FEATURE:
ESTATE PLANNING & TAXATION

By **Les Raatz**

Divorce, SLATs and the Grantor Trust Section 677 Ghost

Time for an exorcism

Divorce is stressful enough without gratuitous tax issues, especially income tax. Imagine your client's reaction after finally getting a divorce and then being told that he's going to pay tax on the income or capital gains on the sale of assets that are in trust for the benefit of his ex-spouse—and there's little, if anything he can do about it. That's the perception many have when a spouse creates and funds an irrevocable trust for the other when they're lovey dovey and, thereafter, part ways.

With one important exception described below, your client won't have to pay those taxes. Internal Revenue Code Section 677 doesn't apply after divorce to cause a spouse to pay tax on any of the income and gain of a trust he's settled and funded: (1) for the benefit of the other spouse solely because the other is, or, in the discretion of the trustee, may be, distributed income from the trust, or (2) that may pay premiums on policies or insurance on the ex-spouse's life.

The relevant IRC sections are 71, 672, 677 and 682.

Setting the Stage

The ghost that haunts the house of the divorcing couple is Section 677, "Income for benefit of grantor." Section 677(a) provides:

> (a) General rule.
> The grantor shall be treated as the owner of any portion of a trust, whether or not he is treated as such owner under section 674, whose income without the approval or consent of any adverse party is, or, in the discretion of the grantor or a nonadverse party, or both, may be—
> (1) distributed to the grantor or the *grantor's spouse*;
> (2) held or accumulated for future distribution to the grantor or the *grantor's spouse*; or
> (3) applied to the payment of premiums on policies of insurance on the life of the grantor or the *grantor's spouse* (except policies of insurance irrevocably payable for a purpose specified in section 170(c) (relating to definition of charitable contributions)).
>
> This subsection shall not apply to a power the exercise of which can only affect the beneficial enjoyment of the income for a period commencing after the occurrence of an event such that the grantor would not be treated as the owner under section 673 if the power were a reversionary interest; but the grantor may be treated as the owner after the occurrence of the event unless the power is relinquished.
> (Emphasis added.)

The section seems rather innocuous, as it appears to apply only when the grantor has a spouse, and so, on divorce, the section no longer applies. But, there's another enigmatic IRC provision that's the source of consternation, the goblin of Section 672(e)(1)(A):

> (e) Grantor treated as holding any power or interest of grantor's spouse.
> (1) In general. For purposes of this subpart, a grantor shall be treated as holding any power or interest held by—

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(A) any individual who was the spouse of the grantor at the time of the creation of such power or interest, ...

The concern in a divorce context is whether subclause (A) applies to prevent divorce from cutting the string of Section 677(a) on divorce.

Tax Consequences Example

Hans and Wendy live in a community property state and have a sizeable estate totaling $20 million. Although they have some income from assets, Hans earns a great portion of their income. They believe that two of their investments are likely to substantially appreciate in value ("the home run property").

They visit their estate-planning lawyer, who explains to them that they're well over the applicable estate tax exemption, so, on the survivor's death, there will likely be a federal estate tax. The lawyer points out that increases in their net worth will have the inexorable consequence of increased estate tax at a 40 percent rate. The lawyer suggests that they consider transferring the home run property into a trust or trusts for one another. The plan is carefully designed so that one of them (assume Hans) is transferred complete ownership of one investment and transfers it as a taxable gift in trust with Wendy as trustee. The trust terms will prevent the trust assets and income from being includible in the estate of either spouse for federal estate tax purposes. The trust provides that Wendy may receive discretionary distributions. At her death or such other time as she determines, their children and other descendants will become successor beneficiaries.

Wendy settles a trust for Hans that has terms, operation, funding and powers that are sufficiently different to not cause the trusts to be "reciprocal trusts," such that they'll be deemed to have created trusts for themselves for estate tax and income tax purposes.

The trusts may also have the benefit of providing asset protection against any creditors. These trusts are sometimes referred to in the estate-planning community as "spousal lifetime access trusts" (SLATs). They're almost always grantor trusts for income tax purposes under Section 677(a). Because Hans and Wendy file a married joint income return, the consequences of grantor trust status fall equally on them.

