the feasibility of a trust.
   ii. MUPC §2-804 revokes will provisions in favor of a decedent’s former spouse, and revokes any disposition of property, grant of a power of appointment, nomination as a fiduciary in favor of the decedent’s former spouse or a relative of the former spouse under any governing instrument, including beneficiary designations executed by the decedent prior to the divorce. MUPC §2-804 also severs the interest of former spouses in property held by them at the time of divorce as joint tenants with right or survivorship, transforming the interests of the former spouses into tenancies in common.
   iii. Better to be safe than sorry – make the necessary changes to estate planning documents rather than rely on a statute.
       1. Review and, if necessary, change ex-spouse designation as executor/personal representative, attorney-in-fact, health care agent, trustee, beneficiary of retirement plan or beneficiary of insurance policy.
       2. A decree of separation which does not terminate the status of husband and wife does not revoke any provisions of a will.
   iv. Appointment of the former spouse as a health care agent under a health care proxy is revoked upon divorce. M.G.L. c. 201D §7.
   v. Note that filing for a divorce does not trigger the above statutes – only the actual decree of divorce does. Typically there is a substantial period of time between filing for a divorce and the actual decree of divorce. During that interim period a soon to be former spouse will retain substantial rights unless the estate planning documents are changed. Thus, the estate planning documents should be changed when it appears the marriage has broken down and not just when the final decree of divorce is entered.
vi. Note that Massachusetts law imposes an automatic restraining order affecting finances. Massachusetts Supplemental Probate Rule 411. The restraining order prohibits any transfers of property or changes in beneficiary designations on insurance or pension or retirement plans. However, there is no prohibition on changing these beneficiaries before formal divorce proceedings are commenced with the exception of certain qualified retirement plans covered by ERISA.

III. Lack of availability of marital deduction means that an estate tax may be due on the client’s death. Consider the need for liquidity e.g. life insurance to cover taxes.

IV. Joint Accounts – be aware of attempt of one spouse to “clean out” joint account just prior to divorce.
Tax Aspects of Property Settlements

I. Income Tax Issues - Section 1041 makes transfers between spouses, or incident to a divorce, a “non-recognition event.”
   i. §1041(a) provides that no gain or loss is recognized on a transfer of property from an individual to or for the benefit of a spouse, or, if the transfer is incident to a divorce, a former spouse.
   ii. Thus, transfers to a spouse at any time and for any reason during a marriage is a non-recognition event for income tax purposes.
   iii. The transfers to a former spouse is also not a taxable transaction for income tax purposes if the transfer is incident to a divorce if:
       1. The transfer is within one year of when the marriage ends (§1041(c)(1) and Temp. Reg. 1.1041-1T(b), Q&A 6), or
       2. The transfer is related to the end of the marriage. §1041(c).
          a. The transfer is related to the end of the marriage if the transfer is pursuant to a divorce or separation agreement (as defined in §71(b)(2)) and the transfer occurs not more than 6 years after the date on which the marriage ends. Temp. Reg. 1.1041-1T(b), Q&A 7.
          b. Note that the transfer of appreciated property between former spouses (other than a nonresident alien spouse) that are made more than one year after the divorce are tax-free but only if made pursuant to a divorce or separation instrument. You don’t have to worry if the property transfer comes before the one year period because the statute will protect you even if there isn’t a divorce or separation instrument. But if the property transfer takes place more than a year after the divorce, you need a divorce or separation instrument to get tax-free treatment under §1041.
   i. Example: A husband and wife getting a divorce own a beach house. The husband wants the beach house but the wife gets the beach house in the property settlement. After the divorce, the husband wins the lottery and wants to buy the beach house. He offers his ex-wife $5,000,000 for the beach house which has an adjusted tax basis of $1,000,000. It was not contemplated at the time of the divorce that the husband would get the beach house. In fact, it is contrary to the agreement which gives the wife the beach house. As long as the transfer happens
within one year of the divorce it is nontaxable under §1041 even though it was not part of the divorce agreement. The transfer is not a sale and there is no gain and no step-up in basis of the asset. If the transfer happens more than one year after the divorce, it is a sale because it is not related to the end of the marriage. For transfers that occur more than one year after the date of the end of the marriage, a tax free transfer must be pursuant to a divorce or separation agreement and the transfer must occur within 6 years after the date on which the marriage ends. Since the transfer happened more than one year after the date the marriage ended and it wasn’t a requirement of the divorce or separation agreement, it is treated as a sale and the wife will realize a taxable gain.

c. Any transfer that is not pursuant to a divorce or separation agreement and occurs more than 6 years after the end of the marriage is subject to a rebuttable presumption that the transfer is not related to the end of the marriage.
   
   i. The presumption is rebuttable upon a showing that the transfer was made to effect division of property owned by the former spouse at the time the marriage was legally dissolved.

   ii. Temp. Reg. 1.1041-1T(b), Q&A 7 says 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.

   iii. For situations where the transfer was made more than 6 years after the marriage ended, see PLR 9644053, PLR 9235026 (delay due to dispute over the purchase price and transfer made shortly after resolution of dispute), PLR 9306015 (8 year delay in property division not made to effect a property division), PLR 9348020, Young v. Commissioner, 113 T.C. 152 (1999) aff’d
iv. In general, a divorce or separation agreement 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 payment for the support or maintenance of the other spouse.

1. In PLR 200233022 the IRS held that Temp. Reg. 1.1041-1T(b) Q&A 7 specifically recognizes that a divorce or separate instrument includes a modification or amendment to such decree or instrument. See also PLR 200442003 and 200709014.

v. §1041 does not apply to the transfer of services.

vi. Under Reg. 1.1041-1T(c), Q&A 9, a transfer of property may be made to third parties on behalf of the spouse (or former spouse) in three situations:

1. Where the transfer to the third party is required by the divorce or separation agreement;

2. Where the transfer to the third party is pursuant to the written request of the spouse (or former spouse); or

3. Where transferor receives from the other spouse (or former spouse) a written consent or ratification of the transfer to the third party.

a. The consent or ratification must state that the parties intended the transfer to be treated as a transfer to the nontransferring (or former) spouse subject to the rules of §1041 and must be received by the transferor prior to the date of filing the transferor’s first income tax return for the year in which the transfer was made.

b. The three types of transfers described above will be treated as though the asset was transferred by the transferring spouse to the transferee spouse who then transferred it to the third party. Reg. 1.1041-1T(c), Q&A 9. The deemed transfer from the nontransferring (or former) spouse to the third party is not a transaction that qualifies for the nonrecognition of gain under §1041.

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. Thus a sale of property by a corporation, all the shares of which are owned by one individual, to that individual’s spouse in not
protected by §1041. If one of the spouses wants to avoid the application of §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.

vii. §1041 does not apply:

1. To property transferred to a person who is a nonresident alien, or a trust for his/her benefit. §1041(d).
   a. §1041 does apply to transfers from a nonresident alien spouse to a spouse who is a United States person, resulting in the resident spouse taking a carryover basis in the transferred property.

2. If the property is transferred to a trust and the liabilities of the property exceed the basis of the property. §1041(e).
   a. §1041(a) does, however, apply to property subject to liabilities in excess of basis transferred outright. For example, if A owns property having a FMV of $10,000 and an adjusted basis of $1,000 secured by a $5,000 debt, A’s transfer of the property to his spouse results in no gain recognition and A’s spouse will take the property with an adjusted basis of $1,000. Temp. Reg. 1.1041-1T, Q&A 12. PLR 9615026.

3. To accrued interest. It is not exempt under §1041.
   a. Example: Husband in divorce has accrued interest on investments e.g. Series E or Series EE bonds. The investments are divided equally between the husband and wife. The accrued interest is recognized by the husband on the transfer despite §1041. Rev. Rul. 87-112. Assignment of ordinary income is often taxable upon transfer especially earned income.

viii. §1041(b)(2) provides that the property transferred is generally treated as acquired by the transferee by gift and that the transferee’s basis in the property is the adjusted basis of the transferor. Temp. Reg. 1.1041-1T(d), Q&A 11. Thus, lifetime, divorce motivated property transfers between spouses result in the recipient spouse receiving the basis of the transferor. The transferor’s holding period also carries over to the transferee spouse. §1223(2).

1. Note that the gain on the property transferred is deferred, not eliminated. In effect, the transferee spouse will bear the burden of the gain on a subsequent sale of the transferred property.
   a. In negotiating a property settlement where one spouse gets low basis assets, the parties must keep
in mind the built-in tax liability assumed by the transferee of the low basis asset and make some sort of financial adjustment to compensate for the built-in tax liability.

b. State courts may or may not take into consideration the income tax consequences of selling property distributed pursuant to a property settlement into account when dividing marital assets.

2. If the property is passive activity property, passive activity losses are handled as follows:
   a. The titled party retains the passive activity losses if the asset is retained by the title holder.
   b. If the property is transferred to the non-title holder, any suspended passive activity losses for the property are added to the basis of the property. §469(j)(6), §1041(b).

3. Note the difference between the basis rules of §1015 (if the basis of the property is greater than its FMV at the time of the gift, then for purposes of determining loss on a subsequent sale, the basis is limited to FMV at the time of the gift) and §1041(b)(2) (transferee takes the transferor’s basis).

4. If the transfer of property pursuant to a marital settlement agreement is in part to the spouse and in part to third parties (e.g. children), the basis of the property transferred to the spouse should be determined under §1041(b)(2) (carryover basis) and the basis of the property transferred to the third parties (e.g. children) should be determined under §1015.

ix. Reporting requirements under Reg. 1.1041-1T, Q&A 14:
   1. The transferor must provide the adjusted basis, holding period and investment tax credit information to the transferee. However, the Temp. Regs. don’t impose a penalty for failure to comply.
   2. The transferee must preserve the records and keep them accessible to the IRS.

x. Stock redemptions.
   1. Frequently, the most valuable asset in the marital estate is a closely-held or family business. Often, much of the family liquidity is invested in the business. Counsel has to be careful of the tax ramifications of accessing cash inside a corporation to accomplish the equitable distribution or asset division.
   2. There are regulations, private letter rulings and court cases that deal with the tax consequences relating to stock redemptions in connection with a divorce. The rules are complicated and confusing.
3. Tax traps include assignment of income, constructive dividends and the conflict between §1041 and §§301 and 302 (dealing with whether a redemption constitutes ordinary (dividend) income or capital gain).

4. The issuance of Reg. 1.1041-2 by the IRS provides a safe harbor and roadmap to successful stock redemption.

5. Reg. 1.1041-2 states that stock redemptions not resulting in a constructive dividend to the non-transferor spouse (under applicable tax law) will be treated as redemptions by the transferor spouse, who will be liable for any tax consequences.

6. Stock redemptions that do result in a constructive dividend to the non-transferor spouse will be treated as such, and that spouse will be liable for any tax consequences.

7. A special rule in Reg. 1.1041-2(c) gives taxpayers the option to choose which spouse will be responsible for the tax consequences. A divorce, separation or other written agreement must state how both spouses intend for the IRS to treat the redemption. Both spouses must execute the agreement before the date on which the spouse responsible for the tax files his or her tax return for the year of the redemption.

8. The spouses can elect this special rule by specifically providing, in a divorce or separation agreement or other valid written agreement that expressly supercedes any other instrument or agreement concerning the purchase, sale, redemption or other disposition of the stock that is the subject of the redemption, their mutual intent concerning whether the redemption should be treated as a redemption distribution to the transferor spouse or to the non-transferor spouse.

9. Example of a tax trap: Husband and wife each own 50% of a small company. Their cars were purchased through the corporation, which have been depreciated by 50%. They agree that husband will keep the business and the wife will keep her car with the title in her name. The value of the car will be taxed to the wife as a dividend. There will also be taxable gain to the corporation if the fair market value of the car exceeds its depreciated basis. §311.

10. Generally, if a corporation buys stock from a divorcing spouse, that spouse transfers stock in return for cash and/or property paid by the corporation. Under applicable tax law, the redemption is considered a constructive distribution to the non-transferor spouse. The reason is because the corporation is deemed to be satisfying a primary, unconditional and pre-existing legal obligation of the non-
transferring spouse. The redemption is taxable to the non-transferor spouse as if he or she (rather than the spouse actually transferring the stock to the corporation and actually receiving payment for the stock) had received the redemption proceeds.

11. Example 1: **Primary and unconditional obligation assumed by corporation, no special election made.** Corporation X has 100 shares outstanding of which husband owns 50 and wife owns the other 50 shares. Husband and wife divorce. The divorce instrument requires husband to purchase wife’s shares and wife to sell her shares to husband in exchange for $1,000,000. Instead of husband buying the stock from wife and paying her from his own personal funds as he was obligated to do, the corporation redeems wife’s shares for $1,000,000, thus relieving husband of his obligation. Under applicable tax law, husband has a primary and unconditional obligation to purchase wife’s stock. That means the stock redemption results in a constructive distribution to husband. It is treated as if husband was paid a dividend equal to the $1,000,000 of cash actually distributed to wife by the corporation. The special rule was not elected. The wife is treated as if she transferred her 50 shares of X corporation stock to her husband in a tax-deferred §1041 interspousal transfer (assuming the other requirements of §1041 are met). The husband is correspondingly treated as transferring the $1,000,000 to his wife in a transfer to which §1041 applies. Wife pays no tax. The husband is treated as transferring the 50 shares of X corporation stock he is deemed to have received from his wife to the corporation in exchange for $1,000,000. However, this transfer is not considered an interspousal §1041 exchange. Capital gains will not apply and the husband will be taxable under §§302(d) and 301.

12. Example 2: **Primary and unconditional obligation assumed by corporation. Special election is made by husband and wife.** Assume the same facts as in Example 1 except that the divorce agreement provides that the redemption will be treated for federal income tax purposes as a redemption distribution to the wife. The divorce agreement also provides that the agreement to treat the redemption as a redemption distribution to the wife supercedes all other instruments or agreements concerning the purchase, sale, redemption or other disposition of the stock that is subject to the redemption. Since the special election applies, the tax consequences of the redemption are determined in accordance with the form of the transaction i.e. a
redemption of wife’s shares by the corporation. It will therefore not be considered a constructive dividend to husband. The rules of §302 apply to determine the nature and extent of wife’s taxation.

13. Example 3: *No primary and unconditional obligation assumed by corporation. No special election made by husband and wife.* Assume the same facts as the Example 1. Assume the divorce agreement requires the wife to sell her shares to the corporation in exchange for a note. Husband guarantees the corporation’s payment of the note. Assume that under applicable tax law the husband does not have a primary and unconditional obligation to purchase wife’s stock and therefore the stock redemption does not result in a constructive distribution to husband. Assume also that the special election is not made or the parties do not qualify. The result is that the tax consequences of the redemption are determined in accordance with its form as a redemption of wife’s shares by the corporation and the rules of §302 apply to determine the nature and extent to which the wife will be taxed.

14. Example 4: *No primary and unconditional obligation assumed by corporation. Special election made by husband and wife.* Assume the same facts as in Example 3. Assume, however, that the divorce instrument says that the husband and wife agree the redemption shall be treated for federal income tax purposes as resulting in a constructive distribution to the husband. The divorce agreement also provides that the divorce agreement supercedes any other instrument or agreement concerning the purchase, sale, redemption, or other disposition of the stock that is the subject of the redemption. Due to the special election, the redemption is treated as resulting in a constructive distribution to the husband so the wife is treated as transferring her stock to him in a tax-deferred §1041 transfer (assuming the requirements of §1041 are otherwise met). Husband is treated as then transferring the stock he is deemed to have received from wife to the corporation in exchange for a note. §1041 does not apply and so the husband’s transaction is not tax deferred. The transactions will instead be taxed to the husband under §§301 and 302(d). Husband will be treated as transferring the note to his wife in a tax-deferred §1041 transfer and she will pay no tax.

15. Capital gain treatment to a high-income redeemed spouse may be subject to the 3.8% surtax on net investment income.
II. Sale or transfer of home
   i. If one spouse transfers his or her interest in the principal residence to the other spouse, §1041 will protect the transferor spouse from recognition of gain even if the transferee spouse transfers property in exchange for consideration.
   ii. $250,000/$500,000 exclusion on sale of personal residence.
      1. Requirements: principal residence owned and used for 2 of the last 5 years. $250,000 exclusion if single, $500,000 exclusion if married, filing joint return.
         a. To qualify for the exclusion there must not have been any prior exclusion within the two years prior to the sale.
         b. If (1) a joint return is filed for the year of sale, (2) either spouse meets the ownership requirement and (3) both use the house as a principal residence. §121(b)(2); Reg. 1.121-2(a)(3)(i).
      2. It may be prudent to sell the home prior to divorce to be able to take advantage of the $500,000 exclusion.
      3. If the house is in joint name and used as a principal residence, both may qualify for the $250,000 exclusion.
      4. Example: H and W owned and used their jointly owned home for more than 2 out of the last 5 years. They are contemplating divorce. They bought the home for $200,000 and it is now worth $700,000. If H signs the house over to W in the divorce proceedings and W sells the house after the divorce, she will be able to exclude only $250,000 of the gain. Alternatively, if H and W sell the house prior to divorce and file a joint return, the entire $500,000 gain may be excluded.
   iii. Imputed use of home. A spouse owning a home is treated for tax purposes as using the home as a principal residence during any period the other spouse or former spouse is granted use of the home under a divorce or separation agreement. The former spouse’s use of the home is attributed to the other spouse. §121(d)(3)(B); Reg. 1.121-4(b)(2).
      1. Example: H (who owns house) moves out of the marital home into an apartment. H and W obtain divorce and wife is granted use of the home under the divorce agreement. In order to qualify for the exclusion on the sale of a principal residence, the H has to own and use the house as his principal residence for two of the five years preceding the sale. W’s use of the home is attributed to the H. H would be able to claim a $250,000 exclusion.
   iv. Imputed ownership of home. If spouse who owns home transfers it to the other spouse pursuant to the divorce, the owner-spouse’s period of ownership is attributable to the other spouse’s ownership
i.e. the owner spouse’s holding period is added to the other spouse’s ownership period. §121(d)(3)(A); Reg. 1.121-4(b)(1).

