I. Introduction

(a) The passage of the 2017 Tax Act brought many changes for business and individual taxpayers. Many of the income tax changes have been highly publicized, such as the decrease of individual income tax rates, the reduction in the taxability of income from certain pass-through entities, and the reduction of the state and local tax deduction.

(b) However, lesser public changes also have a significant impact on taxpayers. In particular, decades of settled-policy regarding the tax impact of a divorce have been largely overturned with the repeal of §71 and §215, which provided for the flexibility to treat the receipt of alimony payments to the recipient spouse (the “recipient”) as gross income and allowed the payor spouse (the “payor”) to deduct such payments. The effects of this change are far-reaching.

(c) The main analysis in this outline is divided into two parts – the first part focuses on the U.S. tax treatment of alimony, and the second part focuses on the U.S. tax treatment of the division and transfer of property as a result of a divorce. Both issues are considered from both the domestic perspective and the cross-border perspective.

II. Alimony

(a) Prior to January 1, 2019

(1) Under prior law, effective for divorce and separation agreements entered into prior to January 1, 2019, §71(a) included in the recipient’s gross income any amounts received as alimony or separate maintenance payments. Correspondingly, §215(a) provided the payor with a deduction of an amount equal to the alimony or separate maintenance payments paid during the payor’s taxable year.

(2) The logic behind this treatment was simple. If the payor is required to pay her/his income to the recipient, the taxability of that income should follow the payment and the payor should not be subject to

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1 Tax Cuts and Job Act, enacted as the “Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018, Pub. L. No. 115-97 (referred to in this outline as the “2017 Tax Act”).

2 For all purposes of this outline, unless otherwise specified, all references to taxes, rates, returns and taxable income shall be to federal taxes, rates, returns and taxable income.

3 All section references are to the Internal Revenue Code of 1986, as amended (the Code), and the regulations thereunder, unless otherwise specified.
income tax on income that she/he no longer has. Likewise, the recipient should be taxed on income that she/he receives if it would have otherwise been taxed to the payor. However, even if the recipient is taxed on such income, it was still income earned by the payor and would be taxed as such. In order to prevent this double taxation, the payor should be able to deduct such alimony payments. In this outline, this is referred to as the “Pre-2019 Alimony Rule.”

(3) It is important to keep in mind that divorce and separation agreements entered into prior to January 1, 2019, remain qualified for the Pre-2019 Alimony Rule, such that alimony paid under such agreements can continue to be treated as income to the recipient, with the payor able to deduct the alimony payments.

(b) After January 1, 2019

(1) Both §71 and §215 are repealed. Under this “New Alimony Rule” the recipient receives the payment without income tax effect. The payor receives no deduction for the payment.

(2) The logic behind the repeal of §71 and §215 is not entirely clear. For over 75 years, both settled case law and the long-standing statutory language of §71 and §215 have determined that alimony should be regarded as an income source.

(3) The Pre-2019 Alimony Rule was logical tax policy that ultimately allowed divorced spouses to preserve greater wealth. The only feasible explanation for the repeal of the Pre-2019 Alimony Rule is that Congress needed more revenue to offset other tax cuts.

(4) Consider an example that helps explain the Pre-2019 Alimony Rule’s repeal. In most instances, if alimony is to be paid, the payor is likely to be in a higher income tax bracket than the recipient. Pursuant to the Pre-2019 Alimony Rule, the payor has a deduction under §215. Alimony is deductible directly from gross income as an “above the line” deduction under §62(10). This means that such deductions are dollar-for-dollar reductions from income and not subject to any thresholds, limitations, or phase-outs.

(A) Example: Suppose that under the Pre-2019 Alimony Rule, a divorcing couple negotiated a settlement that is designed for the payor spouse to pay alimony to the recipient spouse in the amount that will net the recipient with $5,000/month, or $60,000/year, and the settlement will become part of a divorce decree. Assume the payor is in the top income tax
bracket, which, for this example, is 40%, and the recipient is in the 25% income tax bracket.5

(B) Result Under the Pre-2019 Alimony Rule: As the recipient is in the 25% income tax bracket, for the recipient to receive $60,000 in net payments, the recipient must receive $80,000 in total alimony, resulting in $20,000 in income taxes ($80,000 x 25% = $20,000). As the payor is entitled to fully deduct the alimony without any phase-out or limitation, the result is tax-neutral to the payor. Therefore, the total combined income tax consequences under the Pre-2019 Alimony Rule is $20,000.

