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The Wonderful World of Divorce: What Trust and Estate Lawyers Need to Know about Family Law and Vice Versa

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"…In this world nothing is certain but death and taxes."
- Benjamin Franklin (1789)

"Marriage…is a damnably serious business…."
John P. Marquand, The Late George Appley (1937)

Introduction

This presentation is not meant to be exhaustive, but to cover selected, mostly tax-related, issues arising where family law and trust and estate practice intersect. It is intended to be a practice guide for dealing with often-encountered, real-life situations.

I. Gift tax issues arising in the family law setting.

A. Divorce settlements.

1. Unintended taxable gifts to children or others.

a. Example: In a marital settlement agreement Husband is awarded Blackacre and agrees to leave it to the parties' children on his death. This is a taxable gift of a future interest (Treas. Reg. §2503-3). Husband has, in effect, entered into a contract to make a will; a present gift of a future interest to take effect on his death.

If the same provision is contained in a stipulated judgment does that alter the result? The court could not have reached that result without the acquiescence of both parties. Once community property is divided it become separate property and the court has no authority to restrict or direct its disposition.

Question: How likely is the IRS to pursue a taxable gift in this context? How is this different than a gift to a Qualified Personal Residence Trust (QPRT) or other grantor-retained income trust?

b. Example: Assume the same facts as above, but Husband is required to leave stock worth $500,000 to his grandchildren on his death. Is it a generation-skipping gift? How is the gift valued? When is the return required to be filed?

B. Premarital agreements; gifts to third parties.

Example: In a premarital agreement, Husband agrees that if, Wife predeceases him he will leave 25% of his estate to Wife's children. Is a gift made on signing the agreement, to take effect on Husband's death? Is a gift tax return required on signing the agreement? How likely is the IRS to pursue such a gift?

II. Estate planning issues with divorce consequences.

A. Irrevocable Life Insurance Trusts ("ILITS") and other irrevocable trusts.

1. ILITs are routinely prepared for married couples by estate planning lawyers.

2. The estate planning lawyer takes care to document that one spouse is transferring separate property to an irrevocable trust for the benefit of the other spouse and the children.

3. After the trust is signed and funded, the assets are neither community property nor the separate property of either spouse, except for the beneficial interests of the beneficiaries.

4. Fast forward to the divorce.

a. The trust is outside the marital estate and neither community property nor the separate property of either spouse. The court has no jurisdiction to award or confirm it.

b. Following the divorce the trust beneficiaries must decide what to do with the trust.

(1) An ILIT funded only with life insurance:

(a) Are premiums required to be paid?

(b) Premiums may not be required; *e.g.*, a fully paid-up policy or dividends sufficient to pay premiums.

(c) Other assets may produce income.

(2) An ILIT funded with other assets.

c. Example: Suppose a trust is funded with assets, *e.g.*, stock worth $5 million to use a spouse's unified credit. Husband funds the trust with community property that was transmuted to his separate property. A completed gift has been made to the trust, a third party.

5. What ethical steps should the estate planner take in representing Husband and Wife to protect them (and the planner) regarding a possible future divorce?

a. Explain in writing what will become of the trust in case of a divorce.

b. Have both parties acknowledge the advice by signing.

B. Transmutation of assets from separate to community property.

1. Estate planning lawyers like community property because of the stepped-up basis. They may encourage couples to transmute separate property to community. The parties should be cautioned to consider the effect of transmuting separate property to community in case a divorce follows.

2. Does Arizona have a transmutation statue?

3. Does Arizona law provide that a spouse who contributes separate property to the acquisition or improvement of community property is entitled to

reimbursement on divorce unless the right to reimbursement is expressly waived in writing?

4. Non-tax implications of transmutation.

a. The drafting lawyer needs to explain in writing:

(1) Who the client is, or clients are.

(2) If both spouses are clients, describe all conflicts and obtain a conflict waiver from each.

(3) Describe the effect of the transmutation in case of divorce as well as death.