Fast forward: One home run property (held in the SLAT created by Hans for Wendy) generates significant taxable income. It may be sold, thereby generating a large taxable capital gain. The other home run property, held as stock in an S corporation, isn't now valuable and is held in the SLAT for Hans, generating very little taxable income.

Fast forward further: They divorce. If the trusts remain grantor trusts, Hans will pay tax on the high taxable income SLAT for the benefit of Wendy, even though he has no further interest or benefit from it. Because the trust Wendy created for Hans isn't material, she won't bear much in the way of a continuing tax burden, if it remains a grantor trust as to her. Also, if it remains a grantor trust, it continues to be a shareholder qualified

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to hold S corporation stock, because Wendy is deemed the owner of the stock.[1] If it's no longer a grantor trust, then, unless the trust otherwise qualifies as a qualified subchapter S trust or electing small business trust, the S corporation status of the corporation will terminate.

So, the stakes are high in this example. Much hinges on whether the trusts remain grantor trusts under Section 677(a). The application of that subsection depends on the meaning of Section 672(e)(1)(A).

Permanent Problem With Divorce?

As stated above, Section 672(e)(1)(A) is ominous for Hans in the above example. One can easily infer that it's overriding authority, regardless of a subsequent divorce, that "a grantor shall 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." After all, this provision was added in 1988, well after the change in Section 677 in 1969 that caused a trust created by a person for the benefit of his spouse to be treated as a grantor trust of the creator spouse. What

other purpose could Section 672(e)(1)(A) have if it wasn't to extend grantor trust status after divorce? Many commentators so conclude.

There are regulatory signs that grantor trust status from spousal attribution under Section 677(a) doesn't survive divorce. Two Treasury regulations provide such evidence: Treas. Regs. Section 1.677(a)-1(b)(2) and Treas. Regs. Section 1.1361-1(k)(1) Ex. 10. I'm not aware of any case or ruling holding that spousal attribution under Section 677(a) survives divorce.

Treas. Regs. Section 1.1361-1(k)(1) Ex. 10 provides:[2]

> (i) Transfers to QTIP trust. On June 1, 1996, A transferred S corporation stock to a trust for the benefit of A's spouse B, the terms of which satisfy the requirements of section 2523(f)(2) as qualified terminable interest property. Under the terms of the trust, B is the sole income beneficiary for life. In addition, corpus may be distributed to B, at the trustee's discretion, during B's lifetime. However, under section 677(a), A is treated as the owner of the trust. Accordingly, the trust is a permitted shareholder of the S corporation under section 1361(c)(2)(A)(i), and A is treated as the shareholder for purposes of sections 1361(b)(1), 1366, 1367, and 1368.
>
> (ii) Transfers to QTIP trust where husband and wife divorce. *Assume the same facts as in paragraph (i) of this Example 10, except that A and B divorce on May 2, 1997. Under section 682, A ceases to be treated as the owner of the trust under section 677(a) because A and B are no longer husband and wife.* Under section 682, after the divorce, B is the income beneficiary of the trust and corpus of the trust may only be distributed to B. Accordingly, assuming the trust otherwise meets the requirements of section 1361(d)(3), B must make the QSST election within 2 months and 15 days after the date of the divorce.
>
> (iii) Transfers to QTIP trust where no corpus distribution is permitted. Assume the same facts as in paragraph (i) of this Example 10, except that the terms of the trust do not permit corpus to be distributed to B and require its retention by the trust for distribution to A and B's surviving children after the death of B. Under section 677, A is treated as the owner of the ordinary income portion of the trust, but the trust will be subject to tax on gross income allocable to corpus. Accordingly, the trust does not qualify as an eligible shareholder of the corporation because it is neither a qualified subpart E trust nor a QSST.
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> (Emphasis added.)

Treas. Regs. Section 1.677(a)-1(b)(2) is clearly written to cut off grantor trust status for the settlor spouse from spousal attribution on divorce.

