

Top Tax Tips for Making Divorce Less Taxing

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THE NEW STANDARD IN WEALTH MANAGEMENT

AGENDA

- 1 Tax Filing Status, Dependency Exemptions and Child Tax Credits**
- 2 Sale of Principal Residence Exclusion**
- 3 Deductions Related to Divorce**
- 4 Payments After Divorce—Child Support, Alimony and Life Insurance**
- 5 Qualified Retirement Plans and IRAs**
- 6 Property Transfers and Division of Appreciated Property**
- 7 Spousal Trusts**

TAX CUTS AND JOBS ACT¹

Individual Ordinary Income Tax Tables—2018 versus 2021

2018 UNDER PRIOR LAW BEFORE TAX CUTS AND JOBS ACT ¹				
Rate	Single (no children)	Head of Household	Married Filing Separately	Married Filing Jointly
10%	\$0 - \$9,525	\$0 - \$13,600	\$0 - \$9,525	\$0 - \$19,050
15%	>\$9,525 - \$38,700	>\$13,600 - \$51,850	>\$9,525 - \$38,700	>\$19,050 - \$77,400
25%	>\$38,700 - \$93,700	>\$51,850 - \$133,850	>\$38,700 - \$78,075	>\$77,400 - \$156,150
28%	>\$93,700 - \$195,450	>\$133,850 - \$216,700	>\$78,075 - \$118,975	>\$156,150 - \$237,950
33%	>\$195,450 - \$424,950	>\$216,700 - \$424,950	>\$118,975 - \$212,475	>\$237,950 - \$424,950
35%	>\$424,950 - \$426,700	>\$424,950 - \$453,350	>\$212,475 - \$240,025	>\$424,950 - \$480,050
39.6%	>\$426,700	>\$453,350	>\$240,025	>\$480,050

2021 AFTER TAX CUTS AND JOBS ACT ^{1, 2}				
Rate	Single (no children)	Head of Household	Married Filing Separately	Married Filing Jointly
10%	\$0 - \$9,950	\$0 - \$14,200	\$0 - \$9,950	\$0 - \$19,900
12%	>\$9,950 - \$40,525	>\$14,200 - \$54,200	>\$9,950 - \$40,525	>\$19,900 - \$81,050
22%	>\$40,525 - \$86,375	>\$54,200 - \$86,350	>\$40,525 - \$86,375	>\$81,050 - \$172,750
24%	>\$86,375 - \$164,925	>\$86,350 - \$164,900	>\$86,375 - \$164,925	>\$172,750 - \$329,850
32%	>\$164,925 - \$209,425	>\$164,900 - \$209,400	>\$164,925 - \$209,425	>\$329,850 - \$418,850
35%	>\$209,425 - \$523,600	>\$209,400 - \$523,600	>\$209,425 - \$314,150	>\$418,850 - \$628,300
37%	>\$523,600	>\$523,600	>\$314,150	>\$628,300

¹ Rev. Proc. 2017-58. The official name of the bill was changed prior to the final vote but is known as the “Tax Cuts and Jobs Act.”

² Tax brackets listed here are scheduled to sunset at the end of 2025 and revert back to pre-2018 law adjusted for inflation in 2026. Rev. Proc. 2020-45.

TAX RETURNS

If Married—No Final Decree Divorce/Separate Maintenance

- Married filing jointly
 - Responsible, jointly and individually, for taxes, interest and penalties
 - Innocent spouse relief, separation of liability relief, equitable relief
- Married filing separately
 - Responsible only for own taxes due

TAX RETURNS

If Unmarried or “Considered Unmarried”—Final Decree Divorce/Separate Maintenance or Legally Binding Separation Agreement

- Single
- Head of household
 - Paid more than half the cost of keeping up home
 - “Qualifying child” or “qualifying relative” lived in home for more than half year
 - May be “considered unmarried” if also lived apart for at least 6 months of tax year

NAME CHANGE

Social Security Administration (“SSA”)

- Name on tax return must match SSA records
 - Mismatch can delay refunds
- File Form SS-5, Application for a Social Security Card
 - SSA.gov or call 800-772-1213

DEPENDENCY EXEMPTIONS (PRE-2018 AND POST-2025) AND CHILD TAX CREDITS

Who Claims?