(C) Result Under the New Alimony Rule: Under the New Alimony Rule, if the alimony is paid from the payor’s taxable income, the payor is charged with much more than the $60,000 in alimony. Applying the payor’s tax rate of 40%, the actual cost to the payor is $100,000 ($60,000 ÷ (1 – 40%)). Stated differently, the payor has to earn $100,000 to pay a net amount of $60,000 to the recipient. The payor, thus, pays -- and loses the benefit of -- the alimony, income taxes on the alimony, and the income taxes on the funds used to pay the income taxes on the alimony. Based on this approach, the payor must pay total income taxes of $40,000 ($100,000 x 40%). The recipient has no income tax consequences to the alimony because the alimony is not included in her/his gross income. Therefore, the total combined income tax consequences under the New Alimony Rule is $40,000.

(c) Tax Planning Under the New Alimony Rule

(1) If representing the payor, it will now make sense to try to negotiate for reduced payments of “alimony”. A reduction of alimony can be negotiated by increasing the amount the payee spouse receives as part of the division of assets.

(2) What payments are now considered “alimony”?

(A) Under §71(b)(1), “alimony” was simply a cash payment from the payor to the recipient that must meet certain other requirements, such as, (1) the payor and recipient cannot be living together at the time that the payment is made, (2) the payments end when the recipient dies, and (3) the divorce or separation instrument must not specifically provide that the

5 The actual top income tax bracket in 2019 was 37%, but 40% is used so that most of the calculations in this example result in whole dollar numbers. In addition, there is no 25% income tax bracket in 2019, but 25% is used so that most of the calculations in this example result in whole dollar numbers.
payments are not to be included as income by the recipient and deducted by the payor (i.e., the Pre-2019 Alimony Rule).

(B) Now, what is alimony? Does it matter?

(3) Alternatively, without having to structure payments to meet the specific definition of “alimony” under the now-repealed §71 and §215, the payor spouse can try to negotiate more beneficial payment methods. For instance, the use of a trust to make payments to the recipient may be appealing now, allowing the payor spouse or his children to have a remainder interest in the trust assets.

(A) Example: A divorcing couple have negotiated that the payor spouse will pay $500,000 to the payee spouse annually. Because the payor spouse is no longer concerned with ensuring the payments qualify for the alimony deduction, he or she can instead suggest that the payments be made to a non-grantor trust for the benefit of the payee spouse. The payee spouse can act as the Trustee, and have certain powers over the trust, but at his or her death, the remaining assets will be held in trust for the couple’s children. The payee spouse agrees to this proposal, as she understands that the trust will protect her from creditors during her life, and also avoid being subject to U.S. federal estate taxes at her death.

(4) If representing the payee, it will be more appealing to negotiate for a larger share of payments to be structured as alimony, as the alimony payments will no longer be subject to U.S. federal income tax.

(d) Alimony Payments by and to Non-Resident Aliens

(1) Under the Pre-2019 Alimony Rule, if the payor is a U.S. resident, he or she would generally need to withhold 30% of any alimony payment to a non-resident alien payee spouse, as the alimony is treated as U.S. source income under §871 (i.e. FDAP income) to the payee.

(2) Exceptions to the Pre-2019 Alimony Rule exist if the payee provides the payor with a Form W-8BEN, claiming relief under a relevant U.S., income tax treaty, discussed below.

(A) For cases in which the Pre-2019 Alimony Rule applies, whether treaty relief is claimed or not, the payor should still obtain a Form W-8 or Form W-9 from the payee, so that the payor is able to properly report any withholding.
Under the New Alimony Rule, any U.S. resident payor of alimony no longer needs to worry about withholding or reporting on payments to a non-U.S. resident payee. Of course, the alimony paid deduction is no longer available to the U.S. payor. So while there is reduced complexity, there is also a loss of the deduction.

(A) While no guidance has been issued, it is safe to assume that the U.S. payor subject to the New Alimony Rule does not need to obtain a Form W-8 or Form W-9 from the payee.

Under the New Alimony Rule, non-resident payees are not subject to U.S. federal withholding tax on alimony payments from the U.S. sources, but they may be subject to income tax in their jurisdiction of residence. Certain tax treaties continue to give taxing rights to the payee’s resident country.

(A) Thus, there is a potentially harsh scenario when there is a U.S. payor and a non-resident payee. The U.S. payor will pay U.S. federal income tax on earning the funds necessary to pay the alimony. Then when the alimony is paid to the payee, the payee may be subject to income tax in his or her country of residence, with no deduction allowed to the U.S. payor.

(B) Of course, there is the converse situation as well when there is a non-resident payor and a U.S. payee. The non-resident payor may receive a deduction for alimony payments made in their country of residence, while the payments are not subject to U.S. federal income tax upon receipt by the U.S. payee.

Existing U.S. tax treaties provide a variety of different approaches to the taxation of alimony.

