

New Tax Provisions Significantly Impact Treatment of Trusts in Divorce

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Trusts in Divorce

Everyone knows about the income and estate tax changes included as part of the Tax Cuts and Jobs Act of 2017 (the "Act"), but there are several overlooked provisions that may significantly affect taxation in a divorce. Some of these provisions may cause unintended consequences if not addressed as part of the dissolution proceeding or settlement discussions.

Alimony and Maintenance

Beginning in 2019 alimony and maintenance are no longer deductible to the person making the payment or taxable to the person receiving the payment. Unlike many other provisions in the Act, this provision does not sunset in 2026. In addition, Prenuptial Agreements and Postnuptial Agreements are not grandfathered under the Act (there are some efforts to change this, but it is unclear whether that will happen.). Therefore, if a Prenuptial or Postnuptial agreement signed before 2018 includes terms providing for how alimony or maintenance will be taxed, the new tax laws under the Act prohibiting the deduction or taxation of alimony and maintenance will still apply.

Grantor Trusts

There is a section of the Internal Revenue Code (Section 682) that addresses "grantor trusts", that was repealed as part of the Act. "Grantor" trusts are trusts where the person establishing the trust (the grantor) is taxed on the income from the trust even if such person is not the beneficiary of the trust. Prior to the Act, Section 682 provided that after a divorce, income paid to an ex-spouse from a grantor trust would be taxed directly to the ex-spouse, not the grantor of the trust. Section 682 was repealed as part of the Act, which means that now, after a divorce, the grantor will still pay the income tax on the trust income, even though the divorced spouse will receive that income. If this issue is not considered, this outcome may cause significant tax consequences to the grantor spouse after the divorce.

Some examples of the types of trusts and potential consequences are described below:

Spousal Limited Access Trust

This type of trust provides that the trust assets will be held for the benefit of the spouse and children, but not for the benefit of the grantor. The primary purpose of this trust is to utilize the estate tax exemption of one spouse, while allowing the other spouse access to the assets. Typically, these are set up as "grantor" trusts, which means that after a divorce, even though the spouse may be an income beneficiary, the ex-spouse grantor will be responsible for the income tax even though he or she does not receive the income.

Lifetime Qtip Trust

This type of trust provides that all of the income will be distributed to the spouse during his or her lifetime. The typical use of these trusts is to transfer assets to the spouse so that in the event of his or her death, the trust assets may use part or all of his or her estate tax exemption. Again, under the Act if the trust was set up as a grantor trust, the divorced grantor spouse will pay income tax on the income passing to the ex-spouse.

Qualified Personal Residence Trust

Qualified Personal Residence Trusts are set up for a primary residence or vacation home. The purpose of these trusts is estate tax planning, removing the residence or vacation home from the grantor's estate at a reduced value. Again, if the spouse is a beneficiary, he or she may receive the income from the trust, while the other spouse (now divorced), pays the taxes on the income.

If any of these types of irrevocable trusts are part of a divorce proceeding, there are steps that can be taken to address the potential pitfalls. Options include removing the spouse as a beneficiary, or distributing the assets out of the trust to the spouse.

Lastly, as noted above, Prenuptial agreements signed before the Act are not grandfathered. That means the provisions of the Act would apply to these agreements even though they were signed under a different set of rules. This is particularly relevant for alimony and maintenance.

Many provisions of the new tax laws have been well publicized. However, the provisions relating to divorce may be some of the more notable changes, but have not received the same attention. Petitioners and clients need to be aware of these changes to avoid surprises or unintended consequences.