- Generally, the custodial parent
 - Custody for greater portion of calendar year (generally, number of nights spent with parents)
 - If equal, parent with highest adjusted gross income

Creative Solutions

- Can “trade” with IRS Form 8332
- Spouses alternate who claims the child from year to year
- If more than one child, spouses can split the dependency of the children between them (even if same amount of time with each parent)

CUSTODIAL PARENT

Other Tax Benefits for Custodial Parent of Qualifying Child

- Head of household filing status
- Dependent care credit
- Exclusion from income for dependent care benefits
- Hope Scholarship Credit and Lifetime Learning Credit
- Earned income credit

SALE OF PRINCIPAL RESIDENCE EXCLUSION

Requirements

- Ownership and use as principal residence for two of the last five years (exception for “hardship”)
- No prior exclusion within 2 years
- \$250k exclusion if single
- \$500k exclusion if married, and
 - Married filing jointly tax return
 - Either spouse meets ownership test
 - “Imputed” ownership—spouse’s period of ownership is attributable to other spouse
 - Both spouses use house as a principal residence
 - Includes period other spouse is granted use of home under divorce or separation agreement

Which is better, a \$250,000 or \$500,000 exclusion?

MORTGAGE INTEREST DEDUCTION

Deductible Interest Limitation

- \$750,000 on acquisition indebtedness (\$1 million if prior to December 16, 2017)
- Each unmarried taxpayer can individually apply the interest limitation—even for same home¹
- Acquiring interest in home in divorce can be acquisition indebtedness²

¹ In Internal Revenue Bulletin 2016-31 (Aug. 1, 2016), the Internal Revenue Service acquiesced to the decision in *Voss v. Comm'r*, 796 F.3d 1051 (9th Cir. 2015), rev'g *Sophy v. Comm'r*, 138 T.C. 204 (2012). IRC § 163(h)(3).

² Notice 88-74, 1988-2 C.B. 385.

DEDUCTIONS RELATED TO DIVORCE (PRE-2018 AND POST-2025)

Legal Fees for Divorce Generally Are *Not* Deductible

- No deduction for personal expenses

Deductions Under IRC § 212

- Fees and costs for attorneys, accountants, appraisers and actuaries related to:
 - Production or collection of income (e.g., collection of alimony)
 - Management, conservation, or maintenance of property held for the production of income; or
 - Tax advice

CHILD SUPPORT

Overview

- Payor spouse—No deduction for child support on tax return
- Payee spouse—Receipt of child support is not taxable

ALIMONY (PRE-2019)

Overview

- Payor spouse—Deducts alimony (IRC § 215)
- Payee spouse—Includes in income (IRC § 71)
 - Taxable in year received
 - Not subject to tax withholding (may need to make estimated tax payments or increase tax withheld from wages)

**Alimony “Grandfathered” for
Pre-2019 Divorce or Separation Instrument**

Pre-2019 Pre-Nups. and Post-Nups. Not “Grandfathered”

ALIMONY (PRE-2019)

Requirements

- Must be required under divorce or separate maintenance decree or written separation agreement
- Paid in cash
- No liability for payment after recipient's death
- Spouses do not live in same household
- Not designated as anything other than alimony (e.g., child support)