(A) U.S. – U.K. Income Tax Treaty: Alimony payments are not subject to tax in either country, unless the payments are deductible by the payor in his or her country of residence, in which case the payments are taxable in the payee’s country of residence.

(i) Under the Pre-2019 Alimony Rule, a U.S. payor is entitled to a deduction, so the U.K. payee could be taxed in the U.K. on the receipt of the payment. A U.K. payor is not entitled to a deduction, so the U.S. payee is not subject to tax in either jurisdiction.

(ii) Under the New Alimony Rule, a U.S. payor is not entitled to a deduction, so the alimony payment is not subject to tax in either country. Similarly, a U.K.
payor is not entitled to a deduction, so the U.S. payee is not subject to tax in either country.

(B) U.S. – Canada Income Tax Treaty: Alimony payments are only subject to tax in the payee’s country of residence, provided, however, that if the alimony payment would be excluded from taxable income if the payee were a resident of the other country, the alimony payment will be excluded in the payee’s country of residence.

(i) Under the Pre-2019 Alimony Rule, a U.S. payor would be entitled to the deduction under U.S. law, while a Canadian payee would be subject to tax on the payment in accordance with Canadian law. A Canadian payor and U.S. payee would be in a similar scenario, with a Canadian deduction allowed to the payor and U.S. taxation of the alimony payment received by the U.S. payee. Effectively, the treaty only provides relief from source taxation of alimony.

(ii) Under the New Alimony Rule, a U.S. payor is no longer entitled to a deduction. Because an alimony payment is excluded from income in the U.S., the Canadian payee is able to exclude the payment from being taxable income in Canada. For a Canadian resident payor and a U.S. resident payee, the payor receives a deduction in Canada, while the payee is not taxed in the U.S.

(C) U.S. – Mexico Income Tax Treaty: Alimony payments are only taxable in the payor’s country of residence.

(i) Under the Pre-2019 Alimony Rule, a U.S. payor would be entitled to a deduction under U.S. law, while the Mexican payee would only be subject to U.S.-source taxation on the payment. A Mexican payor may be entitled to a deduction, while the U.S. payee could claim relief from U.S. federal income tax and only be taxed in Mexico on the alimony payment.

(ii) Under the New Alimony Rule, a U.S. payor no longer receives a deduction under U.S. law, while the Mexican payee is not subject to tax, as the U.S. does not tax alimony payments. A Mexican payor may still be entitled to a deduction, while the U.S. payee is only taxable in Mexico, whether or not treaty relief is claimed.
(D) For most U.S. income tax treaties, the rules in relation to the taxation of alimony apply even if the payee is a U.S. citizen residing abroad. This is one of the few exceptions from the general savings clause contained in most U.S. income tax treaties that allows the U.S. to tax its citizens despite the terms of any relief granted under the treaty.

(6) In any case involving a non-resident payee, the tax treatment of alimony in the payee’s country of residence and the applicability of any tax treaties should be considered during settlement discussions, as alimony payments may be tax-inefficient under the New Alimony Rule.

(e) Impact of State Income Taxes

(1) Although this outline is focused on the federal tax aspects of divorce for alimony, it is also important to consider state income tax laws, as now certain states are mismatched with federal law.

(2) For instance, in a number of states (e.g., New York, California) and the District of Columbia, the applicable state tax law still provides for the taxation of alimony payments received and the deductibility of alimony payments made. The state income tax treatment of alimony paid and alimony received should be taken into account if either the payor or the payee is a resident of a state with its own income taxation.

(3) Example: Consider a divorce where the parties reside in Florida, which has no state income tax. Suppose that the payee accepts a new position in New York State, which imposes a state income tax (which, for purposes of this example, is deemed to be 8%).

(A) If the Pre-2019 Alimony Rule is not applicable, the payor’s payment of $60,000 of alimony is subject to D.C. taxes, which causes further out-of-pocket costs to the payor.

(B) Result Under the New Alimony Rule: Isolating only the D.C. income taxes (and disregarding the federal taxes), the total out-of-pocket cost to the payor is approximately $65,200 ($60,000 ÷ (1 – 8%)). In other words, the payor would have to earn $65,200 to effectively pay $60,000. Even though the payor would have been subject to the D.C. income tax if she/he hadn’t been required to pay alimony, the tax would have been paid from the funds creating the tax. With the funds being paid as alimony, the payor receives zero benefit.

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6 See, D.C. CODE §47–1806.03; the actual D.C. income tax rates range from 4% to 8.95%.
from the funds and must pay the income tax from other funds.

