Divorce in a Post-Tax Reform World:
with a focus on Cross Border Issues and 1041

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Agenda for Discussion

- U.S. Tax Treatment of Alimony Payments
- Repeal of §682: Treatment of Grantor Trusts Post-Divorce
- U.S. Tax Treatment of Property Transfers Resulting from Divorce
U.S. Tax Treatment of Alimony Payments

• **Divorce and Separation Agreements Entered into Prior to January 1, 2019:**
  – Alimony is deductible by payor (§215) and is income to payee (§71), unless stated otherwise.
  – Generally, preserves wealth as shifts income to a lower income tax bracket.
  – For U.S. payors to non-U.S. payees, 30% withholding tax applied, unless treaty relief.
  – Many treaties do provide relief from U.S.-source taxation, but vary significantly.

• **Divorce and Separation Agreements Entered into After January 1, 2019:**
  – Alimony is not deductible by payor and is not income to payee.
  – Generally, results in a greater loss of wealth as income remains taxable to payor.
  – For U.S. payors to non-U.S. payees, no need to withhold, as not taxable in U.S.
  – Treaties not as important, but can still provide relief from taxation in payee’s home jurisdiction.
# U.S. Tax Treaties Treatment of Alimony Payments

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<tbody>
<tr>
<td><strong>Pre-2019 Alimony Rule</strong></td>
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<td>US. Payor - Non-U.S. Payee</td>
<td>Deduction for Payor; U.S.-source tax to Payee (may also be foreign tax)</td>
<td>Deduction for Payor; only taxable in U.K. for Payee; no U.S.-source tax</td>
<td>Deduction for Payor; only taxable in Canada for Payee; no U.S.-source tax</td>
<td>Deduction for Payor; U.S.-source tax to Payee; no Mexican tax</td>
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<td>Non-U.S. Payor - U.S. Payee</td>
<td>Foreign law determines if Payor can deduct; taxable income for Payee</td>
<td>Payor not entitled to deduction; not taxable to Payee in U.S. or U.K.</td>
<td>Payor entitled to deduction under Canadian law; taxable to Payee only in U.S.</td>
<td>Deduction depends on Mexican law; only tax to Payee is possible Mexican-source tax</td>
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<td><strong>Current Alimony Rule</strong></td>
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<td>U.S. Payor - Non-U.S. Payee</td>
<td>No deduction for Payor; no U.S.-source tax to Payee (may be foreign tax)</td>
<td>No deduction for Payor; not taxable to Payee in U.S. or U.K.</td>
<td>No deduction for Payor; not taxable to Payee in U.S. or Canada</td>
<td>No deduction for Payor; not taxable to Payee in U.S. or Mexico</td>
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<tr>
<td>Non-U.S. Payor - U.S. Payee</td>
<td>Foreign law determines if Payor can deduct; not U.S. taxable for Payee (may be foreign tax)</td>
<td>U.K. law determines if Payor can deduct; not taxable to Payee in U.S. or U.K.</td>
<td>Payor entitled to deduction under Canadian law; not taxable to Payee in U.S. or Canada</td>
<td>Deduction depends on Mexican law; only tax to Payee is possible Mexican-source tax</td>
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Repeal of §682: Treatment of Grantor Trusts Post-Divorce

• **Section §682: Shifting of Income of Grantor Trusts to Beneficiary Spouse**
  – Prior to §682, grantor trust status continued for a trust for spouse, even after spouses divorced.
  – Result is that divorced grantor spouse still must pay income tax on trust income.
  – Section §682 eliminates this scenario, by treating divorced spouse beneficiary as grantor, causing the trust income to be treated as taxable to the spouse beneficiary.

• **Repeal of §682: Trust Income Remains Taxable to the Divorced Grantor**
  – Section §682 does not apply to divorce agreements executed after December 31, 2018.
  – Continued grantor taxation of trusts for spouse should be factored into any agreement.
  – Decanting and death on divorce clauses are potential methods of relief.
U.S. Tax Treatment of Property Transfers Resulting from Divorce

- **Income Tax Treatment: §1041 Provides for Non-Recognition of Gain or Loss**
  - Transfers “incident to a divorce” (timing) have non-recognition treatment apply.
  - Results in carryover basis for property transferred between divorcing/divorced spouses.
  - Not available for transfers to a non-resident alien – those transfers subject to recognition.
  - May make sense for non-resident aliens to receive unappreciated assets, and to receive assets that will not generate U.S. federal income tax and reporting requirements going forward.

- **Gift Tax Treatment: §2516 Protects Against Treatment as Taxable Gift**
  - Property transferred pursuant to written divorce agreement is treated as transfer for FMV.
  - Must be in settlement of the recipient spouse’s marital or property rights.
  - For transfers to non-U.S. citizen spouses, §2516 is critical, as no unlimited marital deduction.
  - In addition, critical for transfers from NRA to non-U.S. citizen, when U.S.-situs property involved, as no marital deduction and no gift tax exemption.