Some States Still Apply Pre-TCJA Federal Law

LIFE INSURANCE CONSIDERATIONS

Typical Uses in Divorce

- Ensure payment of alimony and/or child support
- Provide liquidity at death

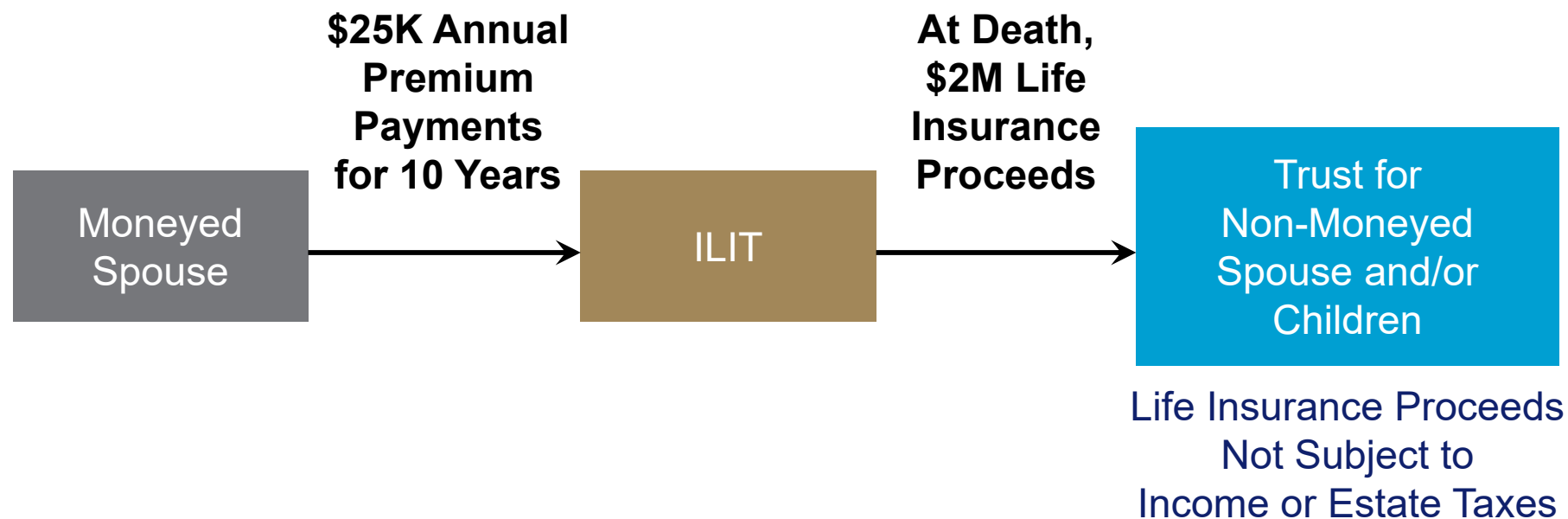
Transfer of Existing Policy

- Generally, not subject to income or gift tax (IRC §§ 1041 and 2516)
- Three year rule—included in insured's estate (IRC § 2035)

Payment of Premiums

- Deductible as alimony (subject to TCJA) if former spouse of payer is owner and beneficiary of the policy (Rev. Rul. 70-218)
- Not deductible if insured spouse retains policy ownership, even if name former spouse as beneficiary
- Not deductible if Irrevocable Life Insurance Trust (“ILIT”)

IRREVOCABLE LIFE INSURANCE TRUST (ILIT)



Hypothetical example—actual life insurance policy, premiums, and death benefit would depend on age, health, and insurability.

QUALIFIED RETIREMENT PLANS IN DIVORCE

Qualified Domestic Relations Order (“QDRO”)

- A judgment, decree or court order pursuant to a state domestic relations law
- Provides for alternative payee (e.g., former spouse)

Need to Comply with Specific Rules

- Failure can cause immediate tax and/or jeopardize entire plan
- Plan administrator should be included in drafting and reviewing QDRO

QUALIFIED RETIREMENT PLANS IN DIVORCE

Taxation

- General rule—No tax on transfer if QDRO and “eligible rollover distribution”
- Alternate payee (former spouse) is taxed on distributions/withdrawals
- 10% penalty for early distribution waived (important for spouses under 59½)

QUALIFIED RETIREMENT PLANS IN DIVORCE

Advantages to Rolling Former Spouse's Pension to IRA

- Distance from former spouse
- Greater control over investments
- More options for beneficiary designations
- Potential to deduct fees (pre-2018 and post-2025)
- No mandatory withholding

Advantages to Keeping in Former Spouse's Pension Plan

- Access to funds, if under 59½
- Possible creditor protection
- Loans and/or hardship distributions
- Life insurance can be retained

IRAS IN DIVORCE

Governed by IRC § 408(d)(6), Not ERISA

- QDROs not required, not appropriate

Taxation Post-Transfer

- Not taxable
 - Pursuant to divorce decree or “written instrument incident to such a decree”
 - Transfer directly (trustee-to-trustee) to donee spouse’s IRA
- Donee spouse treated as owner
 - Regular income tax treatment
 - Can name own beneficiary(ies)
 - Can contribute more funds annually if sufficient earned income (note, alimony treated as “earned income” for IRA, IRC § 219(f)(1))

BENEFICIARY DESIGNATIONS

Don't Forget to Change Names of Beneficiaries!!!