Treas. Regs. Section 1.1361-1(k)(1) Ex.10 points to the continuing authority of Treas. Regs. Section 1.677(a)-1(b)(2). Treas. Regs. Section 1.1361-1 was promulgated in 1992 and amended in 1995, 2000, 2001, 2002, 2003 and 2008. This timing is important because all of those dates are after the Technical Corrections Act of 1988 (TCA 88).[3] TCA 88 revised Section 672(e) to read as it does today.

Treas. Regs. Section 1.677(a)-1(b)(2) is clearly written to cut off grantor trust status for the settlor spouse from spousal attribution on divorce:

> With respect to the treatment of a grantor as the owner of a portion of a trust solely because its income is, or may be, distributed or held or accumulated for future distribution to a beneficiary who is his spouse or applied to the payment of premiums for insurance on the spouse's life, *section 677(a) applies to the income of a trust solely during the period of the marriage of the grantor to a beneficiary.*
>
> (Emphasis added.)

The issue is the continued authority of that regulation.[4]

Although the regulation was originally published

before the Tax Reform Act of 1969 (TRA 69),[5] it was amended twice after TRA 69.[6] TRA 69 Section 332 added the spousal power attribution language. The Treasury considered the law change in T.D. 7148, in amending the applicable regulations in 1971, and there's a caution flag only for TCA 88 and the Tax Reform Act of 1986.[7] (See "Examination of T.D. 7148," p. 32, for more information.) Nonetheless, Treas. Regs. Section 1.677(a)-1 may not be determinative of the limitation of Section 672(e) as it respects the effect of divorce on Section 677, if TCA 88 made any changes other than definitional ones.

Section 672(e)

One of my conclusions is that the TCA 88 Section 1014(a)(1) restatement of Section 672(e) wasn't intended as a change to any rule, but is a harmless change of a definitional provision, the purpose of which is only to clean up wording that describes who isn't a spouse in order to apply Subpart E, including Section 677. It's solely a technical correction.

Section 672(e) now reads:

> (e) Grantor treated as holding any power or interest of grantor's spouse.
>
> (1) In general. For purposes of this subpart, a grantor shall be treated as holding any power or interest held by—
> (A) any individual who was the spouse of the grantor at the time of the creation of such power or interest, or
> (B) any individual who became the spouse of the grantor after the creation of such power or interest, but only with respect to periods after such individual became the spouse of the grantor.
>
> (2) Marital status. For purposes of paragraph (1)(A), an individual legally separated from his spouse under a decree of divorce or of separate maintenance shall not be considered as married.

Before TCA 88, Section 672(e) read:

> (e) Grantor treated as holding any power or interests of grantor's spouse. For purposes of this subpart, if a grantor's spouse is living with the grantor at the time of the creation of any power or interest held by such spouse, the grantor shall be treated as holding such power or interest.

I couldn't find any discussion of Section 672(e) in committee reports regarding TCA 88, which leads me to believe there was no intent to substantively change the existing law. So, even with the regulation preamble caution, it follows that the authority of Treas. Regs. Section 1.677(a)-1(b)(2) is unaffected by TCA 88 and its restatement of Section 672(e). Section 672(e) functions the same way as before with respect to trusts created during marriage, only now, there's an exception out of grantor trust status when there's a legal separation instead of satisfying a condition to cause grantor trust status, which is that of living with the grantor. There was no other legislative change to the statute, except to include trusts settled before marriage and to treat legally separated spouses as unmarried. Another conclusion from all this is that if there's a grantor trust problem (or opportunity) now regarding grantor trust status after divorce, that problem existed before TCA 88, after TRA 69 was enacted. However, the 1971 regulations published in light of TRA 69 eliminated the concern.

> Eliminating spousal attribution on divorce doesn't avoid grantor trust status if the trust holds policies of insurance in the life of the settlor.

What was intended with the TCA 88 revision adding Section 672(e)(2) "Marital status"? I surmise it was solely to deal with a situation in which spouses are getting divorced, but not yet divorced, and the payor spouse is crafting and funding a trust for the donee spouse. In that situation, Congress felt that Section 677 shouldn't apply, because divorce would be coming along anyway. Viewed in this light, Section 672(e)(2) reinforces, rather than weakens, the interpretation of the statutory regime that divorce is intended to cut off Section 677.