1. Example: H purchases house in his name in 2006 and H and W occupy the house as their home from 2006. In 2009 the couple divorce and W gets the home under the divorce agreement. W qualifies for the $250,000 exclusion as H’s ownership period is added to her ownership. W satisfies both the use and ownership requirement.

v. Partial exclusion of gain may be available for taxpayer who does not meet the ownership and use requirements or who has excluded gain within two year if sale results from:
   1. Change in place of employment,
   2. Health,
   3. Unforeseen circumstances – to be determined by regulations. §121(c)(b)(2)(B). Divorce or legal separation under a decree of divorce or separate maintenance is included in the regulations as unforeseen circumstances. Reg. 1.121-3(e)(2).
   4. Formula: days of ownership and use, or, if less, days between dates of sale of previous and current home, divided by 730 days times $250,000 or $500,000 (whichever is applicable).

vi. §121(f) permits taxpayers to elect not to have the §121 exclusion rules apply to an otherwise qualifying sale of a principal residence. Reg. 1.121-4(g) says that a taxpayer makes the election by filing a return for the year of the sale that includes the gain in the taxpayer’s gross income.

vii. If one spouse transfers his or her 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 §163(h) if the note is secured by a mortgage on the residence.
   1. However, it is not clear the above would be the case if the transferee spouse already held legal title to the residence and was paying the other spouse for his or her 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 §163(h).

III. Transfer of life insurance
   i. The transfer of a life insurance policy is a property settlement covered by the §1041 and §2516 rules
      1. §101(a) excludes from gross income the proceeds of a life insurance policy received at the death of the insured.
2. §101(a)(2) denies an exclusion from gross income if the life insurance policy has been transferred for value.

3. If §1041(b) applies to the transfer of a life insurance policy, the transfer is treated as acquired by gift, not sale, so the transfer for value rule is inapplicable.

ii. If the insured retains any incidents of ownership in the policy, it will be included in the insured’s taxable estate. State law may provide that any applicable estate taxes from the policy must be paid from the insurance proceeds, effectively reducing the benefits to the ex-spouse or children. The divorce agreement should provide a clear statement on whether any estate taxes on the policy proceeds are paid from the insured assets or from the policy proceeds. See §2206 which states that unless the insured states otherwise in his will, the executor shall be entitled to recover from the insurance beneficiary the estate tax attributable to the insurance.

IV. Gift Tax Issues

i. Background - §2512(b) defines a gift as a transfer of property for less than adequate and full consideration in money or money’s worth.

1. The consideration received must benefit the donor to prevent the transfer from being deemed a gift – detriment to the donee is not consideration in money or money’s worth. Comm. V. Wemyss, 324 U.S. 303, 305-307 (1945).

2. To avoid gift tax the consideration received by the donor must be (1) equal to the value of the property transferred and (2) reducible to a value in money or money’s worth. Reg. 25.2512-8.

ii. Transfer by donor to a spouse-to-be under a antenuptial agreement.

1. Consideration that is not reducible to a value in money or money’s worth (such as love and affection or the promise of marriage) is not considered valid consideration for gift tax purposes.

2. The total value of the transferred property generally is subject to gift tax because neither the promise of marriage nor the donee’s relinquishment of marital rights constitutes consideration in money or money’s worth. Reg. 25.25112-8; Merrill v. Fahs, 324 U.S. 308, 312-313 (1945); Comm. v. Bristol, 121 F.2d 129, 133-134 (1st Cir. 1941).

a. Example: Taxpayer transfers stock to his prospective wife in consideration of her promise to marry him and to compensate her for the loss of income from trusts created by her former husband that she would not longer be entitled to after her marriage to the taxpayer. The transfer of the stock constituted a taxable gift because neither the
donee’s promise to marry the donor nor the
detriment suffered by the donee (the loss of the trust
income) constituted consideration in money or
money’s worth to the donor. Comm. v. Wemyss,
324 U.S. 303 (1945).

3. Antenuptial agreements. An agreement between
prospective spouses under a antenuptial agreement to
transfer or promise to transfer property, either outright or in
trust, in exchange for the donee’s relinquishment of all of
his or her marital rights in the donor’s property or estate is
not considered consideration in money or money’s worth.
Reg. 25.2512-8.

a. Example: Taxpayer transfers property to a trust
established under the terms of an antenuptial
agreement prior to the marriage of the parties in
exchange for the release of the donee’s claim
against the donor’s estate for widow’s allowance,
dower, homestead, community estate and a statutory
share. The transfer by the taxpayer constitutes a
taxable gift. The donee’s relinquishment of a claim
against the donor’s estate for widow’s allowance,
dower, homestead, community estate and a statutory
share did not constitute consideration in money or
money’s worth for gift tax purposes. Ellis v. Comm,
51 T.C. 182 (1968), aff’d 437 F.2d 442 (9th Cir.
1971).

b. Timing is everything. Generally, an agreement to
transfer property is subject to gift tax when the
promise is enforceable under state law. Rev. Rul.

i. A transfer that is made before the marriage
is subject to the gift tax at the time of the
transfer and the gift tax marital deduction is
not available because the donee is not yet
married to the donor.

ii. If the antenuptial agreement becomes
enforceable only upon the marriage of the
parties, the transfer pursuant to the
agreement that occurs after the marriage is
eligible for the gift tax marital deduction
assuming the requirements for the gift tax
marital deduction are satisfied.

iii. Thus, the gift tax can be avoided where
property is required to be transferred under
an antenuptial agreement if the agreement is
conditioned upon, and all transfers occur,
the marriage of the parties to the agreement.

c. Community property agreements.

i. Some community property states allow prospective spouses to alter by a written agreement the character of the community property to be acquired in the future. For example, in California (Family Code §1500) the property rights of a husband and wife prescribed by statute may be altered by a prenuptial agreement or other marital property agreement.

ii. Merely entering into such an agreement should not constitute a gift because there is no property exchanged at the time of the agreement.

iii. In PLR 8929046, the IRS held that the execution of a written agreement between spouses who reside in a community property state to transmute presently owned community property to separate property results in a taxable gift to the extent that the value of the property rights relinquished by a spouse exceeds the value of the property rights received. The ruling goes on to state that the mere signing of the agreement does not result in a transfer subject to the gift tax because no transfer of property takes place at that time. If the transfer takes place at the time the parties are married, the transfer generally will qualify for the unlimited gift tax marital deduction.

iii. Gift-splitting.

1. The law permits a spouse to elect to be treated as the donor of a gift, even when the other spouse is the sole transferor. §2513.

2. In order for gift splitting to apply, the donor must file a gift tax return, on which the spouse consents to the treatment of the gifts as made one-half by the spouse. Reg. 25.2513-2(a). The return must be filed by the donor spouse, even if a gift tax return was not otherwise required e.g. only annual exclusion gifts were made.

3. Gift splitting for any year applies to all gifts and cannot be made on a gift-by-gift basis.

4. If gift splitting is elected, the spouses have joint and several liability for any gift tax which may be due. Reg. 25.2513-4.
Thus, consenting spouses should be careful to make sure that the value of the gifts are accurate.

5. If neither spouse has filed a gift tax return for the applicable year, the consent may be filed late, without any adverse tax impact. §2513(b); Rev. Rul. 80-224, 1980-2 C.B. 281.

6. If a married couple agrees to gift-splitting, each is treated as though they made the gift for generation skipping tax purposes also. §2652(a)(2).

7. In gift splitting is anticipated early in the year, divorce before year end will terminate the right to gift split.

8. Example: Assume husband made $28,000 in gift split annual exclusion gifts to 15 heirs at the beginning of the year. If husband and wife divorce before year end and the gift tax rate is 40%, delaying the divorce until after the end of the year could save the husband $84,000 in gift taxes (or use of his exemption).

iv. Generally, there are six ways in which a property settlement may be accomplished without the transfer being deemed to constitute a taxable gift to the spouse, former spouse or child.

1. The transfer of property is made in exchange for the relinquishment of obligations of spousal support (e.g. alimony) or for support of minor children.

2. The transfer of property satisfies the requirements of §2516.

3. The transfer of property is pursuant to a court order.

4. The transfer of property is accomplished prior to the legal termination of the marriage and the transfer meets the requirements of the unlimited gift tax marital deduction under §2523.

5. The transfer qualifies for the annual gift tax exclusion, or, 

6. The transfer qualifies as a direct payment for medical or educational payments.

v. Property settlements between spouses incident to separation or divorce before the enactment of §2516.

1. Prior to the enactment of §2516, property settlements resulted in a taxable gift by the donor spouse if the value of the property transferred exceeded the money’s worth of the consideration received. Comm. v. Wemyss, 324 U.S. 303, 306 (1945); Reg. 25.2511-1(g)(1).

2. Transfers in satisfaction of the transferor’s obligation to support the former spouse (“spousal support” or “alimony”) as well as transfers that satisfy the transferor’s obligation to support minor children are deemed to be for adequate consideration and therefore do not constitute taxable gifts.
Rosenthal v. Comm, 205 F.2d 505 (2d Cir. 1953); Keller Estate v. Comm. 44 T.C. 851 (1965).

a. Note that transfers to a spouse in exchange for the relinquishment of spousal support rights constitute adequate consideration in money or money’s worth but transfers of property to a spouse in exchange for relinquishment for other marital property rights (dower, curtesy, homestead, widow’s allowance, statutory share) do not constitute adequate consideration in money of money’s worth. Reg. 25.2512-8. See Rev. Rul. 68-379, 1968-2 C.B. 414, which distinguishes between transfers in satisfaction of the legal obligation of support and transfers in settlement of the transferee spouse’s inheritance rights.

b. The release of spousal support rights in exchange for periodic payments or one lump sum payment, either directly or in trust, generally does not result in a taxable gift if the value of the property transferred equals the value of the support rights released. Rev. Rul. 77-314, 1977-2 C.B. 349; Rev. Rul. 68-379, 1968-2 C.B. 414. Where the value of the money or property transferred exceeds the value of the support obligation discharged or released, the transfer constitutes a gift to the extent of the excess.

i. Thus, it is important to ascertain the value of the transferor’s obligation to support the transferee in order to determine whether, or to what extent, a gift was made. The factors used by the IRS in valuing support obligations are discussed in Rev. Rul. 71-67, 1971-1 C.B. 271.

ii. Valuing support obligations is a challenge. The valuation of support obligations must take into consideration the obligor’s financial resources and standard of living of the parties. Alimony obligations usually terminate upon the death or remarriage of the transferee spouse and on the death of the transferor spouse. Thus, the probability of the transferee spouse’s remarriage, and the life expectancies of the parties must be considered. Child support obligations usually terminate when the child reaches majority or is otherwise emancipated, or on the death of the transferor spouse. Thus, the
The age of the child and the life expectancies of the transferor spouse must be considered. Once the amount and time period of the obligation is determined, the present value of such payments must be calculated.

iii. Generally, it is administratively easier and safer to qualify under §2516 rather than to rely on the exception for spousal and minor support.

iv. Example: H establishes trust for W in exchange for release of her support rights. Trust is to pay income to W for life, remainder to the adult children of the marriage. The value of the W’s income interest in the trust exceeds the value of the support rights released. H is deemed to have made a taxable gift (1) to W in the amount of the excess of the value of W’s income interest over the value of the support rights released and (2) to the spouse’s adult children of the value of the remainder interest in the trust. Rev. Rul. 77-314, 1977-2 C.B. 349, Situation 1.

3. Property settlements (which includes cash payments) between spouses as a result of a divorce or separation, if properly structured, generally are not subject to gift tax because of the enactment of §2516. §2516(1) provides that transfers pursuant to a written settlement agreement in settlement of marital or property rights will be deemed made for adequate consideration if the parties divorce within the 3 year period beginning one year before execution of the agreement.

   a. Section 2516 requirements:
      i. Must be a written agreement;
      ii. Regarding spouse’s marital or property rights or to provide reasonable support of minor children;
      iii. Final decree of divorce is required for §2516 to apply;
      iv. Only payments of cash or property designated and required by the agreement qualify as non-gifts
      v. The parties divorce within a 3 year period beginning one year before execution of the agreement i.e. the divorce must occur no later than 2 years after execution and no
earlier than 1 year before execution of the agreement. Stated another way, the written instrument must be signed either two years before or one year after a divorce.

1. Note: Payments required under a prenuptial agreement entered into more than 2 years before the divorce would not qualify for gift tax-free treatment under §2516. The remedy is to include a provision in the prenuptial agreement that requires each party to sign a separation agreement or instrument that incorporates all of the financial provisions of the prenuptial agreement so that when the payments are actually made you can take the position for tax purposes that they are made pursuant to a separation instrument and not pursuant to the provisions of the prenuptial instrument. The same strategy should be employed to meet the “pursuant to a divorce or separation agreement” requirements under §1041 to make sure that the transfers are income tax-free.

b. §2516 is not the exclusive way to avoid gift tax issues upon the transfer of property pursuant to a divorce. A divorce transfer that is not exempt under §2516 may still escape tax under general gift tax principles i.e. be made for full and adequate consideration.

c. Result of complying with §2516: both direct transfers and transfers in trust are deemed made for adequate consideration.

d. Once the requirements of §2516 are met, the transfer of the property can be made at any time. PLR 7940022.

e. It is not necessary for the §2516 agreement to be approved by the divorce court or incorporated or referred to in the divorce decree. Reg. 25.2516-1(a).

i. §2516 does not require that the divorce decree mention the settlement agreement. It can be entered into by the parties independently of the decree allowing the
parties to keep their property settlement out of the public records.

ii. The marital agreement can be totally independent of the divorce so long as it settles marital or property rights and/or provides for child support and the divorce occurs within 2 years after or 1 year before the execution of the agreement.

iii. Neither the Code nor the regulations define “written agreement” for §2516 purposes. Presumably, the term encompasses any writing memorializing the terms of the property settlement. Thus, the parties should make some type of writing to evidence their property settlement agreement.

iv. In Rev. Rul. 79-118, 1979-1 C.B. 315, the IRS ruled that payments to a former spouse made pursuant to an amendment executed after the requisite time period to a marital agreement signed within the requisite time period was outside the scope of §2516 i.e. the IRS’ position is that the modification itself must be executed within the requisite 1 year and 2 year time periods.

f. The only type of decree that is effective under §2516 is a final decree of divorce. Reg. 25.2516-1(a). See also Reg. 25.6019-3(b). A decree of separation, separate maintenance or annulment (or a decree nisi in Massachusetts) apparently will not suffice under §2516. Estate of Hundley v. commissioner, 52 T.C. 495 (1969), aff’d 435 F 2d 1311 (4th Cir., 1971) (separation agreement coupled with an actual separation did not satisfy the divorce requirement of §2516).

g. Only payments of cash and transfers of property in settlement of the marital and property rights of a spouse and for the reasonable support of minor children fall within the protection of §2516. A payment or transfer for any other purpose is not deemed to be for adequate consideration under §2516 even if the payment was made pursuant to a marital agreement executed within the requisite time frame.

i. §2516(2) refers to a “reasonable allowance” for support of minor issue. Child support payments in excess of a reasonable amount
are not covered by the §2516 exception. What constitutes a reasonable amount of child support depends on the facts and circumstances.

ii. §2516(2) uses the term “issue of the marriage” (which includes more remote descendants than just a child) whereas Reg. 25.2516-2 substitutes the word “children” for issue. The term includes legally adopted children within the definition of children.

iii. §2516 refers to support of issue “during minority.” Payments for the support of children who have reached the age of majority are not deemed to be for adequate consideration under §2516, even if the child may have been a minor when the agreement was signed. Neither the Code nor the regulations define the “age of majority” for purposes of §2516. Is it age 18, 21 or some other age?

iv. The key to a payment falling within the support exception is that the court could have ordered it.

h. §2516 does not apply to payments for the support of an adult child.

i. Example: H and W enter into a separation agreement under which stock was to be transferred to a trust when the divorce was granted. The trust income was payable for the support and maintenance of W and the children of the marriage. The remainder was to pass to the children at the death of W. When the trust was funded, one of the children was an adult and the others were ages 20, 17 and 10. H is deemed to make a gift to the extent that the value of the stock at the time of transfer exceeded the value of the wife’s income interest and the value of the income interest of the minor children for the duration of their minorities. Spruance v. Comm., 60 T.C. 141 (1973) aff’d 505 F.2d 731 (3d Cir. 1974).

ii. In Rev. Rul. 79-363, 1979-2 C.B. 345 the IRS held that the transfer of a remainder interest in trust to an adult child was not made for full and adequate consideration
under §2516 except to the extent that the donee spouse specifically released support rights in exchange for the donor spouse’s transfer to an adult child. In that case, the donee spouse was deemed to make a gift to the adult child to the extent of the value of the released support rights for the value of the remainder interest given to the adult child. See also Rev. Rul. 68-379, 1968-2 C.B. 414 where the IRS held that if the obligee spouse releases future support rights in exchange for payments to third parties, the payor may be deemed to receive adequate consideration for his or her transfer but the spouse releasing the rights will have made a gift of the property assigned to others.

iii. In Rev. Rul. 75-73, 1975-1 C.B. 313 the IRS ruled that the present value of a spouse’s right during her life to receive income from a trust established upon the issuance of a divorce decree, pursuant to a written property settlement agreement, was deemed to be a transfer for full and adequate consideration under §2516 only to the extent that it can be predicted with reasonable certainty that the income will be paid to the spouse. To the extent that the trustee is given the unrestricted discretion to distribute income to the adult children that is not needed for the spouse’s support, no transfer to the spouse has occurred and §2516 is inapplicable.

i. Transferee takes transferor’s basis and holding period.

j. Gift tax reporting requirement. Normally, §6019 requires an individual who has made any gifts (other than gifts qualifying for the gift tax annual exclusion, tuition or medical expense exclusion or gift tax marital deduction) during any calendar year to file a gift tax return (Form 709).

i. Unless the divorce occurs before the due date of the gift tax return, Reg. 25.6019-3(b) also requires a transferor making transfers pursuant to a §2516 marital agreement to file a gift tax return with a copy of the
agreement attached for the calendar period in which the agreement becomes effective and to furnish a certified copy of the divorce decree to the IRS within 60 days after the divorce is granted. Thus, if a property transfer is made under a written agreement before the divorce agreement is final, the transferor spouse should report the transfer on a gift tax return and attach a copy of the written agreement to the gift tax return. The IRS will treat the property transfer as not subject to gift tax until the final decree of divorce is granted but not longer than 2 years after the effective date of the written agreement.

k. Property settlements that meet the requirements of §2516 can be important in avoiding gift tax problems under §2702.
   i. §2702 is designed to provide a special valuation rule for certain transfers of term or remainder interests in property, in trust or otherwise, to a “family member” if the transferor or an “applicable family member” retains an interest in the transferred property. Unless it is in one of several qualified forms, the retained interest is deemed to have a value of zero.
      1. A “family member” includes 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. §2702(e); §2704(c)(2). If transfers are made to these people §2702 will apply.
      2. An “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. §2701(e)(2); §2702(a)(1). These are the people who, in addition to the transferor, cannot retain an interest in the transfer.
ii. Under §2702, a value of zero is assigned to a retained interest, unless it is in one of several qualified forms. As a result, the transferor’s taxable gift would be the full value of the transferred property. §2702(a)(2)(A).

iii. An individual’s spouse is a family member. Thus, a transfer of property in trust to pay income to the transferor’s spouse for a term of years or for life with the remainder retained by the transferor is subject to §2702.