- Qualified Retirement Plan general rule—Beneficiary designation on file usually controls who receives the funds
 - ERISA preempts state laws
 - ERISA exception for spousal protection may over-ride beneficiary designation
- IRA general rule—Beneficiary designation may control
 - State law may over-ride designation post-divorce

Section 514(a) of ERISA provides that the provisions of Title I and IV of ERISA “shall supersede any and all State laws in so far as they may now or hereafter relate to any [ERISA-governed] employee benefit plan.” 29 U.S.C. § 1144(a) (2006). See *Egelhoff v. Egelhoff*, 532 U.S. 141, 144 (2001).

BENEFICIARY DESIGNATIONS

Other Necessary Changes

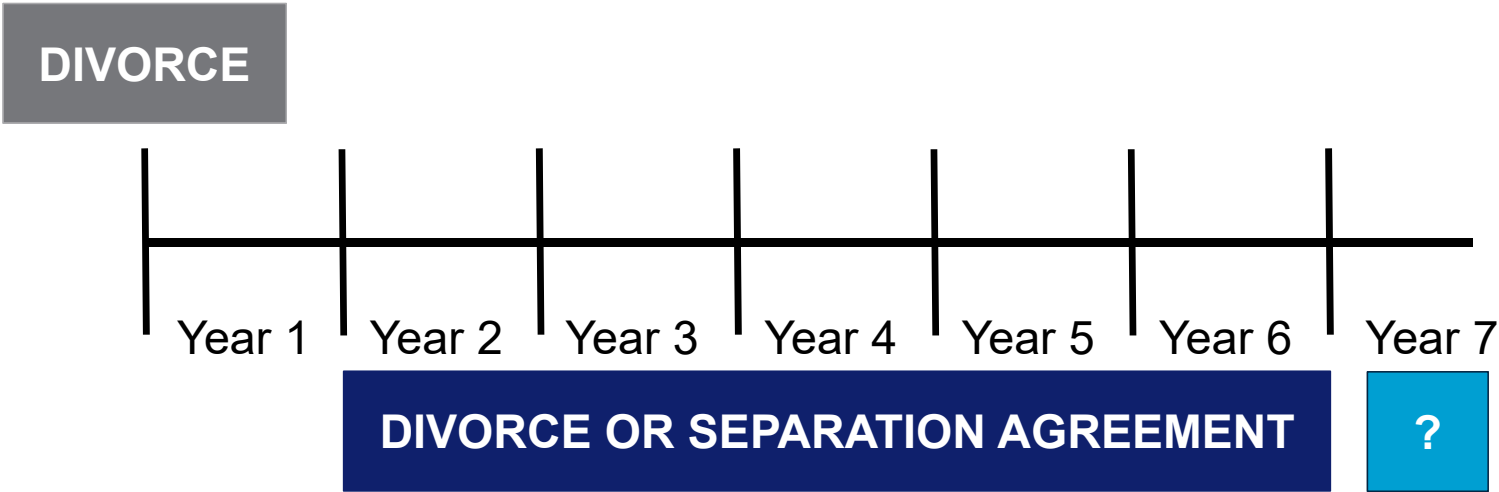
- Executor/Personal representative
- Trustee
- Trust beneficiary(ies)
- Attorney-in-fact
- Health care agent
- Insurance policy beneficiary

PROPERTY SETTLEMENTS AND DIVISION OF PROPERTY

Income Tax

- Tax-free transfers under IRC § 1041—between spouses or “incident to divorce” (assuming U.S. citizens)
 - Occurs within one year after marriage ceases
 - “Related” to cessation of marriage
 - IRS scrutiny if more than one year
 - Divorce or separation instrument
 - Presumption outside of IRC § 1041 if more than six years
- Planning concerns
 - Need to consider carryover tax basis and future taxes