(C) **Result Under Pre-2019 Alimony Rule:** Now consider if the Pre-2019 Alimony Rule applies – the payor would be able to offset the alimony paid as a deduction against the income, so the impact of the D.C. income tax is neutralized.

(4) **Example:** Consider a divorce where the parties reside in Florida, which has no state income tax. Suppose that the payee accepts a new position in New York State, which imposes a state income tax (which, for purposes of this example, is deemed to be 8%).

(A) For federal tax purposes, the payor’s and the payee’s situation has not changed as a result of the payor’s move to New York – under the New Alimony Rule, no deduction is allowed to the payor for alimony paid and the payee is not taxed on the alimony received.

(B) However, for state income tax purposes, the payee is now subject to New York State income tax on the alimony payments received. As the payor continues to reside in Florida, which has no state income tax, there is no need to consider whether the payor is entitled to a state-level deduction for state income tax purposes.

(f) **Alimony Trusts, Income Trusts and the Shifting of Income**

(1) The 2017 tax act includes an additional changes related to alimony; it repeals §682 regarding the taxability of certain trust income as a result of a divorce.

(2) As innocuous as this change may appear to be, it could have major ramifications for a divorced individual who previously created an irrevocable trust for the benefit of his or her former spouse during their marriage.

(g) **“Grantor Trusts” and the Definition of “Spouse” for Certain Trusts**

(1) **Grantor Trusts**

(A) When an individual creates an irrevocable trust (said individual is customarily referred to as the “grantor” of the trust), a provision is often included in the trust that causes the trust income and expenses to be reported for income tax

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7 See, D.C. CODE §47–1806.03; the actual D.C. income tax rates range from 4% to 8.95%.

8 See, §11051(b)(1)(C) of the 2017 Tax Act.
purposes by the grantor and not by the trust. This is colloquially referred to as a “grantor trust.”

(B) Often, the inclusion of these provisions is intentional, as they allow for a “free gift” by the grantor to the trust in the amount of the income taxes paid by the grantor instead of the trust. An example of such a provision is found in §675(4)(C), which applies “grantor trust” treatment if the grantor retains the right, at any time, to withdraw the trust’s assets and substitute other assets of equivalent value in their place (the “Substitution Power”).

(2) “Spouse” and Effect on Grantor Trust Status

(A) Another “grantor trust” provision is found in §677(a)(1), which provides that the grantor is to be treated as the owner of any portion of a trust (and therefore taxed on the trust income) if the income from the trust may be distributed to the grantor or the grantor’s spouse.

(B) Throughout the “grantor trust” provisions of the Code, some terms are defined in a way that they don’t mean what you might think they should mean. “Spouse” is one of those terms.

(C) Under §672(e)(1)(A), a grantor is treated as holding any power or interest of the grantor’s spouse, which is defined as any individual who was the spouse of the grantor at the time of the creation of such power or interest.

(D) For the definition of “spouse,” the only time frame that is critical is the moment that the spouse’s interest was created, i.e., upon the creation of the trust. For the “grantor trust” rules, if a person is a “spouse” at that time, that person remains the “spouse” even if such spouse and the grantor subsequently divorce – there is no continuing review of the marital status of the parties.

(3) Stated differently, based on this definition, if the trust income is required to be paid to the grantor’s spouse, the trust is a “grantor trust” as to the grantor, and the grantor -- and not the grantor’s spouse -- is taxed on the income regardless of whether the grantor and the spouse remain married during the duration of the trust.

(h) Trust Planning with Spouses

(1) Alimony Trusts
When it comes to divorce, trusts may play an important role. Sometimes, instead of having alimony paid directly to the recipient, the payor may be required to establish a trust for the benefit of the recipient that would provide the recipient with trust income in lieu of requiring the payor to pay recurring alimony payments. These trusts are often referred to as “alimony trusts.”

Interestingly, alimony trusts are not always created as a result of the divorce -- if, for example, the donor had previously created an inter-vivos QTIP Trust, the court decree may reduce or eliminate the alimony requirement on account of the income that the recipient receives from the trust.

(i) Alimony Trusts and §682 – the Shifting of Taxability

(1) Introduction

(A) As stated above, a trust created by a grantor that requires the income to be distributed to, or gives the trustee the discretion to pay the income to, the donee spouse would be a “grantor trust” as to the grantor under §677(a)(1) because the income was, or could be, paid to the donee spouse. The income taxation was not an issue because the spouses were part of the “marital unit.”

(B) However, upon a divorce, because §677(a)(1) only looks to the marital status at the time of the “creation” of the power or interest, the “grantor trust” provisions remain applicable.