(4) Revocable trusts should recite that community and separate property transferred to the trust retain their character, if that is the parties' intention.

Practice tip: Don't use a trust instrument to transmute property; do it by a separate agreement.

5. Tax implications of the transmutation rules.

a. To have community property and qualify for the stepped-up basis, there must be a *valid* transmutation.

(1) Don't rely on a "one size fits all" document like a trust instrument that recites all assets contributed to it are community property.

(2) Have the client execute a deed conveying real estate from joint tenancy, separate property or other form of title to community property before conveying it to the trust.

(3) The transmutation agreement should describe each asset being transmuted.

III. Spousal fiduciary duties and their implications for estate planning.

A. In Arizona, do spouses owe fiduciary duties to each other? Is any transaction between spouses that benefits one spouse unfairly at the expense of the other presumed to be the result of undue influence?

B. Beware of transmutations entered into as part of the estate planning process, including postnuptial and transmutation agreements. The document must be transparent and recite facts that rebut the presumption of undue influence. It may be advisable to have each spouse represented by independent counsel.

IV. Consider the Significance of the Parties' Separation. In Arizona, when do each party's earnings become separate property, not community property? Earnings include retirement plan contributions. After separation, do debts incurred by either spouse become the separate obligation of that spouse? Does separation give rise to support rights and post-separation accountings for the use of community property and for the payment of community debts by post-separation earnings?

V. Premarital agreements and estate taxes: portability of the unified credit.

Practice tip: In appropriate circumstances, consider including in a premarital agreement that the less-propertied spouse will agree to have his or her executor timely file an estate tax return following his or her death and make the decedent's unified credit available to the surviving spouse. This can be valuable where one spouse's estate is sufficiently large to require payment of estate tax and the other

spouse has a small estate. This can benefit the client and his or her issue without detriment to the less-propertied spouse. Sample language is attached as Appendix A

VI. Estate planning for the divorcing spouse.

A. The problem: While the divorce is pending, the parties remain married. The existing estate planning by trust or will remains in effect. If a spouse dies during divorce, the result will likely be that the surviving spouse inherits the deceased spouse's entire estate, either outright or in trust, through the prior estate plan or, if none, on intestacy.

B. The solution:

1. Initial estate planning should begin as soon as possible after the divorce is filed.

2. If there is a living trust, it should be revoked.

3. Each party should execute a new will or unfunded trust.

4. *Consider and discuss* whether to terminate joint tenancies.

5. Revoke IRA beneficiary designations. The other spouse will likely be the sole beneficiary of an IRA.

6. Pensions, 401(k), 457 and 403(b) plans are a problem. As qualified plans, the spouse must be the death beneficiary of the entire plan under ERISA, a federal statute that overrides California's community property laws (Pub. L. 98-397, 98 Stat. 1426).

C. Question: What estate planning is permitted in Arizona while the divorce is pending?

D. A post-judgment checklist for the client after the divorce judgment is entered.

1. Transfer assets to the parties in accordance with the judgment. Revoke trusts if necessary.

2. Notify pension plans, IRA and 401(k) custodians, etc., of all transfers of ownership and beneficiary changes.

3. Do permanent estate planning. Fund the unfunded living trust that was signed while the divorce was pending.

4. Don't let the legislature do your work for you. In *Egelhoff v. Egelhoff*, 532 U.S. 141 (2009), a Washington case, ERISA preempted a statute which said a divorce judgment revokes a retirement plan beneficiary designation. ("I read it in a statute, so it must be true.") Husband was awarded all rights to a retirement plan but failed to remove his ex-wife as beneficiary post judgment. On his death ex-wife, not his estate, got the death benefit.

VII. Income tax issues related to divorce.

a. Alimony.

i. Alimony is taxable to the payee and deductable to the payor. Internal Revenue Code §§71, 215.

ii. Same sex-marriage: the same rules now apply for federal tax purposes as in opposite-sex marriages (*U.S. v. Windsor*, 1335, Ct. 2675 (2013)).

iii. Registered domestic partnerships (RDPs).