INCOME TAX—TAX-FREE TRANSFERS UNDER IRC § 1041

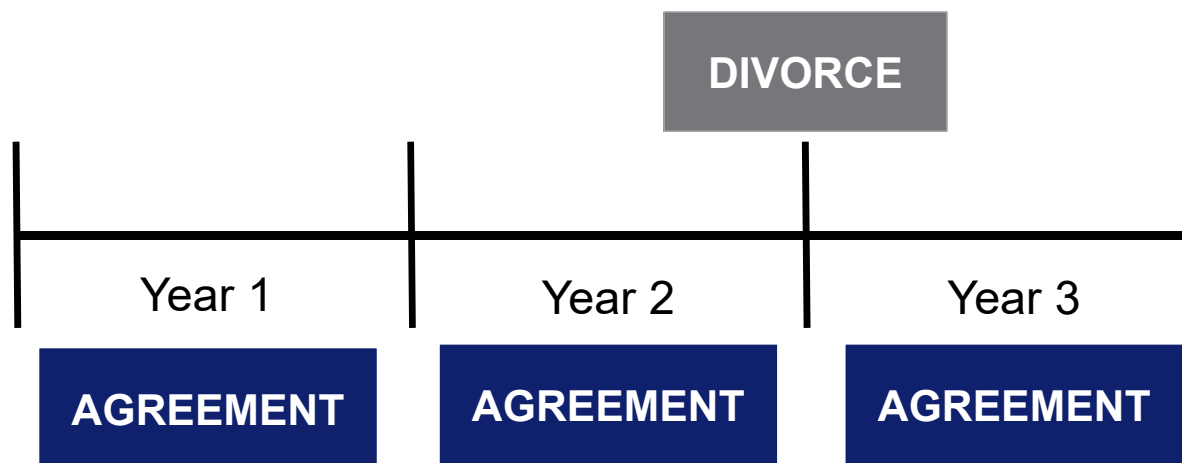


PROPERTY SETTLEMENTS AND DIVISION OF PROPERTY

Gift Tax: Tax-Free Transfers (Assuming U.S. Citizens)

- Accomplished prior to the legal termination of the marriage and the transfer meets the requirements of the unlimited gift tax marital deduction under IRC § 2523
- Satisfies requirements of IRC § 2516—pursuant to a written marital settlement agreement and the divorce occurs within a three year period beginning one year before the execution of the agreement and ending two years after the execution of the agreement
- Pursuant to a court order
- In exchange for the relinquishment of obligations of spousal support (e.g., alimony) or for support of minor children
- Annual gift tax exclusion
- Lifetime exemption amount
- Direct payment for medical or educational payments

GIFT TAX—TAX-FREE TRANSFERS UNDER IRC § 2516



The property transfer does not need to happen within the three year period for gift tax purposes

INTER VIVOS TRUSTS FOR A SPOUSE

Spousal Lifetime Access Trusts (SLATs) and Lifetime QTIPs

Advantages

- Gift, estate and generation skipping transfer (“GST”) tax savings
- Protect ownership interest in a closely held family business
- Provide professional asset management
- Protection from financial insolvency or bankruptcy
- Protect support after death
- Minimize need for future interaction after divorce

GRANTOR TRUSTS AND THE SPOUSAL UNITY RULE

IRC § 672(e)(1)(A)

- Grantor treated as holding any power or interest held by the grantor's spouse at the time of the creation of such power or interest

IRC § 674(d)

- Grantor trust status under IRC § 674(a) shall be triggered if the trustee is the grantor or spouse living with the grantor, even if the trustee is limited by a reasonably definite standard

IRC § 677

- Grantor treated as the owner of any portion of a trust if income [for tax purposes] may be distributed to—or held or accumulated for future distribution to—the grantor or the grantor's spouse

What Happens After Divorce?

- Notice 2018-37, 2018-18 I.R.B. 392, released on April 13, 2018

TAXATION OF GRANTOR TRUSTS AFTER DIVORCE (PRE-2019)

Repeal of IRC § 682 After 2018

Moneyed Spouse

- Taxed on all “income” during marriage
- Not taxed on distributed trust “income” after divorce (IRC § 682)

Non-Moneyed Spouse

- Payment stream for term of years or life
- Not taxed on any “income” during marriage
- Taxed on distributed “income” after divorce (IRC § 682)
- Distributions in excess of “income” treated as principal (i.e., not taxable)

Pre-2019 Trusts Not “Grandfathered” Unless Pre-2019 Divorce or Separation Instrument

See Notice 2018-37, 2018-18 I.R.B. 392, and PLRs 201707008, 201707007, 200408015 and 9235032.

For purposes of Subpart E of Subchapter J, Treas. Reg. § 1.671-2(b) provides that “income” means taxable income and not only income for fiduciary accounting purposes under IRC § 643(b). It is unclear what the term income means for purposes of former IRC § 682, which is in Subpart F of Subchapter J.