(C) As a result of the divorce, because the parties are no longer part of a “marital unit,” not only does the grantor lose the benefit from the trust income, but the grantor is also taxed on such trust income. Under these circumstances, not only does the donee spouse receive the trust income, but the donee spouse would not be required to report any trust taxable income or expenses on her/his income tax return because the trust is a “grantor trust” as to the grantor. The end result is that the donee spouse receives the trust income free of income tax.

(2) Enactment of §682

(A) To avoid this seemingly harsh result, Congress enacted §682 to shift the taxability away from the grantor. Generally, if trust income is distributed to a married person from a trust created by her/his spouse, then, upon a divorce and irrespective of any other income tax provision, §682(a) taxes
the income to the recipient (except as to any income specifically determined to be allocated for child support).  

(B) Example: Suppose that A is married to B. During the marriage, for estate planning purposes, A irrevocably transfers property to a trust that A created for B. Under the trust, B is to receive all of the income for her/his lifetime. Some years later, B obtains a divorce from A under a court decree. Acknowledging that B receives sufficient income from the trust, the court does not award any alimony to B. Because A and B were married at the time that A created the trust, A would be taxed on the trust income under §677(a)(1) notwithstanding the fact the income is paid to B. This would seem logical and non-controversial because, as a married couple, A and B are the equivalent of one “marital unit,” so together, they receive and are taxed together on the income. However, upon divorce, even though A and B cease to be one “marital unit,” the “grantor trust” rules of §677(a)(1) still apply to tax all trust income to A even though B receives such trust income.

(C) Result: For this reason, until the beginning of 2019, §682 came to A’s rescue and taxed the trust income to B. By its design, §682 is designed to match tax implications to economic reality.

(3) 2017 Tax Act and §682 Repeal – Re-Shifting of Taxability

(A) Unfortunately, §682 was repealed as of January 1, 2019.

(B) Starting on January 1, 2019, the income taxability of certain alimony trusts is determined under other Code provisions, such as the “grantor trust” rules. However, the Grandfathering Exception described above should be applicable in that it applies to all of the §11051 provisions of the 2017 tax act and not just to the provisions affecting §71 and §215. Although it is not clearly stated in the 2017 tax act, presumably, if a trust is referenced in a pre-January 1, 2019, divorce decree as paying its income in lieu of alimony,

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9 Note that such taxability appears to only shift the taxability of ordinary income; capital gains, if remaining in the trust and not allocated to trust income, may still be taxed to the grantor under the grantor trust rules. See Barry Nelson & Richard Franklin, Inter Vivos QTIP Trusts Could Have Unanticipated Income Tax Results to Donor Post-Divorce, LISI ESTATE PLANNING NEWSLETTER #2244 (Sept. 15, 2014).

10 See generally Reg. §1.682(a)-1(a)(4) Ex. 1. Again, as stated earlier, this applies to ordinary income and not capital gains (unless capital gains are directed to be allocated to income).

the income tax treatment under §682 should continue to apply.

(C) Recall that in the above example, if A and B’s divorce occurs prior to 2019, §682 taxes the trust income to B. Based on the wording of the Grandfathering Exception, §11051 of the 2017 tax act applies to any divorce or separation instrument executed after December 31, 2018. If the divorce decree references that the trust income is in lieu of a higher alimony (or any alimony) payment, then, because the decree was issued prior to 2019, §682 should still apply even after December 31, 2018.

(D) Example: Suppose in the prior example that the divorce decree is executed after December 31, 2018; §682 would not be applicable and other income tax provisions would determine the trust’s income taxability.

(4) Any Recourse for the Grantor - Modification? Decanting? Death on Divorce Clause?

(A) Section 682 applies to certain trusts regardless if they are referenced in the divorce decree. If a trust is not so referenced, as of January 1, 2019, such trusts are governed under other provisions of the Code, which, because spouses are involved, reverts to the “grantor trust” provisions.

(B) Ordinarily, when an individual creates a “grantor trust,” it is possible to “toggle” the taxability on-and-off by relinquishing a power. For example, if a trust is a “grantor trust” on account of the inclusion of the Substitution Power, the grantor can “turn off” the “grantor trust” provisions by renouncing the Substitution Power. However, from the above analysis, §677(a)(1) cannot be “turned off” -- it remains in effect for as long as the grantor remains alive during the trust term. Similar to the news of the tax treatment of SLATs, this too would appear to be surprising news for any grantor who created an income trust for donee spouse and then became divorced from the donee spouse after December 31, 2018.

(C) Unfortunately, courtesy of the power of §677(a)(1), if a divorce occurs after 2018 there may be few options, if any, to switch the income taxability to the donee spouse (to reflect economic reality).

