TAXATION OF GRANTOR TRUSTS AFTER DIVORCE

AMY KANYUK, of McDonald & Kanyuk, PLLC, concentrates her practice on estate, gift, and generation-skipping planning for individuals and families of high net worth, as well as estate and trust administration. She holds the highest rating of AV from Martindale Hubbell, and is a Fellow of the American College of Trust and Estate Counsel (ACTEC), where she serves on the Board of Regents (ACTEC's governing board), the National Membership Selection Committee, the Tax Policy Study Committee, and the Asset Protection Committee (where she also serves on the State Laws Subcommittee).

In order for a married client to use his or her gift tax exemption, without completely losing access to the gifted property, the client may consider making a gift to an irrevocable trust of which the client's spouse is a beneficiary. Usually, this type of trust (which recently has become known as a "spousal lifetime access trust," or a "SLAT") gives the trustee discretion to distribute trust income and principal to or for the benefit of a group of beneficiaries that includes the spouse and the client's descendants. The spouse's eligibility to receive income from the SLAT makes the trust a grantor trust with respect to the client/grantor.

Under Internal Revenue Code (Code) section 677, a trust is treated as a grantor trust if the trust's income may be distributed to the grantor or the grantor's spouse, or held or accumulated for future distribution to the grantor or the grantor's spouse, in the discretion of the grantor or a non-adverse party, or without the approval or consent of any adverse party. Actual payments of income aren't necessary to invoke section 677—the mere possibility that the income could be distributed or accumulated for future distribution is enough.

The "income" referred to in section 677 is taxable income, not fiduciary accounting income.[1] Accordingly, if capital gains are allocable to corpus (as they usually are), and corpus may eventually be distributed to the grantor, then the grantor is taxable on the capital gain.[2]

Code section 672(e), the "spousal attribution rule," imputes to the grantor any power or interest in a trust held by the grantor's spouse, and states that the grantor will be treated as holding any "power or interest held by any individual who *was the spouse of the grantor at the time of the creation of such power or interest*" (emphasis added).[3] For example, if, as is usually the case with a SLAT, trust income may be distributed to or held for future distribution to the spouse (without the consent of an adverse party), the trust is a grantor trust under Code section 677 because, under section 672(e), the trustee's power to distribute to the spouse is treated as the power to distribute to the grantor.

Section 672(e) was intended to prevent a grantor from creating a non-grantor trust—and shifting income—by using the grantor's spouse to hold powers or interests in the trust. The provision is silent regarding whether the spousal attribution rule ends when the marriage ends, which could reasonably lead one to conclude that a grantor who is married when he or she transfers property to the trust is deemed to hold the powers held by the spouse, *even if* the grantor and spouse later divorce.

A number of provisions of the grantor trust rules[4] depend on whether a particular person is the grantor's spouse. Originally, only two sections of the grantor trust rules (section 672(c) and section 674(d)) referred to the grantor's spouse.[5] However, ensuing amendments to those rules expanded the circumstances in which a spouse's possession of a power or interest in a trust would invoke grantor trust status. Amendments to some sections of the grantor trust rules indicate that the spousal attribution rule should not be applied if the grantor and the spouse divorce. For example, section 675(3) causes grantor trust status if the trust loans the grantor funds

without adequate interest and adequate security, but specifically states (via a reference to section 672(e)(2)) that for this purpose, an individual is treated as the grantor only for periods during which the individual is not divorced from the grantor.[6] Other sections of the grantor trust rules—including section 677—have not been amended to clarify the effect of a subsequent divorce on a trust's grantor trust status. In other words, if the trust income is payable to the grantor's spouse, the trust income is taxable to the grantor, regardless of whether the grantor and spouse remain married for the duration of the trust.[7]

Code section 682 was enacted in 1954. Before it was repealed by the 2017 Tax Act (see below), section 682 provided rules describing how the income of a grantor trust was taxed if it was payable to the grantor's former spouse. Under section 682, the income of a grantor trust that was payable to a former spouse was taxable to the former spouse, not to the grantor.[8] Until its repeal, section 682 protected a grantor who otherwise would be taxed on trust income under the grantor trust rules, to the extent that the trust income was payable to the former spouse.[9] Essentially, section 682 eliminated the need to determine whether section 672(e) applied.[10] For example, before the repeal of section 682, if a grantor created a trust that allowed income to be distributed to the spouse, and the couple later divorced, the grantor ceased to own the trust under section 677,[11] so the income would not be taxable to the grantor, but then section 672(e) would apply to impute the income to the grantor, because section 672(e) treats the grantor as holding an interest held by the grantor's spouse, based on the marital relationship when the power is created, *even if* the marriage later terminates. However, section 682 would require the former spouse to pay the tax on income distributed to him or her.

The 2017 Tax Act repealed section 682, beginning on January 1, 2019,[12] as well as section 215 (which permitted the deduction of alimony payments) and section 71 (which required the inclusion of alimony in the recipient's income).[13] It's important to note that section 682 did not stop the operation of the grantor trust rules—it only operated to shift the taxability of income payable to a former spouse from the grantor to the former spouse.[14]

The implications of the repeal of section 682 on certain estate planning techniques are significant. In particular, the repeal could have unintended and adverse consequences for clients who have created or intend to create a SLAT. Because the spouse is a beneficiary of the SLAT, the grantor can remove assets from his or her estate (and utilize the grantor's gift tax exemption), while allowing the trust assets to technically remain within the "marital unit."