GRANTOR TRUSTS, THE SPOUSAL UNITY RULE AND IRC § 682

Legislative Solution

ACTEC Comments to Congress re Repeal of IRC § 682 (July 5, 2018)

- Tax law changes should “protect those taxpayers who, on the basis of pre-existing rules, made arrangements from which they could not reasonably escape and which, in retrospect, had become singularly undesirable.” *Estate of Gerson v. Comm’r*, 507 F. 3d 435 (6th Cir. 2007)
- Recommends technical amendment to effective date of 2017 TCJA § 11051(c) so that IRC § 682 applies to trusts that were irrevocable on December 22, 2017, to the extent income is not attributable to corpus contributed after that date

ABA Resolution 102A (Aug. 7, 2018)

- Do not repeal the alimony deduction or IRC § 682
- At the very least, grandfather pre-nups., post-nups. and irrevocable trusts that existed prior to the 2017 TCJA

GRANTOR TRUSTS, THE SPOUSAL UNITY RULE AND IRC § 682

Regulatory Solution

ACTEC Comments on Spousal Unity Rule and IRC § 682 Repeal in Response to Notice 2018-37 (July 2, 2018)

- Recommends regulations that terminate application of IRC § 672(e) after termination of spousal relationship
- But, does not help if there are other grantor trust triggers, such as IRC § 673 reversion or IRC § 675(4)(C) “swap” power

See Notice 2018-37, 2018-18 I.R.B. 392.

GRANTOR TRUSTS, THE SPOUSAL UNITY RULE AND IRC § 682

In the Meantime... Potential Solutions

1. Remove spouse as beneficiary by:
 - amendment power in trust agreement
 - decanting permitted under state law or trust agreement
2. Dissolve trust with outright distribution of trust property to the spouse
3. Maintain spouse as beneficiary, but have marital settlement agreement require spouse to reimburse grantor for income taxes attributable to trust income that the spouse is entitled to receive

THE ALIMONY ALTERNATIVE NON-GRANTOR TRUST (“AANT”)

Potential Trust Solution in Lieu of Alimony

- Fund non-grantor trust after divorce pursuant to written marital settlement agreement
 - No income taxes under IRC § 1041
 - No gift taxes under IRC § 2516
- Usual Subchapter J fiduciary income tax rules for non-grantor trusts apply—which generally means
 - Repeal of IRC § 682 and alimony rules does not matter, since trust is a non-grantor trust
 - Ex-spouse subject to tax as beneficiary on distributions of distributable net income
 - No deduction for moneyed spouse, but moneyed spouse not subject to tax on the trust’s net income in the first place

PROTECTING TRUSTS FROM DIVORCE

Better Asset Protection—“Mere Expectancy”

- Spendthrift provisions
- Distributions
 - “May” not “shall”
 - Discretionary vs. ascertainable standard—HEMS
 - Vary distributions—timing and amount
 - Distributions for benefit of, not directly to, beneficiary
- Loans rather than distributions
- Multiple beneficiaries
- Long term trust—avoid outright distribution on termination
- Power to remove beneficiary—e.g., trustee/trust protector power or power of appointment
- Flexibility to decant
- **INDEPENDENT TRUSTEE OR CO-TRUSTEE!!!**

Thank You!

BIO

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Justin Miller is a Partner and National Director of Wealth Planning at Evercore Wealth Management and a Managing Director at Evercore Trust Company, where he works collaboratively with accountants, attorneys, and other advisors to provide comprehensive wealth planning advice to clients. Prior to joining Evercore in 2021, Justin was a national wealth strategist for 10 years at BNY Mellon. He previously was a managing director at Wells Fargo and began his career as a tax attorney at Sidley Austin.

Justin also is an adjunct professor at Golden Gate University School of Law, a Fellow of the American Bar Foundation, and a Fellow of the American College of Trust and Estate Counsel. He has served in leadership positions with the American Bar Association, California Bar Foundation, San Francisco Estate Planning Council, and State Bar of California, and is a former editor-in-chief of the *California Tax Lawyer*. Additionally, he is a past recipient of the Outstanding Conference Speaker Award from the California Society of CPAs and the V. Judson Klein Award from the California Tax Bar.

Justin received a B.A., with honors, from the University of California, Berkeley, and a J.D. and LL.M. in Taxation from New York University School of Law. He also holds the Accredited Estate Planner® and CERTIFIED FINANCIAL PLANNER™ designations and is a member of the State Bar of California.

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