Section 682

Section 682 also addresses taxation of trusts when: (1) one spouse has settled the trust, (2) the other is a beneficiary and, (3) there's been a legal separation or divorce. The section ties to Section 677 because there continues to be language in the regulations under Section 677 referencing Sections 71 and 682 in the event of divorce or separation.[8]

The predecessor statute of Section 682 was the IRC of 1939, Section 171, enacted as part of Revenue Act of 1942, Section 120. I haven't located any commentary or report concerning the wartime enactment relating to this provision. Section 682 (formerly known as Section 171) was enacted to make uniform the taxation of "husbands" who had settled trusts for "wives," which may be in lieu of alimony, to cause the wife to be taxed on the trust income whether or not it was satisfying obligations of the husband and whether the creation of the trust was divorce related.[9]

Section 682(b) twice referred to Section 71 (alimony), but the Deficit Reduction Act of 1984 (DRA 84),[10] Section 422(d)(2)(A), deleted the references as a technical amendment. Early case law under the 1939 IRC and mid-20th century articles discuss situations in which an individual settled a trust that made distributions to his ex-spouse.[11] They include trusts that would revert back to the grantor (the term "*Clifford* trust" was in parlance then). They also describe the tax law in effect that a recipient spouse could have taxable income as alimony[12] even though it was satisfied from a trust settled by the payor spouse, such that the donee spouse could have income greater than the trust distributable net income, even though it was paid solely by distributions from the trust.

Some commentators had expressed a concern that Treas. Regs. Section 1.677(a)-1(b)(2)'s reference to Section 682 appears to have consequence only if Section 677 spousal attribution applies after divorce. But, there are other grantor trust provisions that could cause the settlor spouse to otherwise remain the grantor. In addition, Section 71 applied to tax the recipient spouse, even with application of Section 682. Therefore, references in statutes and regulations to default taxation of such amounts in absence of or outside Section 682 don't necessarily correlate to continued grantor status after divorce due to spousal attribution under Section 677(a)(1), (2) or (3).[13]

There remain possible obsolete regulatory provisions due to subtle law changes. The following regulation provision might not be applicable as it relates to Section 71 because of DRA 84 Section 422(d)(2)(A), which deleted two references to Section 71 in Section 682(b). Treas. Regs. Section 1.677(a)-1(a)(1) states:

> However, section 677 does not apply when the income of a trust is taxable to a grantor's spouse under section 71 (relating to alimony and separate maintenance payments) or section 682 (relating to income of an estate or trust in case of divorce, etc.). See section 671-1(b).

Examination of T.D. 7148

What the Treasury has said

In T.D. 7148, which amended Treasury Regulations Section 1.677(a)-1, the Treasury stated that:

1. It specifically intended to amend regulations to reflect changes made by the Tax Reform Act of 1969 (which added spousal attribution to Internal Revenue Code Section 677):

   'On December 22, 1970, notice of proposed rule making with respect to the amendment of the Income Tax Regulations (26 CFR Part 1) under sections 671 and 677 (relating to trust income for the benefit of the grantor or his spouse) to reflect the changes made by section 332 of the Tax Reform Act of 1969 (83 Stat. 599) [P.L. 91-172, C.B. 1969-3, 10 at 75] was published in the Federal Register (35 F.R. 19360). After consideration of all such relevant matter as was presented by interested persons regarding the rules proposed, the following amendments of the regulations are adopted.'

2. It promulgated the flush language of Treas. Regs. Section 1.671(a)-1(b)(2) as it remains today:

   'With respect to the treatment of a grantor as the owner of a portion of a trust solely because its income is, or may be, distributed or held or accumulated for future distribution to a beneficiary who is his spouse or applied to the payment of premiums for insurance on the spouse's life, *section 677(a) applies to the income of a trust solely during the period of the marriage of the grantor to a beneficiary*. In the case of divorce or separation, see sections 71 and 682 and the regulations thereunder.' (Emphasis added.)