Example: Husband transfers $250,000 to a trust paying income to Wife for 10 years, remainder to Husband. If the actuarial value of Husband’s remainder interest is $150,000, §2702 will treat it as having a value of zero resulting in a gift to Wife of $250,000.

iv. In addition, a transfer of a term interest in property to a spouse is also subject to §2702 if the transferor retains a remainder interest in the property.

Example: Husband and Wife own their house as tenants by the entirety. Their marital settlement agreement gives Husband the right to live in the house for 7 years at which time the house will be sold and the proceeds divided between them equally i.e. the Wife retains a remainder interest in half of the property. §2702 will cause Wife’s retained interest in the residence to be valued at zero.

v. §2702 does not apply if the transfers meet the requirements of §2516. Thus, §2516 creates an exception to the §2702 rules. Reg. 25.2702-1(c)(7) creates an exception for “the transfers of an interest to a spouse [if it] is deemed to be for full and adequate consideration by reason of §2516 … and the remaining interests in the trust are retained by the other spouse.” There is no exception.
to the §2702 rules for any transfers protected from gift tax by other exceptions to the gift tax e.g. court order.

1. The §2516 exception to the application of §2702 does not apply if any person other than the two spouses acquire an interest in the trusts. Thus, if the remainder interest is to pass to the children, the §2516 exception will not protect the transfer.

vi. §2702 does not apply unless the transferor (or an “applicable family member”) retains an interest in the trust. For example, if Husband transfers a term interest to his or her spouse and a remainder interest to his or her children, §2702 will not apply to him or her because neither the transferor nor an applicable family member retained an interest.

Example: Husband transfers $250,000 in trust to pay Wife income for 10 years, remainder to their children. Assume the value of the income interest is $100,000 and the support rights relinquished by Wife are worth $100,000. Husband has not retained an interest in the trust. Husband’s gift to the children is $150,000.

vii. Bottom line: due to §2702, the use of trusts in connection with transfers in satisfaction of support rights should be avoided unless the transfers satisfy the requirements of §2516.

4. Gift tax does not apply to payments made under an agreement incorporated into a divorce decree or separation agreement or made pursuant to a court order – the Harris rule. Harris v. Commissioner, 340 U.S. 106 (1950).
   a. If the payments do not satisfy the requirements of Section 2516, non-gift treatment is available if the payments were ordered by a court.
   b. If a property settlement agreement is approved by a divorce court (that has the power to alter the agreement) and the agreement is incorporated into
the divorce decree or otherwise mandated by the court, adequate consideration is not required to exempt the transfer from the gift tax under the general rule of §2512(b). Harris v. Comm., 340 U.S. 106, 111-112 (1950).

i. The rationale is that payments ordered by a court are not voluntary transfers. Adequate consideration is required only for a voluntary transfer.

ii. Any transfer protected from gift tax under the Harris rule would most likely also be protected by §2516 unless (1) the divorce is not finalized within the time limits of §2516 (for example, because of the death of one of the parties before the divorce is obtained), (2) state law allows the court to order a payment to an adult child (for example, an obligation to support a disabled adult child), or (3) the parties are not able to negotiate a marital settlement agreement.

c. In Rev. Rul. 60-160, 1960-1 C.B. 374, the IRS ruled that payments would not be considered made under a court order even though the agreement was incorporated into a divorce decree unless the court had the power under state law either to (1) decree a settlement of the spouse’s property rights or (2) modify the terms of a prior settlement agreement.

i. In other words, the IRS’ position is that the payments remain voluntary if the court has no power under state law to order a settlement of property rights or modify the terms of a prior settlement agreement.

d. In Rev. Rul. 79-118, 1979-1 C.B. 315 the IRS ruled that a payment made pursuant to a post-divorce modification of a separation agreement incorporated in a divorce decree results in a taxable gift if applicable state law does not permit subsequent modification of the agreement by the court.

e. Example: H agrees to pay W $1,000 per month until W’s death or remarriage under the terms of a separation agreement that is incorporated into a divorce decree. In return, W relinquishes all rights of support from H. Years later, H and W voluntarily agree to modify the terms of the original agreement, increasing the payments to W by $500 per month. The position of the IRS is that the additional $500
per month paid under the modification of the original agreement is treated as a taxable gift to W. The IRS’ reasoning is that since H had no legal obligation to provide for W’s support in excess of the amount originally provided for in the separation agreement, there is no consideration for the agreement to increase W’s support payments. The state law of H and W’s domicile had no authority to modify the original settlement agreement or to enforce the modified agreement. Thus, the additional payments cannot be characterized as transfers effected by a court decree and therefore constituted a gift.

5. The §2523 unlimited marital deduction applies to interspousal transfers before the legal termination of the marriage.
   a. Thus, if the parties can agree on a property settlement and accomplish the transfer before the marriage is legally terminated, that will qualify for the unlimited gift tax marital deduction.
      i. The marital deduction is not available for transfers to a spouse who is not a citizen of the U.S. §2523(i). Instead, the annual gift tax exclusion for gifts to non-citizen spouses is $143,000 (for 2013), adjusted periodically for inflation.
   b. The gift tax marital deduction may be the most useful tax loophole for divorcing spouses if the property transfers are made before the divorce is final.
      i. If the transferor spouse wants to make sure that property transferred to his soon to be ex-spouse will pass at the transferee spouse’s death to the children of the marriage, a transfer to a QTIP trust should be used if the transferor spouse wants the transfer to be eligible for the marital deduction.
      ii. To qualify as a QTIP trust, the transferor spouse must elect QTIP treatment on or before the time for filing a gift tax return under §6075(b).
      iii. In the case of a transfer to a spouse who is not a citizen of the United States, a qualified domestic trust (QDOT) should be used. A QTIP trust alone will not suffice.
iv. The QTIP trust will be included in the transferee spouse’s estate at death. The transferee spouse should make sure that state law will permit his or her estate to recover from the trust the full amount of the incremental state inheritance or estate tax that will be imposed on his or her estate. §2207A(a) gives the transferee spouse’s estate the right to recover from the QTIP trust an amount equal to the federal estate tax imposed on the surviving spouse’s estate reduced by the federal estate tax that would have been imposed on his or her estate if the trust had not been included in his or her gross estate.

v. Caution: income on the inter vivos QTIP will be taxed to the transferor spouse as a grantor trust.

c. Gifts qualifying for the gift tax annual exclusion, the tuition or medical expense exclusion and the gift tax marital deduction are not required to be reported on a gift tax return. §6019.

6. A gift of a present interest of up to the inflation-adjusted annual exclusion (currently $143,000) to the former spouse or children is not a taxable gift. §2503(b).

7. A direct payment of education or medical expenses on behalf of a spouse or children is also not a taxable gift. §2503(e).

a. Payments for other school related costs such as books and room and board do not escape gift tax under §2503(e). Reg. 25.2503-6(c), Example 2.

b. The payments must be direct payments. Thus, payments to a trust to be distributed by the trustee for a beneficiary’s tuition and/or medical expenses do not qualify. Reg. 25.2503-6(a).

V. Executive Compensation

a. Stock options and deferred compensation.

i. An employee spouse who transfers nonqualified stock options and/or nonqualified deferred compensation to a former spouse incident to a divorce is not required to include an amount in gross income upon the transfer. The former (transferee) spouse is required to include an amount in gross income when the former spouse exercises the stock options or when the deferred compensation is paid or made available to the former spouse. See Rev. Rul. 2002-22, 2002-19 IRB 849.
1. Stock options and unfunded deferred compensation are “property” under Section 1041 and are entitled to nonrecognition under Section 1041.

2. In addition, the assignment of income doctrine does not apply to transfer of nonqualified stock options or unfunded deferred compensation in the context of a divorce.

ii. The same result occurs on the transfer of incentive stock options, except that the transfer of an incentive stock options causes the incentive stock option to be classified as a nonqualified stock option.

1. Generally, ISOs are nontransferable. Any transfer causes the ISO to lose its status as an ISO and become non-qualified options. Reg. 1.421-1(b)(2). §1041 does not create an exception to the non-transferability rule for transfer of ISOs to spouses as part of a divorce.

iii. Rev. Rul. 2002-22 does not cover the tax consequences of transferring unvested stock options, deferred compensation or other future income rights that are unvested at the time of transfer.

1. The IRS could treat a transfer of these 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.

2. If there are unvested benefits of any kind or other future income rights that are subject to contingencies at the time of transfer, it may be wise to include a provision in the property settlement agreement specifically indicating how the spouses will treat these items for purposes of Federal and state income taxation.

a. Sample Language: “Tax Treatment of Non-Statutory Stock Options, Unfunded Deferred Compensation or Other Future Income Rights Transferred Incident to Divorce. In the event that all or any part of the property and/or income to be earned and received pursuant to paragraph ____ of this Property Settlement Agreement is not so includible as taxable income by the transferee spouse and is deemed taxable to the transferor spouse, whether by interpretation by the Internal Revenue Service, amendment or repeal of existing revenue statutes, by case law, rulings, regulation or otherwise, then the transferee spouse shall pay to the transferor spouse an amount equal to the transferor spouses’ tax detriment as a result of tax treatment not intended by this Property Settlement Agreement.”
3. In PLR 201016031 the IRS extended Rev. Rul. 2002-22 to apply to non-vested restricted shares.

   1. Nonqualified stock options and nonqualified deferred compensation transferred by an employee to a former spouse incident to a divorce are subject to FICA, FUTA and income tax withholding to the same extent as if retained by the employee.
   a. The taxes are payable by the nonemployee spouse at the time the nonemployee spouse exercises the options or received payments under the deferred compensation plan, not when they are transferred to the nonemployee spouse.
   b. The transferee spouse will get credit for income taxes withheld but the employee spouse gets credit for the FICA wages for purpose of determining social security benefits. PLR 200646003.

   2. The method of collecting and reporting the FICA, FUTA and income tax withholding are detailed in the ruling.

v. It is unclear whether the prohibition on the transfer of ISOs can be circumvented by a divorce or separation agreement that leaves legal title to the ISOs in the name of the employee spouse but gives the beneficial interest in the ISOs to the non-employee spouse and gives the non-employee spouse the right to direct how and when the options will be exercised. PLR 200519011, 200737009 and 8451031 illustrate a creative way to divide incentive stock options and nonqualified stock options in a divorce in a community property state.
   1. PLR 200519011 provides a roadmap for dividing ISOs in divorce and avoiding the prohibition of transfers of ISOs. The IRS issued favorable rulings on income, alternative minimum tax and gift tax issues.
   a. In PLR 200519001, nonqualified stock options were transferred directly to the non-employee spouse.
   b. The ISOs continued to be held in the name of the employee spouse but the non-employee spouse retained all legal and beneficial ownership of the employee spouse’s share of the ISO. This avoided transferring title to the ISOs to the non-employee spouse thereby allowing the options to maintain their status as ISOs.
   c. After the employee spouse exercised the ISOs, the shares were transferred to the non-employee spouse.
d. By maintaining status as ISOs the employee spouse avoided employment taxes (social security, medicare) and avoided regular tax when the options were exercised (assuming the stock was not sold at the time of exercise).

e. The IRS held:
   i. Naming the non-employee spouse as beneficiary of the ISOs and the transfer of the stock from the exercise of the ISO to the non-employee spouse qualifies as non-taxable property division of marital property under §1041.
   ii. The employee spouse’s designation of the non-employee spouse as the beneficiary of the ISO didn’t disqualify the options as ISOs.
   iii. When the non-employee spouse exercises the nonqualified stock options, income will be taxable to the non-employee spouse and the income tax withheld will be credited to the non-employee spouse’s tax liability.
   iv. When the employee spouse exercises the ISO (1) there is no income recognition for regular tax purposes, (2) the alternative minimum tax adjustment (the difference between the FMV of the stock at the time of the exercise and the strike price) is reported on the non-employee spouse’s income tax return, (3) the non-employee spouse is allowed to offset the alternative minimum tax credit against the regular tax reported when the non-employee spouse sells the stock and (4) the transfer of the stock to the non-employee spouse is not a disposition under §424(c)(4). Note that §424(c)(4) provides that a transfer between spouses under §1041(a) is not a “disposition” that results in a disqualifying disposition for purposes of the one and two year holding periods for favorable capital gain treatment of ISOs.
   v. It also held that an employee spouse’s transfer of nonqualified stock options to the non-employee spouse pursuant to a divorce decree is not treated as a disposition under
§1041, Rev. Rul. 2002-22 and community property law.

2. In each of PLR 200519011, 200737009 and 8451031 the non-employee spouse was awarded a 50% interest in the ISOs but legal title was to remain in the employee spouse’s name. The employee spouse was required to follow the non-employee spouse’s directions regarding the exercise of the options. Under community property law the non-employee spouse already owned a 50% interest in the ISOs so the IRS’ favorable ruling may have been based on the fact that under the community property law no transfer took place.

vi. In PLR 200646003 the IRS ruled that income attributable to the exercise nonqualified stock options was includible in the former nonemployee spouse’s gross income and that the nonemployee spouse was entitled to credit for income tax withheld but not for FICA taxes. In this ruling the former spouses lived in a community property state and the former employee spouse was required to keep possession of the nonqualified stock options but to immediately exercise them and transfer the proceeds to the former nonemployee spouse.

vii. PLR 200442003 states that the present value buy-out of future supplemental executive retirement plan (SERP) payments is not considered an assignment of income (because transfers between divorcing spouses are not voluntary assignments within the scope of that doctrine). The transfer is nontaxable under §1041.

viii. State law treatment – some courts hold that options are a form of income, rather than a form of property.

1. If property, ex-spouse has no future claim to them
2. If income, options are eligible for alimony and child support. Alimony and child support can be modified.


1. Although pension rights and stock options may be unvested, they are not like future inheritances in that the pension plan participant has an enforceable legal right to collect benefits if the conditions are met.
2. The uncertainty of the benefits at issue can be handled equitably by dividing the benefit on a deferred percentage basis, requiring the plan participant to pay the non-participant spouse a stated percentage of any funds which are ultimately received. Speculative remainder interest could be divided the same way.
Generally, §409A causes acceleration of income for nonqualified deferred compensation plans that fail to meet the statute’s requirements.

1. A QDRO is an exception to the rules that would otherwise require current inclusion in income.

2. Reg. 1.409A-3(i)(2)(i) says that the required delay of payment to a “specified employee” upon a separation of service is not violated where the payment is made before the end of the requisite 6 month period due to an acceleration of a payment due to a QDRO.

3. Reg. 1.409A-3(j)(4)(ii) says that QDROs are an exception to the general rules governing certain deferrals and accelerated payments.

4. Reg. 1.409A-2(b)(4) provides that a QDRO may provide for a new time and form of payment to a spouse or former spouse or provide that person with discretion to determine the time and form of payment.

VI. Installment Sales

a. §453B(a) requires recognition of income or loss equal to the difference between the amount realized or the FMV (if the obligation is disposed of other than in a sale or exchange) and the basis in the installment obligation upon the sale or exchange of an installment obligation.

b. §453B(g) says that the recognition of gain rule in §453B(a) is inapplicable to a transfer described in §1041 other than a transfer to a trust for the benefit of a spouse.

c. Thus, the transferee spouse will recognize gain when he or she receives payments of principal or disposes of the obligation.
Retirement Benefits - IRAs

I. Introduction

a. Upon divorce, an IRA owner may be required by court order or as part of a property settlement to split his IRA with his ex-spouse or to transfer his entire interest in the IRA to his ex-spouse.

   i. The transferor spouse will want to structure the transfer so that the transfer is not considered a taxable distribution to either party.

b. §408(d)(6) of the Internal Revenue Code contains a special rule designed to prevent the transfer of an interest in an IRA from being a taxable distribution to either spouse.

II. §408(d)(6) provides that the transfer of an interest in an IRA is not a taxable transfer to either spouse if the transfer is pursuant to a valid divorce decree or a written separation instrument incident to the divorce (e.g. a property settlement). Reg. 1.408-4(g)(1).

   a. There are two requirements under §408(d)(6):

      i. There must be a transfer of the IRA from one spouse to the other spouse or ex-spouse, and

      ii. The transfer must have been made under a decree of divorce or separate maintenance or a written instrument incident to such a decree.

   b. Generally, the divorce decree or written instrument incident to the divorce is one described in §71(b)(2)(A) which is a decree of divorce or a decree of separate maintenance or a written instrument incident to such a decree.

      i. The definition of an “instrument incident to a decree” under §71(b)(2)(A) is not defined in either the Code or the regulations. For purposes of §408(d)(6), the safe approach is to regard it as a writing memorializing the terms of the divorce settlement which is referred to, incorporated in, or approved by the court entering the decree of divorce or legal separation.

      ii. The agreement to transfer the IRA must be approved by the court to enjoy the protection of §408(d)(6). See PLR 9344027 where the IRS ruled that a husband’s transfer of his wife’s community share of an IRA titled in his name to the wife pursuant to a “private” written separation agreement where the parties were not
“contemplating entering into a divorce proceedings” was not incident to either a divorce or legal separation and was outside the scope of §408(d)(6). The husband was taxable on the transfer. See also Technical Advice Memorandum 199935055 where the IRS ruled that a withdrawal from husband’s community IRA endorsed over to wife prior to party’s execution of a divorce agreement was not “under” a written instrument. Husband was taxed on the distribution.

iii. Generally, the divorce decree or written separation instrument should address the IRA and stipulate how it is to be divided. An IRA custodian or trustee may require that the divorce decree or written separation instrument refer to the IRA’s account number and the IRA custodian or trustee.

iv. An IRA transfer may be able to be used to meet a support obligation, not just a division of the marital property, as long as the transfer meets the requirements of §408(d)(6) that the instrument requiring the transfer for support be a divorce decree or a written instrument “incident to a decree of divorce.”

c. The “transfer” may consist of executing a separate document assigning the IRA owner’s ownership rights in the IRA to the ex-spouse. PLR 9016077 and 7948054.

i. Note that a transfer of IRA assets pursuant to a separation agreement (but not incident to divorce or legal separation), failed to shift taxation of an IRA distribution from the IRA owner to the spouse. PLR 9344027. See also TAM 199935055. Thus, it is important that the instrument requiring the assignment of the IRA be unmistakably one “incident to a decree” as opposed to being a written separation agreement. In other words, the agreement to transfer the IRA must be approved by the court. See also PLR 8820086 and 9439020.

d. A written separation agreement is not “incident to a decree” until a decree is entered. Thus, the transferor spouse should make sure that the agreement states that the transfer of the IRA is to be made after the divorce decree has been entered.