III. Division and Transfer of Property

(a) Income Tax Treatment - Generally
(1) Under current law, §1041 provides that no gain or loss is recognized on a transfer of property from an individual to (or in trust for the benefit of) a spouse, or a former spouse, but only if the transfer is “incident to the divorce.” This law was left unchanged by the 2017 Tax Act.

(A) “Incident to the divorce” means that the transfer of property happens either (i) within one year after the date on which the marriage ceases or (ii) is related to the cessation of the marriage.

(B) Under Treas. Reg. §1.1041-1T, a transfer of property is treated as related to the cessation of the marriage if the transfer is pursuant to a divorce agreement, as defined in §71(b)(2), and the transfer occurs not more than 6 years after the date on which the marriage ceases. Any transfer not pursuant to a divorce or separation instrument and any transfer occurring more than 6 years after the cessation of the marriage is presumed to be not related to the cessation of the marriage. This presumption may be rebutted only by showing that the transfer was made to effect the division of property owned by the former spouses at the time of the cessation of the marriage. For example, the presumption may be rebutted by showing that (a) the transfer was not made within the one- and six-year periods described above because of factors which hampered an earlier transfer of the property, such as legal or business impediments to transfer or disputes concerning the value of the property owned at the time of the cessation of the marriage, and (b) the transfer is effected promptly after the impediment to transfer is removed.

(2) For U.S. federal income tax purposes, transfers of property incident to a divorce are treated as if they were gifts by the transferor spouse (the “transferor”) to the transferee spouse (the “transferee”). Thus, the transferee takes a carryover basis in the transferred property (i.e., the same basis as the transferor).

(3) Significant tax planning flexibility is provided for under §1041 by allowing for transfers to be made to a spouse in trust. If the parties can agree on using a trust, then the transferee can receive property in a trust that is not subject to U.S. federal estate taxes at the transferee’s death. Of course, U.S. federal gift tax issues must be considered when funding a trust, as discussed below.

(b) Exception - Transferee Spouse Is a Non-Resident Alien

(1) §1041(a) does not apply to a property transfer if the transferee spouse is a non-resident alien for U.S. income tax purposes. See
§1041(d). Taxable gain will likely need to be recognized by the transferor as a result of a transfer of appreciated property to a non-resident alien spouse.

(2) The policy behind denying the application of §1041(d) to property transferred to a non-resident alien divorcing spouse is that if appreciated property is allowed to be transferred tax-free to a non-resident alien, with the transferee spouse taking a carryover basis, there is a possibility that the appreciation will never be subject to U.S. federal income tax, as a non-resident alien is only subject to U.S. federal income tax on limited types of U.S.-source income.

(c) Gift Tax Treatment – Generally

(1) Transfers between spouses are generally free of U.S. federal gift tax consequences, due to the unlimited marital deduction under §2523. However, in the divorce context, property transfers as a result of the divorce will often occur after spouses are divorced, in which case the marital deduction will not be available.

(2) The potential for a taxable gift when property is transferred post-divorce is the case even though property transfers as a result of a divorce are almost always the result of an arms-length negotiation, and lack the traditional characteristics of a gift.

(3) To protect property transfers incident to a divorce from being subject to U.S. federal gift tax, §2516 was enacted in 1954. §2516 treats the transfer of property between spouses or former spouses as “made for a full and adequate consideration in money or money's worth,” and therefore exempt from U.S. federal gift tax, if the following requirements are satisfied:

(A) The transfer is “pursuant to” a written agreement between the spouses “relative to their marital and property rights.”

(B) The transfer is to one of the spouses “in settlement of his or her marital or property rights” or is made “to provide a reasonable allowance for the support of issue of the marriage during minority.”

(C) The spouses are divorced during a three-year period that begins one year before the agreement is made.

(4) The written agreement does not need to be approved by a court for § 2516 to apply. However, § 2516 also does not automatically immunize all transfers between spouses pursuant to a written agreement merely because divorce occurs during the described three-year period. The agreement must be “relative to their marital and property rights.”
(5) Moreover, because the exemption embraces only transfers “in settlement of [the recipient's] marital or property rights,” a transfer does not qualify if all property and marital rights were previously surrendered (e.g., by a valid prenuptial agreement) or to the extent the transferred property exceeds the value of the surrendered rights.

(6) §2516 applies to transfers in trust, but only to the interest in trust that is created for the transferee spouse or for the support of minor children. Any interest in the trust for adult children will not be covered by §2516 and will likely be considered a taxable gift for U.S. federal gift tax purposes. Thus, the transfer will generally use the transferor’s lifetime exemption from U.S. federal gift taxes (11.58M for 2020), unless some other exception applies (i.e., QTIP election is made for the trust).

