

Use of Trusts: Divorce



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How may trusts be used in a divorce context?

Although trusts are not particularly common in divorce situations, they can be used to provide economic protection and to achieve particular income and estate tax goals. If you decide to employ a trust in your divorce settlement, you should be aware of both the legal and tax ramifications.

Why are trusts used relatively infrequently in divorce contexts?

In divorce situations, there are several reasons why trusts are not often considered. First of all, trusts are expensive to establish and maintain. Most divorcing couples lack the necessary wealth to fund a trust in such a way that the economic and tax benefits of the trust will outweigh the cost. Secondly, the relationship between divorcing spouses is usually adversarial; mistrust must be overcome when developing an appropriate trust. Finally, because the rules for trust taxation are somewhat complex, attorneys sometimes discourage the use of trusts in divorce settlements.

Nevertheless, trusts are commonly used in the divorce context to handle life insurance proceeds.

Why should you consider the use of trusts?

If you're contemplating a divorce, there are both financial and tax reasons why you might wish to consider using a trust in your divorce settlement.

Using trusts for financial protection

One or both spouses may want to use a trust for reasons of financial security. For example, if your divorce agreement requires you to pay a cash settlement to your spouse, you may be concerned with the consequences if your spouse squanders the money on gambling. In such a case, could you be liable to pay additional money (alimony) to your former spouse on a periodic basis? If you fund a trust instead of paying your spouse a lump sum of cash outright, you can probably allay your own fears about squandering.

Alternatively, if your divorce settlement requires that your spouse sign a promissory note and pay you a substantial amount of cash each month for 10 years as part of a property settlement, you might be concerned about the consequences if your spouse's business goes bankrupt. If your spouse funds a trust for your benefit instead of signing a promissory note, you can be sure that money will be available to back up his or her promises.

Consider, also, the case when S corporation stock is a significant marital asset. If some or all of the stock is transferred to a spouse who is not active in the business, transferring the stock to a trust for the receiving spouse's benefit keeps the receiving spouse from exercising shareholder rights (i.e., interfering with your business).

In each of the above cases, a properly funded trust can help achieve the economic goals of both spouses.

Using trusts to obtain desired income tax results

Property contained in a trust often earns income. How that income is taxed depends on who receives it and whether an interest in the trust has been retained by the grantor or powerholder (someone who holds a general power of appointment over the trust assets; i.e., someone who has the right to say who gets the income). Often, trust income retained by a trust is taxed to the trust, and trust income distributed to a beneficiary is taxed to the beneficiary. However, trust income will be taxed to the grantor of the trust if the grantor has retained sufficient control over the trust, such as by retaining a right to revoke the trust. If you maintain sufficient control over the trust, the trust will be deemed a grantor trust, and you could be taxed on any trust income, even if the income is distributed to someone else.

Sometimes an alimony substitution trust is used by a divorcing couple to obtain desired tax results. The recipient of alimony doesn't have to depend on his or her ex-spouse to send a check every month. As long as the trust contains sufficient assets, payments will be made on time. As for the payor-spouse, he or she is relieved of the bother of writing a check each month and is afforded less personal contact with the former spouse. When the obligation to pay alimony ends, the trust can be terminated, and



ownership of the trust assets will revert to the payor.

A properly drafted and funded alimony trust may also result in child support or property settlement payments being taxed in a way that more closely resembles alimony for pre-2019 divorces. (For pre-2019 divorces, alimony is taxable to the recipient and tax deductible for the payor. For post-2018 divorces, alimony is not taxable to the recipient or tax deductible for the payor. Child support is not taxable to the recipient and not tax deductible for the payor.) Like alimony for pre-2019 divorces, distributions from a trust are generally taxable to the recipient (to the extent of a trust's distributable net income). However, trust distributions are not subject to the alimony recapture rules (which hinder or prevent deductibility). Further, unlike alimony payments, trust distributions can continue after the death of the receiving spouse.

For tax purposes, a properly drafted alimony trust is treated as a nongrantor trust, even if the trust assets can revert to the grantor upon the occurrence of a particular event. Therefore, the receiving spouse will be taxed on distributed income. Any undistributed income is taxed to the transferring spouse (grantor).

Tip: *The receiving spouse isn't taxed on any trust income that is designated as child support in the divorce decree or separation instrument. Rather, that income is included in the income of the paying spouse.*

For federal income tax purposes, a portion of the amount designated as alimony in a property settlement agreement will be treated as child support (which is less favorable to the payor, tax-wise for pre-2019 divorces) if the payments decrease or are eliminated when a child reaches a certain age, leaves home, or finishes school. However, you can get around this rule if the payments take the form of a distribution of trust income. Using the trust to make the payments results in tax treatment that is similar to alimony for pre-2019 divorces in that the receiving spouse is taxed on the payments.

Example(s): Assume John and Mary are divorcing and have a minor child, Jimmy. In the divorce agreement, John agrees to pay Mary \$2,500 per month until she dies. (The words child support are not specifically mentioned.) The couple agrees that Mary, who has custody of Jimmy, should be taxed on the payments. The divorce agreement states that on January 1, 201X, John's required payment to Mary will decrease to \$1,700 per month. Because Jimmy will turn 18 years old within six months of the date on which the payment is scheduled to decrease, the payment reduction is assumed to relate to Jimmy's reaching 18 years of age. Therefore, the \$800 per month difference is treated as child support right now, regardless of the parties' intent.

Example(s): As an alternative, John can establish a trust funded with sufficient assets to produce at least \$30,000 annual taxable income. The trustee is required to pay Mary \$2,500 per month as long as Jimmy is under age 18; the monthly payment is to be reduced by \$800 per month after Jimmy reaches age 18. The trust instrument also requires that any trust income in excess of the required payment to Mary be paid to John. Mary includes her trust distributions in her income. Although John will not receive an alimony deduction, he is transferring pretax income to his ex-spouse. Mary pays income tax on that money, and John does not have to report that portion as taxable income. The net effect on his taxable income is the same as if he had paid alimony and deducted it.

Caution: Since trust payments will be made from trust income only, make sure you transfer sufficient assets into the trust.

Using trusts to minimize estate taxes

A properly drafted alimony trust can often result in marital property being excluded from the transferring spouse's gross estate at a very low gift tax cost. In addition, the trust can be drafted to exclude the property from the receiving spouse's gross estate as well, thereby passing property to the children with no estate tax. This is a complicated area and beyond the scope of this discussion. For more information, consult an estate planning professional.



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