III. There are only two ways to transfer an IRA in divorce – (1) change the name on the IRA from one spouse to the other spouse or (2) do a trustee to trustee transfer:

a. Change name of IRA owner. The IRA may be continued and the name of the owner changed i.e. an assignment of the IRA to the ex-spouse.
b. **Trustee to trustee transfer - IRA owner sets up the new IRA.** If there is one IRA account, the IRA owner could do a trustee to trustee transfer of the assets equal to the amount that is to go to the ex-spouse and transfer it to a second IRA in the IRA owner’s name. The IRA owner could then assign the second IRA to the ex-spouse.

   i. This should be done as a trustee-to-trustee transfer to the new IRA.

   ii. Note that this IRA can be a new IRA set up by the IRA owner or an existing IRA.

   iii. For assignments of IRAs to an ex-spouse, see PLR 8649053, 9016077 and 9419036.

c. **Trustee to trustee transfer - Ex-spouse sets up the new IRA.** Alternatively, the IRA owner could make a direct transfer of assets from the IRA owner’s IRA to an IRA already set up and owned by the ex-spouse. PLR 9937055, 9739044, 9006066 and 8504079.

   i. Example: In PLR 8504079 H and W were in the process of obtaining a divorce. H rolled over his distribution from a qualified plan into an IRA. He established an IRA for W. As part of the divorce agreement, H transferred his IRA to the IRA established for W. The transfer was held nontaxable and the IRA was treated as belonging to W, incident to the divorce.

d. Could the assets be withdrawn from one spouse’s IRA and transferred to the ex-spouse who sets up an IRA and rolls the distribution from the transferor spouse within 60 days into an IRA set up by the transferee spouse?

   i. A distinction should be made between a *distribution* and a *transfer*. §408(d)(6) requires a transfer for tax-free treatment. A distribution is usually considered a taxable event. Thus, the recommended method is a trustee to trustee transfer.

   ii. §408(d)(6) requires a “transfer” of an interest in an IRA. If the IRA owner withdraws the IRA assets and transfers the assets to his ex-spouse, the IRA owner’s interest in the IRA ends upon withdrawal of the assets and thereafter he does not have an interest in an IRA to “transfer.” The distribution would be a taxable distribution even if the ex-spouse rolled the distribution into an IRA.
1. In Jones v. Commissioner, 80 T.C. Memo 76 (2000) the IRA owner withdrew the entire amount from the IRA in the form of a check and endorsed the check over to his ex-wife who was entitled to the IRA under the divorce agreement. The court ruled that the endorsement of the check didn’t qualify as a “transfer” under §408(d)(6). Once the funds were withdrawn from the IRA, the husband’s interest in the IRA ended and thereafter he did not have an interest in the IRA to transfer. In other words, a distribution from the husband’s IRA followed by an endorsement of the check to his ex-spouse did not constitute a “transfer” of an interest in the IRA under §408(d)(6). The husband had to pay an income tax on the withdrawal plus a 10% penalty as he was under age 59 ½.

2. Similarly, in Bunney v. Commissioner, 114 TC 259 (2000), the Tax Court ruled that where the IRA owner withdrew money from his IRA, deposited it in his money market account and subsequently transferred money to his ex-wife, the IRA owner did not “transfer” his interest in the IRA to his ex-spouse. Instead, what he did was cash out his IRA and pay his ex-wife some of the proceeds. The Tax Court held the distribution was a taxable event that was not covered by §408(d)(6).

3. In Czepiel v. Commissioner, TC Memo 1999-289, a taxpayer who took distributions from his IRA in order to pay his wife a cash sum owed under a divorce decree was not considered to have transferred an “interest” under §408(d)(6). The divorce instrument only required that money be transferred, not an interest in the IRA.

4. In Paul D. Harris, 62 T.C.M. 406 (1991) funds withdrawn from the IRA owner’s IRA and given to his spouse to satisfy an obligation under a divorce decree were taxable to the IRA owner.

5. The Jones, Bunney, Czepiel and Harris cases indicate that the requirements for a nontaxable transfer of a taxpayer’s interest in an IRA under §408(d)(6) will be strictly construed by the Tax Court.

e. Some suggestions:
i. Include language in the divorce or separation instrument that states
the intention that the transfer of the IRA be tax-free under
§408(d)(6).

ii. Have the actual IRA transfer papers incorporated into the divorce
or separation agreement which is approved by the court.

iii. Make the transfer of the IRA by a trustee to trustee transfer. Do
not take a distribution and transfer the distribution to the ex-
spouse.

iv. Make sure the divorce or separation instrument is approved by a
court.

v. Do the transfer after the divorce decree is final.

f. If the rules outlined above are followed, the amount transferred is not
considered a distribution to either the IRA owner or the ex-spouse. Reg.
1.408-4(g)(1). Thus, the distribution is not taxable.

i. However, if the §408(d)(6) exception doesn’t apply, the transaction
is a taxable distribution from one IRA followed by a re-
contribution to the spouse’s IRA. This could trigger not only an
income tax on the distribution but also an excess contribution
penalty on the re-contribution to the spouse’s IRA.

g. Don’t make this mistake! If the money is withdrawn from the IRA and
then transferred to satisfy one spouse’s obligation to the ex-spouse (e.g.
one spouse agrees to satisfy his ex-spouse’s tax obligation), the transfer is
available to rollover into an IRA. If the IRA owner is under age 59 1/2, a
10% premature distribution penalty may also apply.

IV. Is the ex-spouse entitled to a share of the IRA owner’s tax basis in his IRA?

a. It appears that an ex-spouse is entitled to a share of any tax basis the IRA
owner has in his IRA prior to the transfer. The IRA owner’s basis is most
likely the result of nondeductible contributions.

b. It is uncertain how the basis is to be split between the IRA owner and the
portion of the IRA transferred to his ex-spouse.

i. One option is to split the tax basis in proportion to the value of
each spouse’s IRA assets.
ii. Another option may be to allocate a greater portion of the tax basis to one party, a so-called special allocation. See Notice 87-16, Q&A D1 through D7 for whether a special allocation is acceptable.

iii. Form 8606 should be used to notify the IRS of the basis in the IRA.

V. IRA characteristics.

a. Once the transfer is made, the ex-spouse’s interest in the transferred IRA is treated as the ex-spouse’s for all tax purposes. In other words, the IRA becomes the IRA of the transferee spouse as of the date of the transfer. Reg. 1.408-4(g)(2).

i. The ex-spouse will pay income tax when she takes a distribution from the account. See Cohen v. Commissioner, (TC Memo 2004-227) where the court held that the ex-spouse was taxable on a distribution from an IRA transferred to her by a trustee to trustee transfer from her ex-husband IRA pursuant to their divorce agreement.

ii. Once the ex-spouse reaches age 70 ½, or if she is over age 70 ½, minimum required distributions must begin based upon the ex-spouse’s elections.

iii. When the ex-spouse dies, the transferred IRA will be distributed to the ex-spouse’s beneficiaries based upon her designated beneficiary.

iv. Also, the ex-spouse is not bound by his or her former spouse’s election to receive substantially equal periodic distributions from the IRA. PLR 9739044, 200027060, 200040046, 200052039, 200050046, 200116056, 200225040, 200202074, 200202075, 200202076, 200214034, 200717026, and 201030038.

v. The ex-spouse will be subject to the 10% penalty for distributions taken before age 59 ½ unless she qualifies for an exception to the 10% penalty.

VI. The conflict between §408(d)(6) and §1041.

a. §1041 grants tax-free treatment to certain transfers between spouses.

b. Can a married couple not in the process of a divorce transfer an IRA from the husband to the wife tax-free? The IRS in PLR 9422060 says no.
i. In PLR 9422060 the IRS rejected the husband’s claim that the transfer of assets from his IRA to his wife’s IRA was tax-free under §1041. The IRS said that since the transfer was not incident to divorce, §408(d)(6) (being more specific than §1041) superseded §1041. Since §408(d)(6) limits tax-free transfers of IRA funds between spouses to divorce situations, lifetime transfers of IRA funds between spouses not incident to divorce are taxable distributions under §408(a). See also PLR 199937055 and PLR 8820086.

ii. See also PLR 8820086 where the IRS refused to treat a transfer between spouses not incident to a divorce or legal separation as a tax-free spousal transfer pursuant to §1041(a), holding that §408(d)(6) applies in the case of IRA transfers.

VII. The Timing of the Transfer.

a. Should IRA owner wait until after the entry of the decree of divorce to transfer the IRA?

i. A separation agreement that is not “incident” to a decree of divorce is not sufficient to make an IRA transfer nontaxable. See PLR 9344027 where the IRS ruled that where a couple in a community property state divided the husband’s IRA under a private separation agreement, the husband was taxable on the transfer and that §408(d)(6) did not apply.

ii. §408(d)(6) and the regulations thereunder offer no guidance on the issue of the timing of the IRA transfer.

iii. The safe course is to wait until the divorce decree has been approved by a court before making the IRA transfer. Otherwise the parties take a risk that if the IRA is transferred but the divorce is never finalized, the favorable tax treatment under §408(d)(6) will be lost.

iv. Possible scenarios of transferring an IRA after entering into a divorce or separation agreement but before obtaining a divorce decree from a court:

1. The divorce is never finalized.

2. One of the parties dies prior to the divorce decree.

3. The parties reconcile.
VIII. The conflict between §408(d)(6) and §72(t).

a. §72(t)(1) imposes a 10% penalty on a premature distribution of retirement plan benefits. A premature distribution is one that occurs before age 59 ½.

i. §72(t)(2) lists certain distributions from retirement plans which are not subject to the §72(t)(1) penalty tax, including a distribution under §72(t)(2)(A)(iv) which is part of a series of substantially equal periodic payments made not less frequently than annually for the life or life expectancy of the employee or joint lives or joint life expectancies of the employee and his designated beneficiary.

ii. If a taxpayer has begun taking “substantially equal periodic payments,” those payments must continue for 5 years or until the employee reaches age 59 1/2 , whichever is longer.

1. If the payments are modified during this time period, the 10% premature distribution penalty applies from the date the first payment was made. Interest must be paid on the deferred penalty.

b. What happens if a taxpayer, who is under age 59 1/2, has begun taking substantially equal period payments and, as part of a divorce proceeding, is ordered to transfer a portion of his retirement benefits to his ex-spouse? Will the taxpayer become liable for the 10% premature distribution penalty because his future payments from the IRA will be affected by his divorce? PLR 9739044 sheds light on this issue.

i. In PLR 9739044, the husband was age 55 and was taking substantially equal period payments from his IRAs. He and his wife divorced. As part of the divorce agreement, the husband agreed to split his IRAs evenly with his wife. The issue arose as to whether the transfer of half of his IRAs to his wife would cause a “substantial modification” of his IRA payments so that he would become liable for the 10% premature distribution penalty. The IRS held that the transfer of one-half of a husband’s interest in several IRAs to an IRA established for his ex-wife pursuant to a divorce decree, would be considered nontaxable transfers under §408(d)(6). Moreover, the IRS said that the reduced payments that the husband would receive as a result of the division of the principal balances between the ex-spouses would not constitute a “subsequent modification” of the existing payment schedule because the aggregate annual amount that would be distributed from the principal of the IRAs to the ex-spouses under the separation agreement would be substantially the same as it was before the division. Therefore, the amounts transferred from the
husband’s IRA to the ex-wife’s IRA would not be subject to the §72(t)(1) 10% additional tax on premature distributions. It is important to note that in this case the spouse’s ages were two years apart (he was 55, she was 53) and the wife agreed to take substantially equal periodic payments based on her life expectancy on her portion of the IRA while the husband agreed to take substantially equal periodic payments based on his life expectancy on his portion of the IRA. Since the total payments for both spouses after the divorce were approximately the same as the husband’s distributions before the divorce, the IRS ruled that there was not a substantial modification of the payments and the 10% premature distribution penalty did not apply.

ii. See also PLR 200027060 where the IRS held that after the transfer of an IRA incident to a divorce decree, an ex-spouse was not required to continue to receive her proportionate share of the IRA as substantially equal periodic payments to avoid a §72(t) penalty.

iii. In addition, see PLR 201030038, 200040046, 200202074, 200202075 and 200202076 where the IRS held that upon the transfer of an IRA to an ex-spouse incident to a divorce, the IRA owner taxpayer would continue to be in compliance with the substantially equal periodic payment rules (i.e. there would be no modification of the substantially equal periodic payments) if the monthly distribution was reduced by the proportionate share of the IRA transferred to the ex-spouse. In addition, the IRS did not require that the ex-spouse continue the substantially equal periodic distributions from the ex-spouse’s share of the IRA.

iv. In PLR 200717026 the IRS ruled that an IRA distribution pursuant to a divorce settlement that resulted in lower monthly payments was not a substantial modification of the substantially equal periodic payments because the method of calculating the monthly payments did not change. In this ruling the IRA owner was required by the divorce agreement to transfer 50% of his IRA to his ex-wife. The IRA owner, who was taking substantially equal periodic payments from his IRA, was allowed to reduce his payments by the 50% he had to give to his ex-wife. Thus, the IRS allowed him to use the new lower IRA balance and the same fixed amortization method to calculate his reduced payments.

v. Note that while there is no statutory authority providing an exception to the substantially equal periodic payment rules in divorce, the IRS position now seems to be that a taxpayer who is taking substantially equal periodic payments from an IRA will not be deemed to modify the payments upon the transfer of a portion
of his IRA to his ex-spouse incident to a divorce if he continues to receive substantially equal periodic payments on his remaining proportionate portion of the IRA using the same calculation method he used prior to the transfer. This is so even if the ex-spouse to whom a portion of the IRA is transferred does not take substantially equal periodic payments on his or her share. PLR 200027060. See also PLRs 200225040, 200214034, 200116056, 200050046 and 200052039.

IX. Minimum required distributions

a. Amounts transferred incident to a divorce will not reduce the amount of the minimum required distribution in the year of the transfer. The minimum required distribution will be based on the account balance as of December 31 of the prior year even though there is less money in the IRA as a result of the distribution to the ex-spouse as part of the divorce settlement. This is the same result that would occur if the market value of the IRA declined during the year. The ex-spouse does not have to take a minimum required distribution on the amount transferred to her in the year of the transfer. Her first minimum required distribution (if she is over 70 ½) is in the year after the transfer of the IRA to her and is based on the prior year-end balance in the IRA. PLR 9011031.

i. The transferor spouse may be of an age where minimum required distributions are required. This will present a problem where the IRA is transferred to the ex-spouse before the transferor spouse has taken that year’s minimum required distribution. The divorce decree or the written instrument incident to the decree should provide that the amount to be transferred to the ex-spouse is the amount less the amount that the transferor spouse is required to take as a minimum distribution for the year of transfer.

X. The conflict between §408(d)(6) and §691 – can an inherited IRA be split in divorce?

a. An inherited IRA (where a person is named as a beneficiary of a deceased owner’s IRA) is income in respect of a decedent under §691.

b. Nothing in §408(d)(6) prohibits the tax-free transfer of an inherited IRA incident to a divorce.

c. Generally, the transfer of income in respect of a decedent to another individual, including a former spouse, will trigger recognition of income. §691(a)(2).
d. However, §408(d)(6) says that a transfer of an IRA to a spouse or former spouse under a divorce or separation instrument is not a taxable transfer “notwithstanding any other provision of this subtitle…” Since §691(a)(2) (which governs the taxability of transfers of income in respect of a decedent) is contained in the same subtitle of the Internal Revenue Code (Subtitle A-Income Taxes) as §408(d)(6), the §408(d)(6) nontaxability provision trumps §691(a)(2). Thus, the transfer of an inherited IRA should also enjoy the protection of §408(d)(6).

XI. The tax consequences if the transfer fails to satisfy §408(d)(6)

a. If transfer of the IRA to the ex-spouse does not satisfy the requirements of §408(d)(6), the consequences are as follows:

i. The transfer will be treated as a distribution to the IRA owner who will have to report the distribution as taxable income and, if under the age of 59 ½, will be liable for a 10% early distribution penalty.

ii. The transferee ex-spouse will receive the distribution tax-free but will not be able to transfer the proceeds to an IRA in her name. Thus, the benefit of tax-deferred growth will be lost.

iii. If the transferee ex-spouse does receive the transfer directly into her own IRA and fails to withdraw the taxable amount prior to the due date of the tax return for the year of transfer, the transferee ex-spouse’s IRA account will be subject to the 6% excise tax for excess contributions for each taxable year that the excess contributions remain in the IRA. §4973; §408(d)(4).

XII. Who is the IRA beneficiary after divorce?

a. Many IRA owners name their spouse as the beneficiary of an IRA. Once the divorce is finalized and the property rights determined, an IRA owner should review the beneficiary designation. The former designated beneficiary (e.g. the ex-spouse) may not be the person that the IRA owner wants to receive the proceeds of his IRA. If this is the case, the IRA beneficiary designation form should be changed to name the desired beneficiary.