(d) Importance of §2516 to Non-Citizen Transferee Spouse

(A) When one or both spouses of a divorcing couple is a non-U.S. citizen, meeting the requirements of §2516 is even more important, as transfers prior to the effective divorce date are not covered by the unlimited marital deduction under §2523. The unlimited marital deduction under §2523 is only available when the transferee spouse is a U.S. citizen.

(i) Transfers to a non-U.S. citizen spouse are provided an increased annual exclusion for U.S. federal gift taxes – currently, in 2020, a spouse can transfer to his or her non-citizen spouse up to $157,000 free of U.S. federal gift tax consequences. Of course, in the divorce context, this increased exclusion is only helpful for property transfers that occur prior to the divorce date.

(B) Due to the lack of an unlimited marital deduction, it is critical that in divorces involving the transfer of significant property from a U.S. citizen or U.S. resident spouse to a non-citizen spouse that the requirements of §2516 are satisfied. The importance of §2516 is less significant if the transferor spouse is not a U.S. citizen or resident for U.S. federal gift tax purposes, as the U.S. federal gift tax will only apply to transfers of U.S. real estate or U.S. tangible personal property (i.e., artwork, vehicles or physical property located in the United States).

(i) With the above said, if a non-citizen non-resident is transferring U.S. real estate or U.S. tangible personal property to a non-citizen spouse, it is similarly critical that the requirements of §2516 are satisfied, as the
transferor spouse could be subject to significant U.S. federal gift tax liability, with no exemption, if he or she is subject to U.S. federal gift tax on the transfer of a U.S.-situs asset to his or her spouse or former spouse.

(e) Tax Planning for Property Transfers – Both Spouses Are U.S. Citizens

(1) Always be careful when preparing a written divorce agreement covering the division of appreciated property that the timing requirements of §1041 and §2516 can be met in relation to the transfer of such property, especially if representing the transferor spouse:

(A) For purposes of §1041, this means that the property transfers occur within one year of the divorce date, or if that is not possible, within six years of the divorce date and the agreement is incorporated in the divorce decree.

(B) For purposes of §2516, this means that the divorce itself must happen within two years after, or one year before, the date on which the written property division agreement is entered into.

(2) If representing the transferee spouse, be aware of the transferor’s tax basis in the property to be received. If appreciated property is received by the transferee spouse, there will be a potential built-in tax liability that comes with it.

(3) Even though §2516 may not protect all transfers in trust from being treated as taxable gifts for U.S. federal gift tax purposes, considering the very high current lifetime U.S. federal gift tax exemption of $11,580,000 for 2020, it may still make sense to trigger a taxable gift by transferring property to a trust with adult children as remainder beneficiaries.

(A) *Example:* H and W are divorcing and both agree that W should receive transferred property in trust. The trust will provide for a mandatory annuity payment of $500,000 to W, and the remainder beneficiaries are H and W’s children. H transfers $5,000,000 to the trust. Depending on W’s age, some portion of the $5,000,000 transfer will be not be subject to U.S. federal gift tax, as a result of §2516 applying to W’s annuity interest. The remainder interest in the $5,000,000 will be treated as a taxable gift, but it will only use some small portion of H’s lifetime U.S. federal gift tax exemption of $11,580,000, which may be fine if H’s wealth is not considerably in excess of $11,580,000.
(f) Tax Planning for Property Transfers – One or Both Spouses Are Not U.S. Citizens Or Are Not U.S. Residents

(1) If you represent a transferor spouse, with a transferee spouse that is a non-resident alien, it may make sense to structure the transfer of appreciated assets as a true sale, rather than be subject to the recognition of gain under §1041(d). In this way, the transferor spouse will receive cash to pay any taxes that are triggered by the sale. In addition, there is greater certainty regarding the basis that the transferee spouse takes in the transferred assets (i.e., the purchase price).

(2) If you represent a transferee spouse that is a non-resident alien, it may be beneficial to receive property that is not going to be subject to U.S. federal income tax in the hands of the transferee. For instance, the transferee spouse will not be subject to U.S. federal income tax on gains from the sale of U.S. securities. Conversely, the transferee spouse will continue to be subject to U.S. federal income tax and related reporting requirements on rental income and gains from the sale of U.S. real estate. Considering this differing U.S. tax treatment, assuming equivalent value, it may make sense for the transferee spouse to receive any U.S. securities as part of the divorce agreement, rather than U.S. real estate.

(3) If U.S. real estate is transferred by a non-resident alien spouse to a U.S. taxpayer spouse, the U.S. recipient will have to comply with the requirements of the Foreign Investment in Real Property Tax Act (FIRPTA) upon a future sale of the property. FIRPTA generally requires recognition of gain by the transferor and withholding by the recipient when a non-resident alien transfers an interest in U.S. real estate.