A SLAT is a grantor trust under Code section 677 because its income is, or could be, paid to the grantor's spouse. As long as the grantor and spouse are married, there's usually no problem, because the grantor is paying taxes on income that is available to his or her spouse and, indirectly, to the grantor. However, if the parties divorce, the grantor will lose this indirect access to the trust property, *and* will be responsible for paying the taxes on the SLAT's income that is distributed to the former spouse. The former spouse, on the other hand, still is eligible to receive the trust's income tax-free. Before its repeal, section 682 was available to save the day, by shifting the tax burden on the trust's income to the former spouse.

The question then, is how to manage SLATs that were created before the repeal of section 682, and how to structure new SLATs in light of that repeal. Usually, mechanisms exist to "toggle off" grantor trust status, for those occasions when the grantor is unable or unwilling to continue to bear the burden of taxes generated by property being enjoyed by people other than the grantor himself or herself. However, it seems that if grantor trust status is caused by the spouse having a beneficial interest (Code section 677), that status can't be toggled off upon divorce, because the spousal attribution rule under section 672(e) is only determined one time—when the spouse's interest in the trust is created.

For existing SLATs, the options include:

- Decanting or modifying the SLAT to eliminate or modify the spouse's interest in the trust. This option brings with it a host of fiduciary concerns

that probably would be heightened in the event of a divorce.[15]

- Having the trustee reimburse the grantor for the taxes the grantor pays on the trust's income (or at least on the income that is distributed to the former spouse). This option also raises fiduciary concerns, and is only available if the trustee is authorized to reimburse the grantor for taxes paid under the terms of the trust agreement or state law.[16] In addition, a pattern of reimbursement could cause the trust property to be included in the grantor's estate.[17]
- Entering into an agreement with the former spouse whereby the spouse agrees to pay the taxes attributable to the income distributed to him or her. This solution is probably unpalatable to the former spouse, absent other accommodations with respect to the property settlement.
- Terminating the trust and distributing the assets outright to the spouse and/or other beneficiaries. This will defeat the grantor's purposes in creating the trust altogether.

For SLATs to be created in the future, the drafter should consider:

- Requiring that in the event of divorce, distributions to the spouse from the SLAT be subject to the consent of an adverse party, since that would eliminate grantor trust status under Code section 677(a). The grantor would need to be careful, however, not to include any other provisions in the agreement that would cause grantor trust status under section 672(e).
- Authorizing the trustee to reimburse the grantor for income taxes paid on the trust, if those taxes relate to income payable to the former spouse (see comments above).

  Sample language:

  The Grantor hereby negates any right the Grantor might have under state law to require the Trustee to reimburse her for any federal or state income tax liability the Grantor pays as a result of the existence of the Grantor's power under the immediately preceding Paragraph. Notwithstanding the foregoing, during the Grantor's lifetime, the disinterested Trustee, in its sole and absolute discretion, may reimburse the Grantor for all or any portion of the Grantor's federal or state income tax liability attributable to any trust hereunder under Subchapter J of the Code, or any similar tax law. The disinterested Trustee is authorized, in its sole and absolute discretion, by an instrument filed with the trust records, irrevocably to release the right to reimburse the Grantor for any such tax liability. Under no circumstances shall the provisions of this Paragraph result in the Grantor being considered a beneficiary of any trust created hereunder.

- Stating in the trust agreement that the spouse's beneficial interests in the trust are dependent upon the spouse remaining legally married to, and living with, the grantor of the trust. The trust still would remain a grantor trust under section 672(e), but at least the income would not be payable to the former spouse.

  Sample language:

  Any rights, powers and interests granted herein to the Grantor's wife, whether they be rights and powers granted to such wife as a beneficiary, accountee, Trustee or appointment powerholder, shall be suspended upon the filing of a domestic relations action to which both the Grantor and the Grantor's wife are parties, and shall be finally terminated in the event of a divorce ending the marriage of the Grantor to the Grantor's wife. In administering the provisions of this Trust Agreement, the Trustee shall interpret any such suspension or termination of the Grantor's wife's rights, powers and interests as the equivalent of the Grantor's wife's death. The Trustee shall not be held liable for any action the Trustee takes hereunder after the occurrence of any events that would cause such suspension or termination, unless the Trustee had actual knowledge of such events or, with reasonable diligence, could have made him, her or itself aware of the occurrence of such events.

Finally, it's important to remember that even if there is a workaround to the section 677 issue, after

a divorce a SLAT may still be a grantor trust under some other section of the grantor trust rules (e.g., the grantor has a nonfiduciary power to require trust property by substituting other property of an equivalent value).[18]

On July 2, 2018, ACTEC submitted comments to the IRS regarding the taxation of grantor trusts in light of the repeal of section 682.[19] In those comments, ACTEC recommended that the ambiguity surrounding these issues be resolved in favor of terminating the application of section 672(e) once the spousal relationship has been terminated by divorce or legal separation. Unfortunately, this appears to be a low priority item for the IRS, and no action has been taken.