XIII. What happens if the ex-spouse inadvertently remains the designated beneficiary? In the absence of a statute or a specific or implied provision in the divorce agreement revoking the ex-spouse as the beneficiary, it appears that the ex-spouse would receive the IRA proceeds. Paine Webber v. East, Maryland Court of Appeals (March, 2001).
a. However, check state law as a state statute may revoke the beneficiary designation in the event of a divorce.
Retirement Benefits – Qualified Plans

d. Qualified Plans

i. Need for qualified domestic relations order. §414(p).

1. In the absence of statutory authority, the spendthrift requirement for qualified plans would likely prohibit a division of qualified plan interests between an employee and his or her spouse. §401(a)(13)(A) and (B).

2. The Retirement Equity Act (REA) of 1984 created an exception to the non-assignability for interests transferred under a qualified domestic relations order (QDRO).

3. A QDRO is a domestic relations order made under a state’s domestic relations law that creates or recognizes the existence of an alternate payee’s right to receive all or a portion of a participant’s interest in a plan.

4. A domestic relations order is a judgment, decree or order (including approval of a property settlement) 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 relation law. §414(p)(1).

5. Counsel must ensure that the QDRO meets all the requirements of §414(p). QDRO requirements:

a. It must (1) clearly state the name and last known address of the participant and the alternate payee, (2) the amount or percentage of the benefits to be paid to the alternate payee or the manner in which the amount or percentage is to be calculated, (3) the number of payments or periods to which the order applies and (4) each plan to which the order applies.

b. It must not (1) require any type or form of benefit not otherwise provided by the plan, (2) require the plan to provide increased benefits, or (3) require the payment of benefits to an alternate payee that are required to be paid to another and prior alternate payee.

c. A QDRO may, however, require payments to a alternate payee on the earliest day on which the participant attains his or her earliest retirement age under the plan. §414(p)(3) and (4).

d. The alternate payee must have the right to receive benefits directly from the plan. It is not permissible for a domestic relations order to direct the participant to withdraw funds from the plan and pay the funds to the spouse or former spouse.

6. Income taxation of the QDRO – if the alternate payee is the spouse or former spouse of the participant, the alternate payee rather than the participant will be taxed on the plan distributions made to him or her. §402(e)(1)(A). The taxation of the QDRO to the spouse or former spouse cannot be altered by the terms of the QDRO. Clawson v. Commissioner, T.C. Memo 1996-446 (1996).
   a. The recipient spouse can take a withdrawal pursuant to the QDRO without having to pay an early withdrawal penalty. §72(t)(2)(C).
   b. A spouse that receives a distribution under a QDRO from his or her spouse’s qualified retirement plan can avoid immediate income taxation of the distribution by rolling the amount received within 60 days of receipt into an IRA, an IRA annuity, a qualified trust or an annuity plan. Reg. 1.402(c)-2, Q&A-12. However, if the spouse takes a distribution from the qualified plan pursuant to a QDRO and rolls the distribution to an IRA, there is a 20% withholding requirement. §3405(c). A direct trustee to trustee transfer from the qualified plan to the IRA will avoid the 20% withholding requirement.
   c. There are advantages to transferring funds from an ex-spouses qualified retirement plan to an IRA such as control over the money, the ability to select investments and distance from the ex-spouse.
   d. However, if the withdrawal is taken pursuant to the QDRO and rolled over to an IRA, distributions from the IRA will be subject to the 10% penalty on early withdrawal if the IRA owner is under 59 ½.
   e. If the spouse needs some of the money in the retirement account before 59 1/2, one option is to leave some of the money in the qualified retirement account until age 59 ½, rather than immediately rolling over the distribution to an IRA. Distributions from the qualified retirement plan will not be subject to the 10% penalty on early withdrawals. There is no time limit on when money received under a QDRO must be rolled over into an IRA.

7. Payments made to a child pursuant to a QDRO remain taxable to the participant spouse.

8. The Internal Revenue Service can levy or seize the non-participant spouse’s share of a retirement plan that he/she
received pursuant to a QDRO for back income taxes, even for income reported on a pre-divorce joint return. While ERISA prevents ordinary creditors from attaching pension payments, court have unanimously held that a federal tax lien or levy may be imposed on ERISA qualified retirement plans. Ameritrust Co. N.A. v. Derakhshon, 830 F.Supp. 406 (N.D. Ohio 1993).

9. A QDRO can be used as collateral.
   a. Generally, qualified retirement plans can be alienated i.e. they are immune from the grasp of creditors. §401(a)(13)(A).
   b. A QDRO is exempt from the anti-alienation and anti-assignment provisions of ERISA. §401(a)(13)(B).
   c. Thus, a QDRO can be used as collateral to protect an alternate payee’s interest in a marital settlement agreement or court order. Few accountants and attorneys realize or use this.
   d. Example: A participant spouse’s retirement plan is QDRO’ed i.e. QDROs are placed on both spouse’s portion of the plan. A certain percent is assigned to the alternate payee spouse. The remainder in a QDRO belongs to the participant spouse. A judgment of divorce assigns a security interest in the participant’s QDRO to the alternate payee spouse. See PLR 9234014 and PLR 2002292093.
   e. Equitable distributions, alimony/child support and education obligations can all be secured by the QDRO.
   f. For case law approving the use of a QDRO as collateral see Renner v. Blatte, 650 N.Y.S. 2d 943 (1996) (approving the use of a QDRO as security for future support obligations), Silverman v. Spiro, 438 Mass. 725, 735-736 (2003) (court granted husband’s request for attorney’s fees associated with the order that provided for back child support orders) and Hayden v. Hayden, 662 So.2d 713 (1995) (use of QDRO to secure alimony or child support arrearages permitted).
   g. Example: Husband has a business and assets in the qualified retirement plan. Husband and wife are going through a divorce. Husband wants to retain control of a business. The property settlement agreement calls for the husband to give the wife a promissory note equal to half of the business. The wife demands that the promissory note be secured.
The retirement plan is to be divided between the spouses pursuant to a QDRO. A QDRO is imposed over both spouse’s share of the plan. The QDRO of the husband/business owner is pledged to the non-business owner/wife as collateral for the promissory note. If the husband defaults on the note or the business loses value, the wife can tap the husband’s share of the qualified plan to satisfy the promissory note.

h. Who pays the income tax if the creditor spouse has to proceed against the security interest in the participant spouse’s QDRO which has been pledged as security? The creditor spouse becomes the alternate payee and, as such, is responsible. Counsel representing the creditor spouse should negotiate a gross-up in the amount subject to the collateral agreement to address the income taxes that will have to be paid by the creditor spouse to enforce the security interest.


1. Although pension rights may be unvested, they are not like future inheritances in that the pension plan participant has an enforceable legal right to collect benefits if the conditions are met.

2. The uncertainty of the benefits at issue can be handled equitably by dividing the benefit on a deferred percentage basis, requiring the plan participant to pay the non-participant spouse a stated percentage of any funds which are ultimately received.

3. M.G.L. c. 208 §34 specifically allows the division of “all vested and nonvested benefits, rights and funds accrued during the marriage.” These include “retirement benefits, military retirement benefits if qualified under and to the extent provided by federal law, pension, profit sharing, annuity, deferred compensation and insurance.” Both public and private pensions are subject to distribution.

4. In Massachusetts, the present division of marital assets is preferred if the present valuation of future pension benefits can be ascertained. Dewan v. Dewan, 399 Mass 754, 506 NE2d 879 (1987). However, if present valuation of a pension is uncertain or impractical, the better practice is to order that any future recovery or payment be divided, if and when received, according to a formula fixed in the property
iii. Naming beneficiaries after a divorce
      a. While married, David Egelhoff named his wife, Donna Rae, as the beneficiary of his ERISA plan benefits. David and Donna Rae subsequently divorced without David removing her as the beneficiary of his ERISA plan benefits. Washington state statute revokes designation of an ex-spouse as the beneficiary of retirement plan benefits upon divorce. ERISA does not automatically revoke the designation of an ex-spouse as the beneficiary of ERISA plan benefits. David died intestate in a car accident weeks after the divorce was finalized never having removed Donna Rae as the beneficiary. David’s children by a previous marriage and Donna Rae, the former spouse, both claimed the ERISA plan benefits. The United States Supreme Court held that ERISA preempts the Washington state law revoking the designation of Donna Rae as the beneficiary. Since David never removed Donna Rae as the beneficiary, Donna Rae was entitled to the ERISA plan benefits.
      a. William named his wife, Liv, as the beneficiary of his ERISA plan benefits. Subsequently, William and Liv divorced. Liv joined in a divorce decree giving up all her rights in, among other things, William’s ERISA plan benefits. William never removed Liv as a beneficiary of his ERISA plan benefits. Upon William’s death, his estate sued claiming rights to the plan benefits. The United States Supreme Court held that a divorcing spouse could waive plan benefits through a divorce decree under state law. However, Liv was held to be entitled to the plan benefits as she was the named beneficiary as of the time of William’s death and the ERISA plan documents trump the divorce waiver to determine who is entitled to the plan benefits upon the plan participant’s death. The Court said that the plan documents (of which the beneficiary designation form is a part) govern who
is entitled to the plan benefits regardless of the provisions of a divorce decree to the contrary. Thus, the bottom line is that the plan documents determine plan distributions. The court left open the issue whether William’s estate could sue Liv under a contract theory (the waiver in the divorce decree being the contractual agreement) to recover the plan benefits after Liv actually received them.

i. Courts have subsequently held that the plan beneficiary could sue under a contract theory when the named beneficiary under a pension plan waived his or her rights to the pension plan benefits pursuant to the waiver contained in a divorce agreement. Although a deceased participant’s benefit in a pension plan must be distributed to the named ex-spouse/beneficiary despite a prior waiver of his or her rights to the benefits, the participant’s estate may subsequently sue the ex-spouse under a contract theory for recovery of the distributions where the ex-spouse waived his or her rights to the proceeds of the pension plan upon their divorce. See Estate of Kensinger v. URL Pharma, Inc., 674 F.3d 131 (3rd Cir. 2012) and Andochick v. Byrd, No. 1:11-cv-739, 2013 WL 781978 (4th Cir. March 4, 2013), cert. Denied October 17, 2013.

iv. Retirement Equity Act of 1984

1. Surviving spouse protections of the Retirement Equity Act of 1984 do not apply to IRAs, even if the funds in the IRA came from an ERISA plan without the spouse’s consent. Charles Schwab & Co. v. Debickero, 105 AFTR 2d 2010-692 (9th Cir. 2010).
Miscellaneous

I. Charitable remainder trusts

i. CRT may be split into two CRTs tax-free upon divorce giving one spouse a life interest in one CRT and the other spouse a lifetime interest in the other CRT, with the remainder interest in the trust going to the same charity as that in the original CRT. Rev. Rul. 2008-41, 2008-30 IRB 170 and numerous private letter rulings approve this division as part of a divorce. PLR 200143028, 200109006, 200045038, 200333013, 200310120, 200035014, 200502037, 200524013, 200524014, 200539008, 200616008, 200728026, 200744019, 200814003 and 200824022. The rulings conclude that the division is tax-free either because of the application of §1041 or because it was a non-taxable partition of property between joint owners.

1. The basis and holding period of the assets in the CRT will be the same as before the division.

ii. The division of a CRT is desirable to, among other things, avoid the need to agree on trust investments and the selection of the ultimate charitable beneficiaries.

iii. It is also possible to sell the income interest and divide the proceeds.

iv. Rev. Rul. 2008-41, 2008-30 I.R.B. 170 dealt with the income tax-free division of a CRT which involved a joint CRT that paid an annuity or unitrust amount in equal shares to a husband and wife. The CRT was split into two equal shares, each one funded with an equal share of each asset held by the original CRT.

1. Rev. Rul. 2008-41 does not cover the situation where the CRT assets are not divided equally asset by asset but, instead are divided on a pro rata basis with each new CRT receiving assets with an equal aggregate value. It also doesn’t cover where one spouse created the CRT and was the original annuitant or unitrust recipient and the divorce agreement requires a division of the trust between spouses.

2. In the above cases not specifically covered by Rev. Rul. 2008-41, the division of the CRT upon divorce should be tax-free. §1041 should apply even if the division results in each spouse receiving materially different interests in the CRTs as §1041 protects inter-spousal transfers from treatment as tax realization events.
3. Even if §1041 does not apply, if the CRT is one in which each spouse had an equal interest, it should be protected by Rev. Rul. 81-292, 1981-2 C.B. 158 which holds that an approximately equal division of the total value of jointly owned property under a divorce settlement agreement which provides for the transfer of some jointly owned assets in their entirety to one spouse and other jointly held assets to the other, is a non-taxable division of property. See also Rev. Rul. 76-83, 1976-1 C.B. 213 reaching the same conclusion as to equal division of community property under a divorce agreement.

v. If CRT is not split at divorce, and former spouse becomes the life beneficiary after the death of grantor of the CRT, the former spouse’s interest will no longer qualify for the marital deduction and the actuarial value of the former spouse’s interest in the CRT will be includable in the estate of the deceased grantor and subject to estate tax.

1. The CRT should contain the language suggested by Revenue Ruling 82-128, meaning that the former spouse’s right to become the income beneficiary of the CRT is contingent on the former spouse being responsible for the estate taxes attributed to the inclusion of her interest in the deceased CRT grantor’s estate.

II. Life insurance
   a. Splitting up a second to die policy after a divorce

III. Buy-sell agreements
   a. Buy-sell agreement requiring a S corporation to redeem stock in the event of a divorce is ignored in determining if the corporation has two classes of stock. Reg. 1361-1(i)(2)(iii)(3).
   b. Buy-sell agreement of S corporation may provide that, in the event of a divorce, the divorced spouse’s shares will be converted to nonvoting stock without creating impermissible second class of stock. §1361(c)(4).

IV. Tax Carryovers
   a. Charitable contribution carryover.
      i. Any charitable contribution carryover originally claimed on a joint return is allocated between the spouses in divorce based on the ratio of the amounts each of them would have carried forward if they had filed separate returns in the year in which the excess charitable contributions were made. Reg. 1.170A-10(d)(4)(i)(b).
b. Capital loss carryover.
   i. Any capital loss carryover incurred on a joint return is allocated between the spouses in divorce on the basis of their individual net losses that gave rise to the carryover. Reg. 11.1212-1(c)(1)(iii).
      1. Thus, if a husband and wife take a capital loss on a joint income tax return and the next year file separate returns, the capital loss carryover is allocated to the spouse who actually suffered the capital loss.
   ii. Some states treat capital loss carryovers as marital assets subject to equitable division.
I. Initial requirement – does the interest in the trust constitute marital property?
   a. Revocable trust – if the grantor retains the power to revoke the trust, the non-grantor beneficiary has, at most, a mere expectancy and this does not constitute an interest in property for divorce purposes. Rather, the assets of a revocable trust are treated as owned by the grantor.
   b. Irrevocable trust – income interest
      i. The right of an income beneficiary to receive distributions from the trust may depend on the discretion of the trustee.
      ii. Discretionary right to income. Where the right to receive income depends entirely on the discretion of the trustee so that the beneficiary has no enforceable right to demand any amount of income, the income interest in the trust is not property. D.L. v. G.L., 61 Mass. App. Ct. 488, 811 N.E. 2d 1013 (2004) (various interests in income and principal which were dependent upon the discretion of the trustee were not property, even though consistent distributions of income had been made to the beneficiary). Thus, Massachusetts recognizes the fundamental distinction between discretionary and non-discretionary trusts. “While a judge is not necessarily precluded from including within the marital estate … a party’s beneficial interest in a discretionary trust … because of the peculiar nature of such a trust, the trust instrument and other relevant evidence must be examined closely to determine whether that party’s interest is too remote or speculative to be so included.” The D.L. court further analyzed certain other “non-discretionary” remainder trusts, which it similarly concluded were “too remote or speculative” to constitute property.
         1. A discretionary trust is probably the most effective means of keeping the nongrantor beneficiary’s creditors away from the beneficiary’s interest in the trust. This is because the beneficiary has no enforceable right to an identifiable portion of the income or principal of the trust. Pemberton v. Pemberton, 9 Mass. App. Ct. 9, 20, 411 N.E. 2d 1308 (1980) (noting that “if even apart from the spendthrift clause a trustee is given the discretionary power to distribute income or principal to described beneficiaries [a] right of any beneficiary to receive anything is subject to the condition precedent of the trustee having first exercised his discretion” with the result that “the immunization of the trust assets from the reach of creditors of beneficiary is complete.”)
belonging to the beneficiary for purposes of determining how the other items of marital property are to be allocated between the parties i.e. for valuation purposes. This was so even though the interest could not be reached by the spouse and children of the nongrantor beneficiary because of a spendthrift provision.

b. In Child v. Child, 58 Mass. App. Ct. 76, 84 n.4, 787 N.E.2d 1121, 1126 n.4 (2003) where the appellate court in a divorce case speculated that had the husband raised at the trial level the issue of the valuation of his equitable interest under two non-self-settled discretionary trusts, the principal might have been entered on the husband’s side of the ledger at a discounted value, the husband seeming to lack a “present, enforceable right to use the trust property for his own benefit.”

c. In Williams v. Massa, 431 Mass. 619, 628-29, 728 N.E. 2d 932, 940-41 (2000) the court found that the contingent equitable remainder interest in a discretionary trust was a “mere expectancy” and therefore not susceptible of valuation.

d. In Dwight v. Dwight, 52 Mass. App. Ct. 739, 756 N.E. 2d 17 (2001) the court awarded the wife alimony after the husband received a contingent equitable interest in a non-self-settled discretionary trust to be shared with other permissible beneficiaries, the husband’s shared contingent equitable interest being deemed to be a “substantial inheritance” for asset valuation purposes. The court in Dwight ruled that in determining the amount of alimony that would be appropriate given the change in circumstances attributable to a substantial inheritance, the husband’s potential income rather than his actual income as limited by any voluntary action may be considered by a trial judge. In Dwight, the husband became a beneficiary of a discretionary spendthrift trust and the facts showed that the husband told the trustee he did not want any income. The Dwight decision, as written, has nothing to do directly with the spendthrift rule or creditor’s (e.g, spouse’s) ability to reach the assets in a non-self-settled discretionary trust but it does cause one to wonder about the viability of spendthrift protection doctrine in Massachusetts as it relates to domestic relations cases.
e. In S.L. v. R.L., 55 Mass. App. Ct. 880, 774 N.E. 2d 1179 (2002) the court avoided the issue of valuing equitable interests under discretionary trusts by providing that at least a portion of any future distributions made by the trustee be physically allocated to the nonbeneficiary spouse. The court ordered 20% of any future distributions actually made to the wife/beneficiary of the discretionary trust be paid to the husband. This is a form of a charging order.

i. In this case a spouse’s contingent equitable remainder interest in one of five trusts established by her father was not included in the marital estate for computation purposes because her mother had a testamentary power of appointment over the trust property and the non-exercise of both the mother’s inter vivos and testamentary power of appointment was a condition precedent to the spouse receiving an interest under the trust. The interest in this trust, which was susceptible to complete divestment upon the wife’s mother’s exercise of a power of appointment over the remainder in favor of beneficiaries other than the wife, was considered too remote or speculative for inclusion in the estate for property division purposes. In addition to her mother not appointing the remainder to others, the wife had to survive her mother to take an interest in the trust. The wife’s interest in the trust was deemed to be the equivalent of an expectancy and was excluded from the assets divided as part of the marital estate.

ii. The wife’s interest in the other four trusts, which were subject only to surviving her mother were included in her estate for property division purposes. The court in Davidson had previously ruled that a survivorship requirement in a trust was not a bar to inclusion within the marital estate.

f. Some courts have declined to include contingent interests in the calculation of the value of marital estates for equitable distribution purposes.