— 1971-2 C.B. 251

Life Insurance on the Settlor

Eliminating spousal attribution on divorce doesn't avoid grantor trust status if the trust holds policies of insurance in the life of the settlor. Section 677(a)(3) treats taxable income and items thereof as those of the settlor if trust income, in the discretion of a non-adverse party, may be applied to pay premiums on policies of insurance on the settlor's life. It's irrelevant whether the settlor is married or whether the former spouse is a beneficiary. It may not matter much to the settlor that spousal attribution wasn't the reason for a lifetime of paying that tax on a trust benefitting the ex-spouse. Even in this case, typically there's little taxable income in SLATs exclusively designed to hold life insurance. The fact pattern for which Section 677(a)(3) would pose an irritating problem after divorce is a SLAT holding assets generating significant taxable income that also holds insurance policies on the settlor's life. Even then, there may be means available to address this situation, such as: (1) having independent trustee discretion to reimburse the settlor for such taxes if state law is cooperative,[14] (2) prohibiting the payment of premiums from income of the trust, or (3) dividing the trust in two and separating the insurance policies from the assets producing taxable income.

After Divorce

Attribution of spousal powers and rights under Section 677 doesn't apply after divorce because:

1. Section 677 was part of the original IRC of 1954. It provided that a settlor of a trust will include its taxable income as his income if he has certain rights or powers or if income of the trust may be used to pay premiums on insurance policies on his life. That is, the trust is a grantor trust of which he's the grantor.
2. In 1969, TRA 69 amended Section 677 to cause the settlor to be the grantor of the trust if his spouse has the above rights or powers or if the policies of insurance are on her life.
3. In 1971, Treas. Regs. Section 1.671-1 was amended in light of TRA 69 and provided that, on divorce, the settlor's ex-spouse is no longer his spouse in order to attribute to him the ex-spouse's rights, powers or status as an insured life under policies.
4. In 1988, TCA 88 amended Section 672(e), but the restatement didn't change its meaning as it pertains to divorce. Therefore, Treas. Regs. Section 1.671-1 remains fully effective.

It's interesting that this important consequence of divorce is so little understood and uncertain. Part of the reason is that it's had a complicated and multilayered legislative and regulatory history. There's also the historic lack of IRS examination of trusts. The legislative and regulatory authority leads only to this conclusion, once the history of legislative enactments and regulations is discovered.

It's time to put this bad boy to bed.

Endnotes

1. Revenue Ruling 85-13.
2. This regulation provision was brought to my attention by The American College of Trust and Estate Counsel Fellow Marc A. Chorney, and it inspired me to research the subject of this article.
3. P.L. 100-647. The regulation isn't flagged as not addressing any legislation. The Treasury promulgates regulations under Treasury decisions. It may provide notice that certain regulations haven't been revised to take into account subsequent law changes. References to cautions in the regulations' preambles in this article derive from Research Institute of America text.
4. Although this really isn't a concern, there's a caution (what's referred to in this article as a "flag") in the preamble in "Reg §1.677(a)-1. Income for benefit of grantor; general rule: Caution: The Treasury has not yet amended §1.677(a)-1 to reflect changes made by P.L. 100-647, P.L. 99-514."
5. P.L. 91-172.
6. It was amended in 1971 (T.D. 7148, 36 FR 20749, Oct. 29, 1971) and in 1996 (T.D. 8668, addressing environmental remediation trusts). The regulation text doesn't have a caution flag.
7. P.L. 99-514. One may ask. "Why is there a flag for TCA 88 in the regulation, if not for amendment to Internal Revenue Code Section 672(e)?" I believe that's the reason, but it's for Section 672(e)(1)(B) (adding trusts created prior to marriage) and possibly Section 672(e)(2) (adding treatment of legally separated spouses as unmarried). The then-new Section 672(e)(1)(A) merely restated the law in effect before amendment.
8. Treas. Regs. Section 1.677(a)-1(b)(2) (last sentence).
9. Private Letter Ruling 200408015 (Feb. 20, 2004).
10. P.L. 98-369.
11. One such article is "Alimony Trust Income: A Challenge to Taxability," 4 *Val. U. L. Rev.* 181 (1969) (author unknown).
12. Section 22, IRC of 1939 (predecessor of Section 71, IRC of 1986).
13. Section 677(a)(3) was added in 1969.
14. Rev. Rul. 2004-64.