Notes

1 Treas. Reg. § 1.671-2(b) ("[W]hen it is stated in the [grantor trust regulations] that 'income' is attributed to the grantor or another person, the reference, unless specifically limited, is to income determined for tax purposes and not to income for trust accounting purposes. When it is intended to emphasize that income for trust accounting purposes (determined in accordance with the provisions set forth in Section 1.643(b)-1) is meant, the phrase 'ordinary income' is used.").

2 Subchapter J covers Code sections 641 through 692, and deals with the taxation of estates, trusts, beneficiaries and decedents. The grantor trust rules are contained in Subpart E of Subchapter J (sections 671 through 679). Subchapter J contains two conflicting definitions of "income." For purposes of the grantor trust rules (Subpart E), the term "income" means "income determined for tax purposes and not to income for trust accounting purposes." Treas. Reg. § 1.671-2(b). See also Treas. Reg. § 1.677(a)-1(g), Ex. 2 (capital gain held or accumulated for future distributions to the grantor causes grantor trust status); and Treas. Reg. § 1.671-3 (inclusion of ordinary income and capital gains in grantor's income). Note that Treasury Regulation section1.671-3 was issued in 1960 and amended in 1969, and therefore does not reference the grantor's spouse (since the spousal attribution rule of Code section 672(e) was not added to the Code until 1986). On the other hand, Code section 643(b) defines income for trusts *other than* grantor trusts, and states that for trust accounting purposes, "income" means the amount of income of the estate or trust for the taxable year determined under the terms of the governing instrument and applicable local law.

3 Code section 672(e) was originally enacted in 1986, and amended in 1988. There are no regulations under section 672(e).

4 See I.R.C. §§ 671-679.

5 See ACTEC Comments to the IRS on Guidance in Connection with the Repeal of Section 682, p. 3 (Jul. 2, 2018) (ACTEC Comments).

6 See also I.R.C. § 674(c) (If trust income may be allocated in the trustee's discretion among a group of beneficiaries, and the grantor's spouse is one of the trustees, the grantor is treated as the owner of the trust. However, section 674(c) specifically states that the spousal unity rule of section 672(e) only applies if the spouses are married during the time that the spouse is serving as trustee); and section 674(d) (If the grantor's spouse is "living with the grantor" and can pay income to the beneficiaries according to an ascertainable standard, the grantor is treated as the owner of the trust, suggesting that if the grantor and the spouse divorce, the spousal unity rule should not apply, even if the former spouse continues to serve as trustee).

7 See George Karibjanian et al., Alimony, Prenuptial Agreements, and Trust under the 2017 Tax Act, BNA Est. Gifts & Tr. J. (May 10, 2018).

8 See Treas. Reg. § 1.682(a)-1(a)(1) ("[T]he spouse actually entitled to receive payments from the trust is considered the beneficiary rather than the [grantor of the trust])."

9 ACTEC Comments, supra note 5, at p. 2.

10 Code section 682 provided an exemption from grantor trust treatment for distributions to former spouses, but did not, itself, override the grantor trust rules.

11 See Treas. Reg. § 1.677(a)-1(b)(2) (§ 677(a) applies only during the marriage of the grantor to a beneficiary). This regulation was issued in 1971 (see 36 Fed. Reg. 20479 (Oct. 29, 1971)), a decade and a half before § 672(e) was enacted.

12 Section 11051(b)(1)(C) of the Tax Cuts and Jobs Act of 2017, P.L. 115-97, repealed section 682. Section 11051(c) of the 2017 Tax Act provides that this repeal applies to any divorce or separation instrument executed after December 31, 2018. See also IRS Notice 2018-37, Section 3.

13 Repealing Code section 682 prevents the grantor spouse from shifting income to a former spouse in a lower tax bracket.

14 See ACTEC Comments, supra, note 5, at 6.

15 See, e.g., Hodges v. Johnson, 177 A.3d 86 (N.H. 2017).

16 A handful of states, including Delaware and New Hampshire, have statutes that authorize the trustee to reimburse the grantor for taxes paid on the trust's ordinary income and capital gains, even if the trust agreement does not expressly give the trustee that power. See Del. Code Ann. title 12, § 3344 (2019), and N.H. Rev. Stat. Ann. § 564-B:8-816(c) (2016).

17 See Rev. Rul. 2004-64, 2004-27 I.R.B. 7 (an understanding or pre-existing arrangement between the grantor and the trustee regarding the trustee's exercise of the discretion to reimburse for taxes could cause the inclusion of the trust assets in the grantor's estate).

18 I.R.C. § 675(4)(C).

19 Comments on guidance in connection with the Repeal of Section 682, ACTEC, Jul. 2, 2018, available at https://www.actec.org/assets/1/6/Notice_2018-37_Comments_on_guidance_in_connection_with_the_Repeal_of_Section_682.pdf?hssc=1.