2. A discretionary income interest is not property subject to division even if the trustee is actually giving substantial
amounts to the income beneficiary as long as the right to receive those amounts is not legally enforceable.

a. It appears that a beneficiary of a discretionary trust can only compel the trustee to make a distribution if the beneficiary can show that the trustee is “abusing its discretion by acting arbitrarily, capriciously or in bad faith.” Town of Randolph v. Roberts, 195 N.E. 2d 72, 346 Mass. 578 (1964). In Roberts the defendant Roberts was sued by the town to recover disability payments she had received prior to the death of her aunt. The aunt had established a testamentary trust which paid the income to her niece, Roberts, and had the discretion to pay her principal of the trust. The court denied the claim of the town by finding as to the principal that the distribution of the principal was discretionary with the trustee. She had no absolute right to principal and could compel principal payments only by showing that the trustees had abused their discretion by “acting arbitrarily, capriciously or in bad faith.”

3. In United States v. O’Shaughnessy, 517 N.W. 2d 574, 577 (Minn. 1994) the court held that under Minnesota law, the beneficiary of a certain discretionary trust does not have “property” or any “right to property” in undistributed trust principal and income before the trustees have exercised their discretionary powers of distribution under the trust agreement. The case involved an unsuccessful attempt by the IRS to reach a taxpayer’s contingent equitable interest in a discretionary trust and/or the underlying property in order to satisfy an income tax deficiency.

4. The Restatement (Third) of Trusts has adopted a more creditor-friendly position to a beneficiary’s equitable interest in a non-self-settled discretionary trust. Restatement (Third) of Trusts §60.

5. Uniform Trust Code §504(c) provides that “to the extent a trustee has not complied with a standard of distribution or has abused a discretion...a distribution may be ordered by the court to satisfy a judgment or court order against the beneficiary for support or maintenance of the beneficiary’s child, spouse or former spouse...” Thus, the Uniform Trust Code makes an exception for support claims of a child, spouse or former spouse who has a judgment or order against a beneficiary, even a nongrantor beneficiary, for support or maintenance but only if the trustee has not complied with a standard of distribution or has abused his discretion. The court shall direct the trustee to pay...
child, spouse or former spouse such amount as is equitable under the circumstances but not more than the amount the trustee would have been required to distribute to or for the benefit of the beneficiary had the trustee complied with the standard or not abused the discretion.

6. If the grantor is also the beneficiary of a discretionary trust, the assets of the trust are reachable by the grantor-beneficiary’s creditors. Restatement (Third) of Trusts, §56, comment b; Ware v. Gulda, 331 Mass. 68, 117 N.E. 2d 137 (1954) (property of a fully discretionary trust is reachable by the grantor-beneficiary’s creditors).
   a. However, some states (Alaska, Delaware, Hawaii, Missouri, Nevada, New Hampshire, Ohio, Rhode Island, South Dakota, Tennessee, Utah, Virginia and Wyoming) have enacted legislation that protect self-settled discretionary trusts from creditors.

7. The procedure for a creditor to use to subject the beneficiary’s interest in a trust to satisfy his claim is a proceeding in equity to reach and apply the beneficiary’s interest in the trust. The creditor cannot reach the beneficiary’s interest until he has attempted without success to satisfy his claim out of the legal interests of the beneficiary unless it appears that such an attempt would be unsuccessful.

8. A charging order may assist a trust beneficiary’s creditor who is prevented from getting the underlying assets of a spendthrift or discretionary trust. A charging order would allow the creditor to grab any distributions that are actually made by the trustee before they reach the beneficiary.
   a. The Uniform Trust Code §501 allows attachment under certain circumstances of “future distributions.”
   b. The Uniform Trust Code §506 would also allow a creditor or assignee of a beneficiary of a spendthrift trust to reach mandatory distributions of income or principal, provided the trustee has not made the distribution to the beneficiary within a reasonable time after the required distribution date.

iii. Mandatory right to income. A mandatory right to income, requiring the trustee to distribute income to the beneficiary does constitute an interest in property
   1. Uncertainty in the amount of income which the trust may actually produce does not prevent the income interest from constituting property as long as the beneficiary has a legally enforceable right to a stated amount or percentage of whatever income is produced.
a. The uncertainty in the amount of income produced is a factor in valuation and division but it does not affect the classification of the interest as property.

b. Example: Father funds an irrevocable trust with income producing rental property, the income to be divided equally between son and daughter. The son’s income interest constitutes property even if the amount of income the rental property will produce varies year to year. The uncertainty in the amount of income that will be produced is a factor in the valuation of the income interest but it does not affect son’s income interest classification as property.

2. In the case of a mandatory distribution right, the creditor will institute an action to reach and apply (attach) the mandatory distribution stream rather than the trust’s underlying assets. Restatement (Third) of Trusts §56, Comment A; Uniform Trust Code §501.

c. Support trust – A support trust is a trust in which the trustee is directed to make distributions of income and/or principal for health, education, support and maintenance of a beneficiary.

   i. The beneficiary of a support trust can compel the trustee to make distributions by showing that the money is needed for whatever standard is set forth in the trust document.

d. Irrevocable trust – remainder interest

   i. A majority of the cases have adopted the common law distinction between vested and unvested remainder interests to determine if the remainder interest in question constitutes property.

   ii. Vested remainder. Where the remainder interest is vested, the interest is deemed sufficiently certain to constitute property. Lauricella v. Lauricella, 409 Mass. 211, 565 N.E. 2d 436 (1991).

      1. In Lauricella v. Lauricella, the Massachusetts Supreme Judicial Court held that when a spouse’s “rights in the trust property are present, enforceable and valuable … (his or her) beneficial interest is the trust property is subject to equitable assignment …” In Lauricella, the beneficiary had an interest in a trust “subject to divestment only if [the husband did] not survive until the trust terminate[d] according to its terms.” Based upon the husband’s young age, the court concluded that the “likelihood is that he will survive to receive his share …” The court concluded that the fact that “valuation of the interest may be difficult does not alter its character as a divisible asset.”

      iii. Unvested remainder. Conversely, where the remainder is unvested, it is deemed too speculative to constitute property. Williams v. Massa, 431 Mass. 619, 628-29, 728 N.E. 2d 932, 940-41 (2000)
(husband’s contingent remainders in two trusts were “mere expectancies, comparable to a future inheritance, which are not sufficient property interests to be considered a part of the marital estate”).

iv. Query – does the use of vesting as the dividing line between certain and speculative remainder interests make sense? Consider the following example.

1. Example: Husband establishes an irrevocable trust, income payable to wife for life, remainder upon the wife’s death to the children of the grantor. Wife is age 55 and the wife and the grantor have two children, a daughter age 30 who is getting divorced and a son, age 32. If the trust names the daughter and son by name, or creates a remainder in the grantor’s children at his death, the remainders are vested under common law, subject to divestment if the daughter predeceases her mother. The daughter’s remainder is vested and is considered property for divorce purposes even if she is terminally ill and unlikely to ever receive anything. On the other hand, if the trust document creates a remainder interest in the grantor’s children living at the death of the life tenant (his wife), the remainder is unvested at common law until the grantor’s wife actually dies. In that case the daughter’s interest is not property for divorce purposes, even if the grantor’s wife is terminally ill and the receipt of the remainder interest is almost certain. The classification of the remainder as vested if the daughter and son are named in the trust document or are members of a class of beneficiaries who are determined at the grantor’s death but unvested if the trust document determines the class members only upon the life tenant’s (wife’s) death is questionable from a policy point of view. Since the daughter will most likely outlive her mother, it arguable that it is not unreasonable to hold that the daughter’s remainder interest does constitute property for equitable distribution purposes. The issue is really whether the remainder is certain or speculative. The status of the remainder as vested or unvested does not determine the speculative nature of the interest.

2. Some states (e.g. North Dakota, Oregon, Vermont) resolve this issue by holding all remainder interests, vested or unvested, constitute property.

3. The Massachusetts approach. The Massachusetts courts have rejected the mechanical use of the common law vested/unvested distinction as the sole criterion for determining if a remainder interest is property for equitable distribution purposes. Instead, the court adopted a general

a. The trial court in D.L. v. G.L. noted that the husband’s remainder interest was contingent as it was subject to conditions precedent, including a survivorship requirement. However the trial court stated that even when a party’s remainder interest in a trust cannot strictly be characterized as vested, it still may be included, in appropriate circumstances, within the marital estate. See S.L. v. R.L., 55 Mass App. Ct. at 881, 886-887, 774 N.E. 2d 1179. Cf. Baccanti v. Morton, 434 Mass. at 794-795, 752 N.E. 2d 718.

i. In D.L. v. G.L the court held that the husband’s remainder interest in a trust was “too remote or speculative” to be included within the marital estate. The court said that although certain conditions of survivorship might not be a bar to the inclusion of a trust interest within the marital estate, the husband’s remainder interest in the trust was conditioned not only on his survival but also upon his father’s death by that date. At the time of trial, the father was 67 year old (the court did not indicate that nature of the father’s health). The court held that there was a likelihood that the husband’s father would not be alive on April 10, 2011 and the husband will be alive on that date. In short, the husband’s benefit depended not on his survival, but also upon the death of his 67 year old father before April 11, 2011.

ii. The court pointed out other cases where a trust interest was included in the marital estate. See Lauricella v. Lauricella, 409 Mass. 211, 565, NE 2d 436 (1991) (vested remainder was sufficiently certain to constitute property); Davidson v. Davidson, 19 Mass. App. Ct. at 371-372, 474 N.E. 2d 1137 (remainder interest of husband, who was 33 years old at the time of divorce, would be distributed free of trust when his mother [then living] died and he attained the age of 35); S.L. v. R.L. 55 Mass. App. Ct. at 884, 774 N.E. 2d 1179 (wife’s interest in
trust subject only to her surviving her mother).

b. The Massachusetts equitable distribution statute (M.G.L. c 208 §34) defines “nonvested benefits, rights and funds” as part of a party’s estate, clearly indicating that vesting during marriage is not a requirement to have a remainder interest considered property for equitable distribution purposes.

i. In Davidson v. Davidson, 19 Mass. App. Ct. 364, 474 N.E.2d 1137 (1985) the court held that property interests acquired after the dissolution of the marriage are not subject to division under Massachusetts law. The court held that only property that existed as of the date of the termination of the marriage can be considered in asset division. At the time of the divorce proceedings the husband had an irrevocable remainder interest under a testamentary trust of his deceased father. Although the value of the interest was uncertain, in a proceeding under Mass. Gen. Law c. 208 §34 for division of marital property, it was within the discretion of the judge to conclude that the husband’s interest under the trust from which he had received distributions after the divorce, constituted a sufficient property interest to make it part of his estate for property division purposes. The court concluded that the husband’s remainder interest under his father’s testamentary trust, while it was at the outer limits of what could be considered a property interest, constituted a sufficient property interest to make it a part of his estate for property division purposes under Massachusetts law. The court noted that the husband’s right to the remainder interest was fixed at the time of the couple’s divorce, subject only to the condition of survivorship. The uncertainty of the value of the interest in the trust was not sufficient to exclude the interest from inclusion in the husband’s estate for purposes of property division. The fact that the value of the remainder interest was uncertain, actuarial calculations would be of no avail and the remainder interest was
subject to a valid spendthrift clause and could not have been reached by the wife in satisfaction of any judgment or claim was not determinative. Note that the result in Davidson may have been different if the father had given his wife (who survived her husband and was the income beneficiary of the trust) a limited power of appointment to disinherit the ex-husband.

1. Davidson decided that as a matter of law a remainder interest in a spendthrift trust could be divisible. Whether to divide the interest, however, was left to the judge’s discretion.


iii. Other states have held that a vested remainder interest in a discretionary trust will not be considered marital property for domestic relations purposes. Rubin v. Rubin, 527 A.2d 1184 (Conn. 1987); Storm v. Storm, 470 P.2d 367 (Wyo. 1970).

c. Thus, in Massachusetts, the courts have rejected the vested/unvested classification and instead consider whether the acquisition of assets is “fairly certain.”

d. Even if a remainder interest is vested, a Massachusetts court will closely scrutinize the circumstances of each case. In Lauricella v. Lauricella, 409 Mass. at 216, 565 N.E. 2d 436 (1991) the court found that the husband had a vested right to certain trust property “subject to divestment only if [the husband] did not survive until the trust terminated according to its terms.” The court noted that the husband was about 26 years old and the likelihood was that he would survive the roughly 18 years required to receive his
share of the trust. The court was evaluating the degree of speculativeness to which the remainder was subject and it rejected the mechanical use of the common law vested/unvested distinction as the sole criterion for making the determination.

e. In D.L. v. G.L., the court quoted the following language from Williams v. Massa, 431 Mass. 619, 628, 728 N.E. 2d 932, 940 (2000), one of the leading Massachusetts Supreme judicial Court cases on the division of interests in trusts: “This court is not bound by traditional concepts of title or property in considering what constitutes a party’s “estate” for purposes of [M.G.L. c. 208] §34, and we have held a number of intangible property interests to be subject to division, See Lauricella v. Lauricella, 409 Mass 211, 214, 565 N.E. 2d 436 (1991) and cases cited. When the future acquisition of assets is fairly certain and current valuation possible, the assets may be considered for assignment under [M.G.L. c. 208] §34. Compare Dewan v. Dewan, 399 Mass. 754, 757, 506 N.E. 2d 879 (1987) (nonvested pension rights part of marital estate), with Drapek v. Drapek, 399 Mass 240, 244, 503 N.E. 2d 946 (1987) (potential future earnings not marital assets).”

f. Future inheritances are one of the types of interests most commonly held not to be property.

e. Irrevocable trust – general power of appointment

i. The common law rule is that appointive assets covered by an unexercised general power of appointment, created by a person other than the donee, cannot be reached by the donee’s creditors. Until the donee exercises the power, he has not accepted control over the appointive assets that gives the donee the equivalent ownership of them. The nongrantor holder of a general power of appointment cannot be compelled to exercise it. State Street Trust Co. v. Kissel, 302 Mass. 328, 333, 19 N.E. 2d 25 (1939),

1. However, if the power is exercised, the property subject to the power is accessible by the powerholder’s creditors.

2. In National Shawmut Bank v. Joy, 315 Mass. 457, 53 N.E.2d 113 (1944) the Massachusetts Supreme Judicial Court held that an unexercised general power of appointment is not property and cannot be reached by creditors of the power holder.

3. Some states and the Restatement (Third) of Trusts take the position that creditors of the holder of a non-self-settled general power of appointment can reach the property even
if the power is unexercised. The Restatement (Third) of Trusts takes the position that an unexercised general power of appointment is an ownership equivalent power. The Restatement (Third) of Trust would allow even post-mortem creditors of the holder of the power to access the subject property to the extent the power had not been exercised during the holder’s life. Restatement (Third) of Trusts §56, comment b.

4. The Uniform Trust Code §505(b)(1) says creditors of holder of general inter vivos power of appointment who is not the settler will have access to property subject to power even during periods when power is unexercised.

f. Irrevocable trust – special power of appointment
   i. Property subject to a special power of appointment can generally not be reached by the holder’s creditors whether or not the power is exercised, except to the extent required by the rules of law relating to fraudulent conveyances.
   ii. In Cooley v. Cooley, 628 A.2d 608 (1993) the Connecticut Court of Appeals determined that a husband’s limited power to appoint property during his life in favor of his wife and his brothers should not be considered part of the marital estate and not be subject to division as part of a divorce. The court found that a court could not order the husband to exercise his limited power of appointment. The court distinguished a limited power of appointment from a general power of appointment finding that the holder of a general power of appointment is generally considered the owner of the underlying property whereas the holder of a limited power of appointment, at least under the facts in this case, does not have any interest in the underlying property.
   iii. Conversely, in Ruml v. Ruml, 50 Mass. App. Ct. 500, 738 N.E.2d 1131 (2000), the Massachusetts appeals court upheld a probate court decision that awarded the spouse all of the trust property where the trust had been created by the husband for the benefit of his spouse and children and over which the husband held a limited power of appointment exercisable in favor of a broad class of individuals, including the spouse of the husband/settler.

g. Irrevocable trust – spendthrift provision
   i. A spendthrift provision prevents the transfer of a trust beneficiary’s interest to another whether the attempted assignment is by gift, sale or exchange or as security for a new or existing debt. Restatement (Third) of Trusts §58, comment c.
      1. The grantor of a spendthrift trust withholds from the trustee the authority to honor assignments and attachments of the equitable interests.
2. The rationale for the court’s enforcement of a spendthrift trust is that the grantor has determined what restrictions (if any) he will place on the property.