1. Tax deductible by the payor and taxable to the payee per State income tax rules, but federal tax law does not apply.

2. There will presumably be fewer RDPs since the recognition of same-sex marriage.

iv. Some frequently-encountered support taxation rules that can be troublesome:

1. Alimony must be paid in “cash.” Checks are acceptable, but support must not be in exchange for services, property, a promissory note, or the use of property. To be deductible in a certain year, it must be paid in that year.

2. Alimony must be “to or on behalf of a spouse or former spouse.” This rule allows for creativity. Payment may be made to a third party for the benefit of the payee. Payments such as cash payment of rent, mortgage, debts, taxes or tuition for the payee’s benefit will qualify if the order so provides or the payee requests it in writing. *Simpson v. Comm’r,* T.C.M. (CCH), 1999-251 (1999); Treas. Reg. §1.71-

1T,Q&A(b)(6),(7)(1984). Mortgage or other debt payments must be for debts owed by the payor. IRS Publication 504 (2008), 12, table 5.

3. Payments must be made under a written order or agreement. The instrument must be in existence when the payment is made. Payments made before the instrument is signed are not deductible, even if it retroactively characterizes them as alimony. *Rafferty v. U.S.*, D. Colo. (July 8, 2008); Treas. Reg. §1.71-LT, Q&A (a)(4)(1984). This rule is often not enforced if the payor and payee report the payments in a consistent manner.

Practice tip: Have the support order provide that the recipient is required to report the support as income and to reimburse the payor for any taxes caused by the failure to do so.

4. Only temporary support is deductible if the parties are living together. IRC §71(b)(1)(c); Treas. Reg. §171.-1T, Q&A(b)(9)(1984).

5. Recapture: A trap for the unwary. This rule is intended to prevent the deduction of front-end loaded support. If the support paid in year two is $15,000 or more greater than that paid in year three, the excess will be recaptured. The rule is complicated and often a problem in short marriages. It does not apply to

temporary support or if the reduction is due to the death of either party or the payee's remarriage. (IRC §71(f)(5)(A)).

6. The payor may be required to withhold taxes from alimony if the payee is a non-resident alien.

7. The problem of "available" net income versus the amount of spousal support. "I only take home $5,000 per month. I have to pay spousal support of $6,000?" An employee may now claim more than 10 exemptions without prior permission of or notice to the IRS (See IRS website, "Form W-4 & wage Withholding").

b. Capital gains taxes on the sale of a residence.

i. Each spouse is entitled to an exemption of $250,000 (IRC§121).

ii. To claim the exemption the spouse must reside in the home for two of the last five years (*Ibid).*

1. When one spouse is granted exclusive use and possession of the residence by court order, the excluded spouse can claim occupancy during the exclusion period to qualify for the $250,000 exemption (*Ibid*.)

2. The above rule applies equally to deferred home sale orders.

C. Penalty-free distributions from qualified retirement plans before age 59 ½.

1. Normally, amounts distributed from a qualified retirement plan before the participant reaches age 59 ½ are taxable as ordinary income and are also subject to a 10% additional tax on the amount of the distribution (Internal Revenue Code §72(t)). Amounts distributed to an alternate payee under a Qualified Domestic Relations Order (QDRO) are not subject to tax if they are rolled over into an IRA in the alternate payee's name (IRC §72(t)(2)(C)). Distributions to the alternate payee from a QDRO that are rolled over into an IRA avoid recognition of taxable income (IRC§402(e)). Internal Revenue Code §72(t) also allows the alternate payee the option to have any part of his or her distribution paid directly to the alternate payee. The portion received directly by the nonparticipant from a qualified plan, is subject to income-taxes, but is free of the additional tax imposed under §72(t). These cash distributions may be useful for paying living expenses, attorneys fees, a down payment on a residence or other needs of the newly-divorced spouse. Once the distribution pursuant to a QDRO is made into an IRA,

further penalty-free distributions are allowed only under very limited circumstances.

(IRC §72(t)).