(A) Fortunately, a transfer of an interest in U.S. real estate to a U.S. taxpayer spouse should qualify for non-recognition under §1041(a), so the FIRPTA tax and withholding requirements should be able to be avoided (possibly with the filing of a notice of non-recognition with the IRS).

(4) If both spouses are non-resident aliens, the transfer of U.S. real estate between them will result in the recognition of gain under §1041(d), and thus the application of U.S. taxation, withholding and reporting requirements under FIRPTA. In this case, the recipient spouse should negotiate to have the transferor spouse pay the FIRPTA withholding tax at the time of the transfer to avoid any transferee liability.

(5) When a transferee spouse who is a U.S. citizen or U.S. resident is receiving property from a transferor spouse who is a non-resident
alien, there may be significant U.S. estate tax benefits to receiving the assets in trust. If the trust is drafted properly, the assets of the trust will not be included in the transferee spouse’s U.S. gross estate for U.S. federal estate tax purposes at the transferee’s death. This may be an agreeable solution for both parties, especially if the spouses have children together and agree that the children will be the remainder beneficiaries of the trust. The transferee spouse gains the U.S. federal estate tax protection, while the transferor spouse obtains some assurance that the assets will ultimately pass to the benefit of his or her children.

(A) The transferor spouse is not subject to U.S. federal gift tax on the transfers into the trust, as long as the property transferred in is not U.S. real estate or U.S. tangible personal property.

IV. Conclusion – Change is Permanent, So What Can Be Done?

(a) Prior to January 1, 2019, the income tax laws regarding current and pending divorces and legal separation were somewhat clear. After December 31, 2018, “clarity” has become a fluid term of art.

(b) For example, what happens with prenuptial agreements entered into before January 1, 2019, where alimony is required and subject to the Pre-2019 Alimony Rule but the divorce or legal separation occurs on or after January 1, 2019? Based on the plain meaning of “divorce or separation agreement,” it would appear that a prenuptial agreement does not qualify as a “divorce or separation agreement” and therefore the Pre-2019 Alimony Rule for alimony would appear to be ineffectual. It is certainly possible for the parties to reopen the prenuptial agreement to provide for some form of alternate provision. However, especially if other financial circumstances have changed, many parties would probably not wish to reopen the prenuptial agreement for fear that additional concessions would have to be made. The difference to the payor spouse could be dramatic, however.

(c) For cross-border marriages, the New Alimony Rule significantly changes the requirements in relation to U.S. withholding of tax and reporting by a U.S. payor spouse. In addition, the application and impact of U.S. tax treaties is different under the New Alimony Rule, as the treatment of alimony under many treaties was based upon an assumption that alimony payments would remain deductible in the United States by the payor and taxable to the payee.

(d) The 2017 tax act also changes the effect of divorce on trust income. What, if anything, can be changed regarding the shifting of taxable income after December 31, 2018?
If the divorce decree references the trust and is issued before January 1, 2019, the special taxability rules of §682 should continue to apply even after December 31, 2018.

Hopefully, if the couple divorced prior to January 1, 2019, the decree referenced the particular trust where the trust income is payable to a recipient in lieu of divorce so that the Grandfathering Exception could apply.

If the decree fails to reference a particular trust where the trust income is payable to a recipient in lieu of divorce, the only possible way to fall within the Grandfathering Exception is to seek a clarification and amendment to the divorce decree specifically referencing the trust income as a means of satisfying an alimony obligation.

As for other trusts that are not “alimony trusts,” while the decree can be revised to reference such trusts, it is unknown whether that change will be retroactively accepted within the Grandfathering Exception.

The 2017 tax act did not change the rules regarding property transfers incident to a divorce – the rules of §1041 and §2516 still provide significant protection from U.S. federal income taxes and U.S. federal gift taxes when property is transferred as a result of a divorce, but there are specific requirements that must be met for the relief to be available under each Code Section. Those requirements should be reviewed in any divorce involving the transfer of property.

Finally, with respect to many of the tax law changes created under the 2017 tax act, there is a “sunsetting” of such provisions, meaning that the changes expire after a certain date and the law reverts back to the 2017 law. The provisions regarding alimony and divorce, however, do not sunset – these changes are permanent (or as permanent as tax law changes can be) and their pain will be enduring.

These and all other issues pertaining to a divorce or other marriage termination should be discussed with matrimonial and estate and tax planning counsel. This includes both for divorces that occurred prior to January 1, 2019, and those that have occurred since January 1, 2019 and going forward.