3. A spendthrift provision will not protect the interest of a grantor-beneficiary. Restatement (Third) of Trusts §58.

4. Massachusetts will enforce a spendthrift provision with one possible divorce related exception. Lauricella v. Lauricella, 409 Mass. 211, 565 N.E. 2d 436 (1991) (nongrantor beneficiary’s interest in realty trust subject to equitable division in divorce proceedings notwithstanding spendthrift clause.)

   a. The “good old days.” Historically, Massachusetts enforced spendthrift trust provisions, even against former spouses.

      i. In Buckman v. Buckman, 294 Mass. 214, 200 N.E. 918 (1936) the Massachusetts Supreme Judicial Court held that a former spouse of a trust beneficiary attempting to enforce a divorce decree granting her alimony and child support, “stands no better than any other creditor.” In Buckman, the husband/trust beneficiary pledged his interest in a trust established by his mother as security for his obligations under a divorce settlement. When the husband failed to pay, the former spouse sued the trustees to enforce the agreement. The Massachusetts Supreme Judicial Court upheld the lower court’s dismissal of the case based on the spendthrift provision.

      ii. In a following and related case, Burrage v. Buckman, 301 Mass. 235, 16 N.E.2d 705 (1938) the Massachusetts Supreme Judicial Court denied a request for an order instructing the trustees of a trust to make support payment to the former spouse and her husband’s minor child.

      iii. Massachusetts will uphold the validity of a spendthrift provision in the context of a creditor other than the spouse or for child support. In Gershaw v. Gerfield, 52 Mass. App. Ct. 81, 751 N.E. 2d 424 (2001) the court held that trusts containing spendthrift provisions are recognized as valid in Massachusetts and the trust precludes voluntary or involuntary alienation of the
beneficiary’s interest for the payment of creditors or claims.

5. Some states draw a line as to spendthrift provisions when it comes to the beneficiary’s spouse and children. For example, Arizona, California, Georgia, Illinois, Kentucky, Louisiana, Missouri, New York, Oklahoma, Pennsylvania, Washington and Wisconsin by legislation give the spouse and dependents, under certain circumstances, access to a beneficiary’s equitable interest in a spendthrift trust.

   a. The Restatement (Third) §58 gives spouses, former spouses and children access to a beneficiary’s equitable interest in a trust despite a spendthrift provision.
   
   b. The Uniform Trust Code §506 allows a creditor or assignee of a beneficiary of a spendthrift trust to reach a mandatory distribution of income or principal, provided the trustee has not made the distribution to the beneficiary within a reasonable time after the distribution date.

6. A spendthrift provision will not prohibit the United States or a state from attaching the beneficial interest for taxes owed by the beneficiary.

h. Irrevocable trust – self-settled trusts

   i. A self-settled trust is a trust created by a party who may also be a beneficiary.

      1. A self-settled trust can be either revocable or irrevocable.
      2. If the trust is irrevocable, the universal common law is that the assets in the trust are subject to the donor’s creditors. Ware v. Gulda, 331 Mass. 68, 117 N.E.2d 137 (1954); State Street Bank & Trust Co., v. Reiser, 7 Mass. App. Ct. 633, 389 N.E.2d 768 (1979); Restatement (Second) of Trusts §156 (1957); Restatement (Third) of Trusts §58. (2003).

   ii. As a matter of public policy, a donor cannot place property in trust for his own benefit and keep the property beyond the reach of his creditors. If the donor retains the right during his lifetime to revoke the trust or retains an unrestricted right to amend the trust, the trust property will be reachable by the donor’s creditors and later by the creditors of the donor’s estate, to the extent the property would be reachable if the property was owned by the donor outright and free of trust. Uniform Trust Code §505(a)(1); Restatement (Third) of Trusts §25, comment e.

      1. The creditors can reach the maximum amount which the trustee could pay under the terms of the trust to the beneficiary. Restatement (Third) of Trusts §58, comment e. See also Uniform Trust Code §505(a)(2).
iii. The donor’s postmortem creditors as well as the surviving spouse can access the principal of an inter vivos trust if the donor retained a power to consume the trust property at the time of his death. Restatement (Third) of Trusts §25(2), comment e; State Street Bank and Trust Co., v. Reiser, 7 Mass. App. Ct. 633, 389 N.E. 2d 768 (1979) (creditor access because of power of consumption at time of beneficiary’s death); Sullivan v. Burkin, 390 Mass. 864, 460 N.E. 2d 572 (1984) (spousal access because of power of consumption during marriage).

1. §505(a)(3) of the Uniform Trust Code provides that the property of a revocable trust at the grantor’s death is subject to the claims of the grantor’s creditors, costs of administration of the grantor’s estate, the expenses of the grantor’s funeral and disposal of remains, and statutory allowance to a surviving spouse and children to the extent of the grantor’s probate estate is inadequate to satisfy those claims, costs, expenses and allowances.

iv. Alaska, Delaware, Hawaii, Missouri, Nevada, New Hampshire, Ohio, Rhode Island, South Dakota, Tennessee, Utah, Virginia and Wyoming have enacted self-settled trust legislation designed to protect self-settled trusts from creditors i.e. so-called domestic asset protection trusts (DAPT). In a DAPT the donor is usually a discretionary beneficiary and, by statute, creditors of the donor are not permitted to reach the assets of the trust, provided certain criteria are met. In most cases, certain creditors, such as a spouse, may be excluded from the list of creditors who cannot attach trust assets. However, a spouse or former spouse is not an exception creditor in Alaska, Nevada, Virginia and Wyoming regardless of when the parties were married.

1. The Uniform Trust Code in the comment to §505 has rejected the approach taken by the self-settled trust legislation in states like Alaska and Delaware.

2. §156(2) of the Uniform Trust Code alters the common law of property and trusts where the donor creates a trust for his own benefit, giving the trustee discretion over income and principal. §156(2) allows the principal of the trust to be attacked by the donor’s creditors even if (1) the trustee never chooses to exercises the discretion to make distributions to himself, (2) the trustee is independent, (3) the remaindermen are unrelated third parties and (4) the original transfer in trust was not procured by fraud.

3. Alaska’s self-settled trust statute insulates self-settled discretionary trusts created after April, 1997 from the reach of the grantor’s creditors. Alaska Stat. §34.40.110. The reserved contingent equitable interest may be unavailable to the grantor’s creditors if (1) the trust is irrevocable, (2)
the trust is fully discretionary as to income and principal at its inception, (3) the trustee with the discretionary authority is someone other than the grantor, (4) the transfer in trust is not established to defraud preexisting creditors and the grantor so swears in an affidavit, (5) at the time of transfer the grantor is not in default by 30 or more days of making payment due under a child support judgment or order and (6) the trust is sited in Alaska. The grantor may serve as a co-trustee, may serve as an advisor and/or may appoint a trust protector.

a. Alaska statute - allows the creation of a self-settled spendthrift trust which denies spousal claims even if the marriage existed at the time of the trust’s creation. This may allow a client to create a pre-marriage self-funded spendthrift trust which is protected from the new spouse without having to use a pre-nuptial agreement.

b. Note that under the Alaska statute all creditors, of whatever nature and kind, are barred from attaching the trust assets before distribution to the beneficiary. In Alaska there are no exceptions for spouses seeking support, ex-spouses seeking alimony, providers of necessaries, tort creditors or children seeking support. Alaska Stat. §34.40.110(h).


a. Delaware statute – a creditor is not permitted to reach and apply the trust assets if a creditor’s claim arose before the transfer to the trust was made unless the creditor brings suit within four years after the transfer or, if later, within one year after the creditor discovered (or should have discovered) the transfer.

i. Claims by a spouse at the time of the creation of the trust cannot be avoided, but claims by someone who married the donor after the creation of the trust may not have a claim against the trust assets. See Del. Code Ann. Title 12, Section 3570 et. seq.

1. A spouse whose claim arose from an agreement or court order providing for alimony, child support, or property division, can reach and apply trust assets if that spouse was married to the donor of the trust
when it was created. Del. Code Ann. Title 12 Section 3573.


6. Generally, existing creditors may attack a transfer to the trust by the later of four years from the transfer or one year from the time the transfer was or could reasonably have been discovered by the creditor. Nevada, on the other hand, establishes a 2 year statute of limitations for existing creditors and a 6 month statute for future creditors.

7. The self-settled domestic asset protection trust may save estate taxes. The property of a fully discretionary “self-settled” irrevocable inter vivos trust has been subject to estate tax upon the death of the grantor not because the grantor died with a reserved contingent equitable interest but because the property was reachable by the grantor’s creditors such that §2038 of the Internal Revenue Code caused inclusion in the grantor’s gross estate.

   a. PLR 9837007 held that a transfer to an Alaska asset protection trust was a completed gift for tax purposes. The PLR did not opine on the potential estate tax consequences of the transfer.

   b. PLR 200944002 held that a transfer to an Alaska asset protection trust did not cause the assets to be included in the grantor’s gross estate barring a finding that there was an implied understanding that the grantor would receive benefits from the trust.

8. All irrevocable trusts should be drafted in contemplation that one or more of the beneficiaries may get divorced. The documents should contemplate the possibility that the grantor and the beneficiary/spouse are later divorced. The document could provide that all rights and powers of the spouse, including the right to serve as trustee, immediately terminate upon either legal separation or divorce. However, such a provision will jeopardize the marital deduction if the trust was designed to so qualify.

V. Defeating the spouse’s rights

   a. Most states have an elective share statute i.e. spouse is entitled to a statutory share of the estate regardless of what is provided for in the deceased spouse’s estate plan.

      i. As originally enacted, these statutes applied to “probate” assets.

      ii. Some states have revised the elective share statutes (by statute or case law) to provide that the elective share
applies to an “augmented” estate e.g. probate assets, asset in a revocable trust etc. Sullivan v. Burkin, 390 Mass. 864, 460 NE2d 572 (1984)

VI. Parent’s estate plan
   i. Spouse’s divorce attorney may request copies of parent’s estate plan in discovery phase of divorce litigation.
   ii. It is now common in Massachusetts divorce cases for each party to request through discovery information about the estate of the other spouse’s family. The discovery request can be satisfied by furnishing the requesting party with the requested information or, in the alternative, furnish what is referred to as a Vaughan affidavit. The Vaughan affidavit is an affidavit stating the following information about the family’s wealth: (1) their approximate net worth (plus or minus $500,000), (2) a general description of their current estate plan and (3) the date their estate plan was significantly amended.

b. Consideration should be given to having parent amend estate plan to allow child’s share of estate be held in spendthrift trust rather than distributed outright. Idea is to take advantage of state spendthrift statute, if possible.

VII. Need for alimony trust
a. Used to protect recipient spouse’s interest in alimony where the assets of the obligor spouse could be jeopardized in the future or the alimony recipient is financially unsophisticated. Is essentially an upfront payment of alimony.

b. Tax treatment governed by Section 682 of IRC.
   i. Trust is established by transfer of cash, investment assets or business assets from obligor spouse to the trustee of the trust.
   ii. Trust provides that the income from the trust is payable to the obligee spouse in satisfaction of alimony and/or support obligations.
   iii. Absent Section 682, the obligor spouse would be taxable on all or part of the trust income rather than the obligee spouse. Section 682 provides that the recipient spouse includes in gross income any income (other than income constituting child support) to which a recipient spouse is entitled and which, but for Section 682, would be includable in the income of the obligor spouse. The trust is
governed by the rules for the taxation of trusts under Subchapter J i.e. the DNI concept and the distribution rules apply.

iv. Section 682 does not shift the income tax burden for income distributed in satisfaction of the obligor’s child support obligations – the obligor is still required to pay the tax on such income. Reason: if a spouse is a discretionary beneficiary, the trust is a grantor trust. §677(a)(1).

VIII. Pre-nuptial agreement
a. Governed by state law
   i. Recognized in every state
   ii. State law requirements for a valid and enforceable prenup between the states
b. General considerations:
   i. Adequate disclosure of assets and liabilities of each spouse
   ii. Representation of competent counsel for both spouses
   iii. Sign agreement well in advance of marriage
   iv. Relinquish rights in divorce as well as rights of either spouse against the estate of a deceased spouse – many states give a surviving spouse the right to be supported by the estate even if the spouse is not named as a beneficiary of the decedent’s will.

c. The spouse’s right to an ERISA retirement plan cannot be waived prior to the marriage of the parties. Thus, if the parties intend for such a waiver, the waiver should be required to be signed after the marriage occurs.

d. A planning alternative to a prenup is the creation of a domestic asset protection trust (DAPT) prior to the marriage.
   i. A DAPT, when used as an alternative to, or in combination with, a prenup eliminates the unpleasant and troublesome prenup requirements and may be an effective way to protect assets in the event of a future divorce.
   ii. Unlike a prenup, there is no legal requirement to disclose the creation of the SAPT, to ask a future spouse to sign it, or to disclose financial assets.
   iii. Alaska, Delaware, Hawaii, Missouri, Nevada, New Hampshire, Ohio, Rhode Island, South Dakota, Tennessee, Utah, Virginia and Wyoming have enacted self-settled trust legislation designed to protect self-settled trusts from creditors.
   iv. Some DAPT statutes make an exception for spousal claims. In these cases, spouses are considered exception creditors i.e. the DAPT will not protect against spousal claims. However, in most states this only applies to spouses who are married to the grantor at the time the DAPT is
established. In these states, if the spouse is not married to the grantor at the time the DAPT is funded, the spouse has no claim against the trust.

v. However, a spouse or former spouse is not an exception creditor in Alaska, Nevada, Virginia and Wyoming regardless of when the parties were married.

vi. In some states, DAPT assets are not protected if the transfer is a fraudulent conveyance. If a claim was brought against the trust by a future ex-spouse who was not married to the grantor on or before the transfer to the DAPT was made, the ex-spouse would have to prove that the transfer was fraudulent i.e. that the transfer was made with the actual intent to defraud the ex-spouse. Not only must the spouse prove by clear and convincing evidence that the transfer to the DAPT was fraudulent, but the spouse must also bring a claim for a fraudulent transfer within the applicable statute of limitations – 4 years in Alaska, Delaware, New Hampshire, 2 years in Nevada and South Dakota and 18 months in Ohio. A ten year statute will apply in a federal bankruptcy proceeding.

IX. Miscellaneous tax rules.

a. Uncollected alimony at recipient’s death is income in respect of a decedent and can result in both estate and income tax at the death of the recipient.

b. Tax status as single, married is determined as of end of the year.

i. If the couple are divorced, legally separated or the abandoned spouse rule applies, a joint return cannot be filed.

ii. Be aware of the joint and several liability of signing a joint income tax return if the couple is contemplating or in the midst of a divorce.

1. The spouses can file a “separate liability election” under Section 6015(c)(3) which states that neither has liability for the other’s tax reporting or taxes.

b. Alimony is treated as “earned income” for purposes of qualifying for IRA contributions. See Section 219(f)(1).

X. New Hampshire case – New Hampshire Supreme case interprets Uniform Trust Code by holding that wife/spouse/child’s interest in trust established by the wife’s father is protected from husband/spouse in divorce proceeding.

a. In the Matter of Theodore J. Goodlander and Elizabeth M. Tamposi, (Case No. 2009-309 (NH S.Ct., Feb. 25,2011) addressed the issue of the extent to which an irrevocable trust established for the benefit of a child is protected from the claims of the child’s divorcing spouse.
b. In the Tamposi case the wife trust beneficiary’s divorcing husband asserted three claims against the assets of the trust established by his father-in-law for the benefit of his spouse. The husband claimed:
   i. The assets of the trust should be counted as assets of the marriage subject to division on divorce;
   ii. The assets of the trust should be considered when dividing the other non-trust marital assets upon divorce; and
   iii. The trustees should be compelled to pay directly to the husband the alimony that the wife was ordered to pay to the husband.

c. The New Hampshire Supreme Court ruled for the wife on the first two issues and remanded the case to the Superior Court on the last issue.

d. The case involves two issues frequently encountered when assets in an irrevocable trust are involved in a divorce proceeding. The first issue is whether the beneficiary’s interest in a trust constitutes a property interest subject to division in divorce. A second separate issue is whether a beneficiary of a trust with a spendthrift clause can reach the beneficiary’s interest in the trust to satisfy an award of alimony.

e. Property interest issue. In view of the fact that the wife beneficiary’s interest in the trust was entirely discretionary and that the trustees were independent trustees, the court held that the wife beneficiary’s interest in the trust was a “mere expectancy” as that term is defined by UTC §8-814(b). As such, the wife beneficiary’s interest in the trust was not a property interest subject to division on divorce. In addition, since the wife beneficiary was not guaranteed any distributions in the future, the trust assets were properly excluded from consideration in dividing the other non-trust marital assets. Thus, the beneficiary wife was successful on both of the first two issues.
   i. The court seems to have relied on three things: (1) the trust was entirely discretionary, (2) the trust required that there be an independent trustee at all times and (3) the trustee owed a fiduciary duty to the other beneficiaries in determining whether or not to make distributions to the wife beneficiary.

f. Spendthrift clause issue. §5-502 of the UTC protects the assets of an irrevocable trust from the claims of a beneficiary’s creditor’s subject to a few exceptions. Two of those exceptions are contained in §5-503(b)(1) and (2) of the UTC which allow enforcement of child support orders (not involved in this case) and limited alimony awards against a beneficiary’s interest in an irrevocable trust.
   i. §5-503(b)(2) provides that an award of alimony is enforceable against the paying spouse’s interest in a trust.
only to the extent needed for basic food, shelter and medical needs of the spouse or former spouse.

ii. The court remanded the case to the Superior court to determine if the alimony award met the husband’s basic needs for food, shelter and medical care.

iii. Thus, the trust could be tapped for the alimony award for the husband’s basic needs but could not be tapped for more than that amount i.e. it couldn’t be tapped for an amount to allow him to live in his customary standard of living.
Filing Status

I. The filing status options for taxpayers are (1) Single, (2) Married filing jointly, (3) Married filing separately, (4) Head of household and (5) qualifying widow(er). The status filed by the taxpayer may affect the taxes paid, as well as the deductions, exemptions and credits taken. The following is a discussion of the status as it affects divorce decrees and separation agreements.

If a taxpayer’s status is married, he or she must file either married filing jointly or married filing separate. A taxpayer is considered married for the whole year if they are separated but have not obtained a final divorce decree or separate maintenance by the last day of the tax year.

If a taxpayer is unmarried, their filing status is either single or head of household. The taxpayer is considered unmarried for the whole year if he or she has obtained a final divorce decree or separation maintenance by the last day of the tax year. The taxpayer should also follow the state law to determine if he/she is divorced or legally separated.

A taxpayer can have head of household status if he or she meets the following requirements:

1. The taxpayer is unmarried or “considered unmarried” on the last day of the year.
2. The taxpayer paid for more than half the cost of keeping up a home for the year.
3. A “qualifying person” lived with the taxpayer in the home for more than half the year. If the “qualifying person” is a dependent parent, the dependent does not have to live with the taxpayer. “Qualifying person” will be discussed later.

A taxpayer is “considered unmarried” for head of household purposes on the last day of the tax year if they meet all the following tests:

1. The taxpayer files a return claiming single, married filing separately or head of household status.
2. The taxpayer paid more than half the cost of keeping up the home for the tax year. These cost include rent, mortgage interest, real estate taxes, insurance, repairs, utilities and food eaten in the home. The costs not included are clothes, education, medical, vacations, life insurance or transportation.
(3) The taxpayer’s spouse did not live in the home during the last 6 months of the tax year.

(4) The home was the main home of their child, stepchild or foster child for more than half the year.

(5) The taxpayer must be able to claim an exemption for the child. However, the taxpayer meets this test if they can’t claim the exemption only because the noncustodial parent can claim the child. This will be further discussed below.

a. Married Filing Jointly

This type of return can only be filed if the taxpayers are married at the end of the year. (IRC §7703(a)(1)).

Both spouses may be held responsible, jointly and individually, for the taxes, interest and penalties payments. (IRC §6013(d)(3)) In other words, the spouse that did not earn the income may still be held liable for the taxes due on the income that was earned by the other spouse. Both spouses are responsible for any tax, interest or penalties due on a joint return prior to the divorce even if the divorce decree states that one spouse is responsible for any amounts due on a previously filed joint return. There are currently three options the other former spouse can ask for to be relieved of the joint liability. (IRC §6015)

(1) Claim of innocent spouse relief where the understatement of tax is attributable to an erroneous item of the other spouse. (Publication 971)

(2) Request of relief by separation of liability for an understatement of tax between the parties.

(3) The IRS can grant equitable relief if it would be unfair to hold the taxpayer liable for the tax that should be paid only by the other former spouse.

b. Married Filing Separately

When filing married filing separately, each spouse should report their own income, exemptions, deductions and credits. Each spouse is responsible only for their own taxes due. If one spouse itemizes deductions, than the other spouse cannot claim the standard deduction, and should also itemize. Typically this filing will result in an overall higher tax liability.

c. Single, head of household or qualifying widow(er)

If the taxpayer is unmarried, he/she would either file as single, or head of household, depending on the requirements.
Exemptions

I. Personal exemption

Each taxpayer can claim a personal exemption for themselves unless someone else can claim it. So if you are filing a joint return, there will be two personal exemptions claimed. If the taxpayers are filing married filing separately, an exemption for the other spouse cannot be taken unless that spouse had no income, is not filing a return and was not a dependent of another taxpayer. If a taxpayer obtains final divorce decree or separation maintenance during the year, the taxpayer cannot claim an exemption for the former spouse. If a taxpayer paid alimony to a former spouse, that taxpayer cannot take an exemption for the former spouse.

The amount of the personal exemption and the phase out amounts for 2013 and 2014 are discussed with the dependency exemption.

II. Dependency exemptions

In addition to a personal exemption, taxpayers are allowed to claim one exemption for each person claimed as a dependent. In the case of taxpayers involved in divorce or separation arrangements, only one taxpayer can claim the dependent. The custodial parent is entitled to the dependency exemption, assuming that the parents together, or at least one parent, contributed to one-half of the child’s support (IRC §152)

a. This applies to the following:

(1) If the parents are divorced or legally separated under a decree of divorce or a decree of separation, (IRC §152(e)(1)(A)(i))

(2) If the parents are separated under a separation agreement, (IRC §152(e)(1)(A)(ii)) or

(3) If the parents live apart at all times during the last 6 months of the calendar year. (IRC §152(e)(1)(A)(iii)

b. Custody and custodial parent

The custodial parent is the parent having custody for the greater portion of the calendar year. (IRC §152(e)(4)) Custody is determined by the number of nights spent with the parents, although there is an exception for parents that work at night. (Treas. Reg. §1.152-4(d)(i) and Treas. Reg. §1.152-4(d)(5)) Even if the
custody decree grants physical custody to one parent, the tax court has held that “this parent is not entitled to a dependency exemption when the children did not live with this parent for most of the year.” (Maher v. Commissioner, T.C. Memo 2003-85) In other words, if the mother is granted physical custody, but the child spends every week night at the father’s house (5 nights) and only weekend nights with the mother (2 nights), the father would claim the dependency exemption. If the child resides with both parents for the same amount of time during the taxable year, the parent with the highest adjusted gross income is entitled to the exemption. (IRC §152(c)(4)(B)(1) and (2)).

c. The taxpayer must show the total amount of support from all sources for the taxable year in order to establish that they contributed over one-half of the support for a dependent.

Support is generally an expense incurred by the taxpayer, including for food, shelter, clothing, medical and dental care, and education. The support can be in the form of property or lodging; in this case the amount of support is in terms of the fair market value. To determine whether or not an individual received over half of his support from the taxpayer, you have to take into account the amount of support received from the taxpayer as compared to the entire amount of support which the individual received from all sources. (IRC §152(e)(1)(A)) If you are remarried, the support provided by your new spouse is treated as provided by you.

d. The dependent is either a qualifying child or a qualifying relative. (IRC §152(a))

Qualifying child is an individual who bears a relationship to the taxpayer, who has the same residence as the taxpayer for more than one-half the taxable year, meets the age requirement and who has not provided over one-half of their own support for the calendar year in which the taxable year of the taxpayer begins. (IRC §152(c)) Relationship for the individual is a child of the taxpayer or a descendant of such child, or a sibling or stepsibling. Child is defined as son, daughter, stepson, stepdaughter, adopted child or eligible foster child. The age limit for the exemption is 19 unless the child is a student, as defined under IRC §152(f)(2), under the age of 24 at the close of the calendar year. There are exceptions for a disabled individual.

A dependent can also be a qualifying relative, which is an individual who has a relationship to the taxpayer, whose gross income is less than the exemption amount, the taxpayer provides over one-half the individual’s support and is not a qualifying child. (IRC §152(d)) The relationship to the taxpayer is a child or descendent of a child, a sibling or step sibling, a parent or step parent, niece or nephew, sibling to parents, in-laws, and an individual who has the same residence as the taxpayer for the taxable year.

A child might meet the conditions to be a qualifying child for both parents but only one parent can claim the dependence exemption and take the tax benefits.
Besides the dependency exemption, the tax benefits for a qualifying child include the child tax credit, the head of household filing status, the credit for child and dependent care expenses, the exclusion from income for dependent care benefits, and the earned income credit. The parents cannot agree to divide up the tax benefits; the benefits only go to the taxpayer claiming the dependency exemption. The following are the tiebreaker rules that are used to determine which person can claim the child as a qualifying child:

(1) If only one of the persons is the child’s parent, the child is treated as the qualifying child of the parent.

(2) If the parents do not file a joint return together, but both parents claim the child as qualifying child, the IRS will treat the child as a qualifying child of the parent with whom the child lived for the longer period of time during the year. If the child lived with each parent for the same amount of time, the IRS will treat the child as the qualifying child of the parent who had the higher adjusted gross income for the year.

(3) If no parent can claim the child as qualifying child, the parent with the higher adjusted gross income for the year treats the child as the qualifying child.

(4) If a parent can claim the child as a qualifying child but no parent does claim the child, the child is treated as the qualifying child for the person with the highest adjusted gross income for the year. This is only if the person’s adjusted gross income is higher than the highest adjusted gross income of any of the child’s parents who can claim the child. If the child’s parents file a joint return with each other, this rule can be applied by dividing the parent’s total adjusted gross income evenly between them.

e. Exceptions

There are two exceptions to the rule that the custodial parent is entitled to the dependency exemption. The first is if a pre-1985 multiple support agreement is in effect that states the noncustodial parent can claim the dependent. (IRC §152(d)(3)) The second is if the custodial parent relinquishes the exemption. (IRC §152(152(e)(2)(A)) A written declaration by the custodial parent must be attached to the non-custodial parent’s tax return. The custodial parent should use Form 8332 or a similar statement for the release of the exemption.

III. Exemption Phase out

a. The personal exemption amount claimed for the dependent in the 2013 tax year is $3,900. The amount increases to $3,950 in the 2014 tax year.
b. The ability to utilize the dependent exemption phases out when a taxpayer reaches a certain level of income. When the AGI exceeds the phase out levels, 2% of the exemption amount is lost for every $2,500 or fraction thereof that AGI exceeds the threshold amounts. (IRC §151(d)(3)) Married filing separately loses 2% for every $1,250 or fraction thereof of the AGI in excess of the phase out level. (IRC §151(d)(3)(E) and (F))

For the 2013 tax year:

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<th>Filing Status</th>
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<th>Phase Out Ends</th>
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</tbody>
</table>

For the 2014 tax year, the phase-out begins with AGI of $254,200 for individuals and $305,050 for married filing jointly. The phase-out ends at $376,700 for individuals and $427,550 for married filing jointly.

A simple example of the phaseout is a taxpayers filing married filing joint having an AGI of $302,500, or $2,500 over the phaseout amount. In this case, the dependence exemption would be reduced by $78 or 2% of the $3,900.
Alimony

I. Alimony

a. Alimony is a payment to or for a spouse or former spouse under divorce or separation instrument. Alimony is deductible by the payer and must be included in the payee’s income. This discussion only relates to divorce or separation instruments executed after 1984. (IRC §71)

b. In order for a payment to qualify as alimony, the payment must be under a divorce or separation instrument, the payment must be in cash, the payment is not treated as child support, the spouses are not members of the same household when the payments are made, and the instrument or agreement does not designate the payment as not alimony. Additionally, the liability for payments of spousal support (in cash or property) must end when the payee dies, under provisions of the law of the applicable state. It is recommended that the divorce decree or separation instrument have a termination clause but it is no longer required.

II. Substitute Payments – Disqualified Alimony

a. If the payer is required to make any payments after the spouse’s death as a substitute for continuing payments that would have qualified as alimony prior to death, the otherwise qualifying payments would not be alimony; it would be a substitute payment.

b. Temp. Treas. Reg. Q&A-14 of §1.71-1T provides 2 examples of substitute payments. In the first example, a divorce decree stated that a payer must pay $30,000 a year until the payee’s death or until the end of 6 years, and that upon the payee’s death, the payer must put $10,000 annually into a trust for the minor children until they reach maturity. In this case, of the $30,000 annual payment, only $20,000 would be considered alimony since the $10,000 continued after the payee’s death.

c. Another example provided is if the taxpayer pays $30,000 annually to the former spouse for 15 years. If the former spouse dies prior to the 15 years, the taxpayer must pay the estate the difference between the total payment for the 15 years of $450,000 and the amount that had been paid by the time of death. So if the former spouse dies at the end of the tenth year, the estate would be paid $150,000 ($450,000 total less the $300,000 already paid). The entire
$30,000 annual payment is not considered alimony since the lump sum payment is a substitute for the annual payments.

d. Life insurance is one way to avoid the substitute payment issue when paying alimony. Joseph W. Cunningham discusses this in his article, *Tax Consequences of Divorce*.

“The House Ways and Means Committee Report on the Tax Reform Act of 1984 (1984 TRA) specifically states that life insurance proceeds payable on the death of the payee spouse are not considered a ‘substitute payment.’...Thus, a life insurance policy appears to be an acceptable method of ensuring that the payee’s spouse’s successors in interest will receive most, if not all, of the value of the payments that would typically intend to survive the payee’s death.”

e. Life insurance premiums a taxpayer pays under the divorce or separation instrument for insurance on the taxpayer’s life to the extent the spouse owns the policy are included as alimony.

III. Alimony Recapture

a. If alimony payments decrease or end during the first 3 calendar years after the divorce decree or separation maintenance began, the taxpayer may be subject to the recapture rule. The 3 year period starts with the first calendar year that an alimony payment has been made. The reasons for a reduction or end of alimony payments that require a recapture include the following:

i. A change in the divorce or separation instrument,

ii. Failure to make timely payments,

iii. A reduction in the ability to provide support, or

iv. A reduction in the spouse’s support needs.

b. If the taxpayer is subject to this rule, they have to include in income in the third year part of the alimony payments that were previously deducted. This would go on line 11 for Form 1040, altering the form to say recapture instead of received. The spouse can deduct in the third year of the alimony payments he or she previously included in income. This deduction would be shown on line 31a of Form 1040, crossing out paid and entering recapture.

c. The taxpayer is subject to the recapture rule in the third year if the alimony paid in the third year decreases by more than $15,000 from the second year or the alimony paid in the second and third year decreases significantly from the
alimony paid in the first year. Do not include the following amounts when you figure a decrease in alimony:

(1) Payment made under a temporary support order.

(2) Payments required over a period of at least 3 calendar years that vary because they are a fixed part of income from a business or property, or from compensation for employment or self-employment.

(3) Payments that decrease because of the death of either spouse or the remarriage of the spouse receiving the payment before the end of the third year.

d. There are exceptions to the recapture rules:

(1) Where payments cease because of the death of either party or remarriage of the payee,

(2) Where payments are pursuant to a temporary order for support or

(3) Where payments fluctuate outside of the payor’s control because they are a percentage or a fixed portion or portions of income or compensation received by the payor.
Tax Overpayments and Estimated Tax Payments

I. Overpayment of taxes

a. If the direct deposit option is used to receive the refund from a joint return, and both parties are entitled to a portion, then Form 8888 should be filed with the return to allow for the refund to be deposited into more than one bank account. This allows for one amount to be deposited into the husband’s account and a different amount to be deposited into the wife’s account. There is a place on the 1040 tax return to check that Form 8888 is attached.

b. For spouses that are entitled to a refund or credit from their joint return that would apply to the next year’s taxes, a determination must be made as to each spouse’s entitlement when filing separate returns. A joint return does not create equal property interests for the overpayments. The overpayments are apportionable to each spouse to the extent they contributed to the overpayment. However, if the overpayment is not readily apportionable because it was derived from numerous sources, the courts have concluded that each spouse is equally entitled to half of the carry-over for each spouse’s separate returns. (Hathaway v. United States, 1993 WL 207532 (W.D Wash.))

II. Estimated tax payments

a. Usually taxpayers withhold taxes from their salaries and wages. The taxpayer/employee completes a Form W-4 to tell their employer how much to withhold for each paycheck. Estimated tax payments are used to pay taxes on income that is not subject to withholding or if the amounts withheld from salary is not enough. This includes income from self-employment, interest, dividends and alimony. The estimated tax payments are divided into four quarterly payments and a penalty will be charged if the payments are not made by the due date. (IRC §6554) The IRS provides guidance on calculating the estimated tax payments.

b. Estimated tax payments should be made by the former spouse receiving alimony since alimony is considered income but is not subject to withholding. The payer of alimony can deduct the payments.

c. A newly divorced or separated person may want to file a new Form W-4 with their employer to claim the proper withholding allowances.

III. Joint estimated tax payments
a. Spouses cannot make joint estimated tax payments if they are legally separated under a divorce decree or separate maintenance.

b. There are several options that married taxpayers can take when they have made joint estimated tax payments during the year, but are now filing separate returns, either married filing separate or separate individual returns, if divorced at the end of the tax year.

1. The payments can be claimed by one former spouse, or divided in a way that both former spouses agree. The IRS will recognize this agreement for allocating the estimated payments.

2. If the parties cannot agree, the estimated tax payments will be allocated in proportion to the individual tax amounts shown on the separate returns. The calculation for this is as follows: Total estimated tax paid times the tax shown one spouse’s separate return for the tax year divided by the total tax shown on both former spouses’ return.
Non-Divisibe Retirement Plans

I. There are retirement plans that do not fall under ERISA, are not divisible by a Qualified Domestic Relations Order (QDRO) and therefore, not divisible in a divorce.

a. ERISA is the Employment Income Securities Act of 1974 that governs retirement plans.

b. A QDRO is a domestic relations order which recreates or recognizes the existence of an alternative payee’s right to, or assigns to an alternate payee the right to, receive all or a portion of the benefits payable with respect to a participant under a plan. (IRC §414(p))

c. These non-qualified plans are often provided for high ranking employees. These plans usually have terms in their names such a (1) Supplemental, (2) SERP, (3) Non-qualified, or (4) Excess Benefit. The plans normally contain provisions which specifically prevent them from making payments to anyone other than the employee so there is no way for the plan to make payments directly to a spouse, regardless of a court order.

d. The settlement agreement can include a provision that recognizes that the funds can’t be divided until the employee spouse actually receives payments from the plan, which usually occurs after retirement.

e. Alternatives to this are having the employee spouse take out an insurance policy for the benefit of the other spouse, increasing the alimony payments, or awarding the other spouse assets with comparable value.

f. Other plans that can’t be divided by a QDRO are Section 457(f) non-qualified deferred compensation plans, and religious organized sponsored plans. These plans may have their own procedures for division incident to divorce.
**Itemized Deductions Related to Real Estate on Separate Returns**

I. When filing married filing separately, certain itemized deductions can be taken whether the taxpayer paid the expenses separately or jointly with the spouse. Who claims the deductions can be determined by the terms of the settlement and the form of ownership after the divorce. If the entire interest in the home is transferred to one taxpayer (spouse) as part of the settlement, only that spouse can take the deduction.

For property that is held as tenants by entirety, different deduction amounts are taken. Tenants by entirety is a form of property ownership where the husband and wife own property as one marital unit. This means that any property sales or transfers cannot be executed without both spouse’s consent. Additionally, the property automatically goes to the surviving spouse if one spouse dies. If after the settlement, the property is still owed by both, the following rules apply:

a. The taxpayer can deduct the property taxes he or she paid separately.

b. The taxpayer can deduct the mortgage interest he or she paid separately.

c. If the taxpayer incurs a casualty loss on a home, each spouse can take half the loss, subject to the deduction limits.