Roots and Wings – Structuring Trusts to Give Beneficiaries a Chance at Success, Despite Inheriting Money

Taxation of Grantor Trusts after Divorce

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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 Code §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 nonadverse party, or without the approval or consent of any adverse party. Actual payments of income aren't necessary to invoke §677 – the mere possibility that the income could be distributed or accumulated for future distribution is enough.

The "income" referred to in §677 is taxable income, not fiduciary accounting income.[1]

[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.")

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 §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***…"[3] (emphasis added) 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 §677 because, under §672(e), the trustee's power to distribute to the spouse is treated as the power to distribute to the grantor.

Code §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. §672(e) 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

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[2] Subchapter J of the Code covers Code §641 through §692, and deals with the taxation of estates, trusts, beneficiaries and decedents. The grantor trust rules are contained Subpart E of Subchapter J (§§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 Treas. Reg. §1.671-3 was issued in 1960 and amended in 1969, and therefore does not reference the grantor's spouse (since the spousal attribution rule of Code §672(e) was not added to the Code until 1986). On the other hand, Code §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 §672(e) was originally enacted in 1986, and amended in 1988. There are no regulations under §672(e).

[4] See Code §§671 through 679.

is the grantor's spouse. Originally, only two sections of the grantor trust rules (§672(c) and §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, Code §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 §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 §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 §682 was enacted in 1954. Before it was repealed by the 2017 Tax Act (see below), §682 provided rules describing how the income of a grantor trust was taxed if it was payable to the grantor's former spouse. Under §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,

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[5] See ACTEC COMMENTS TO THE IRS ON GUIDANCE IN CONNECTION WITH THE REPEAL OF SECTION 682, p. 3 (July 2, 2018) (the "ACTEC Comments").

[6] See also Code §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, §674(c) specifically states that the spousal unity rule of §672(e) only applies if the spouses are married during the time that the spouse is serving as trustee); and §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 Karibjanian, Franklin and Law, *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]…)"

§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, §682 eliminated the need to determine whether §672(e) applied.[10] For example, before the repeal of §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 §677[11], so the income would not be taxable to the grantor, but then §672(e) would apply to impute the income to the grantor, because §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, §682 would require the former spouse to pay the tax on income distributed to him or her.

The 2017 Tax Act repealed §682, beginning on January 1, 2019,[12] in connection with the repeal of Code §215 (which permitted the deduction of alimony payments) and Code §71 (which required the inclusion of alimony in the recipient's income).[13] It's important to note that §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 §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,

[9] ACTEC Comments, *supra* note 5, at p. 2.
[10] Code §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] §11051(b)(1)(C) of the Tax Cuts and Jobs Act of 2017, P.L. 115-97, repealed §682. §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 §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 p. 6.

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 §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, and receives it tax-free. Before its repeal, §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 §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 §677), that status can't be toggled off upon divorce, because the spousal attribution rule under §672(e) is only determined one time – when the spouse's interest in the trust is created.[15]

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

[15] For most other tax purposes, whether an individual is someone's spouse is determined as of the close of the taxable year. Code §7703(a)(1).

heightened in the event of a divorce.[16]

- 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.[17] In addition, a pattern of reimbursement could cause the trust property to be included in the grantor's estate.[18]
- 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 to him or her 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 §677(a). The grantor would need to be careful, however, to not include any other provisions in the agreement that would cause grantor trust status under §672(e).
- Authorizing the trustee to reimburse the grantor for income taxes paid on the trust, if

[16] See, e.g., Hodges v. Johnson, 177 A.3d 86 (N.H. 2017).
[17] 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).
[18] 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).

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 §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 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 §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[19]).

On July 2, 2018, ACTEC submitted comments to the IRS regarding the taxation of grantor trusts in light of the repeal of §682 (attached as Appendix A). In those comments, ACTEC recommended that the ambiguity surrounding these issues be resolved in favor of terminating the application of §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.

[19] Code §675(4)(C).

Appendix A

ACTEC comments to the IRS regarding the taxation of grantor trusts
in light of the repeal of §682

July 2, 2018

(attached)

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Please Address Reply to:

Executive Director
DEBORAH O. McKINNON

July 2, 2018

Internal Revenue Service
CC:PA:LPD:PR (Notice 2018-37)
Room 5203
Post Office Box 7604
Ben Franklin Station
Washington, D.C. 20044

Submitted electronically at Comments@irscounsel.treas.gov

Re: Comments on guidance in connection with the Repeal of Section 682

Dear Ladies and Gentlemen,

The American College of Trust and Estate Counsel ("ACTEC") is pleased to submit comments pursuant to Notice 2018-37, 2018-18 I.R.B. 392, released on April 13, 2018. The Notice requests comments on whether guidance is needed regarding the application of Sections 672(e)(1)(A), 674(d), and 677 of the Internal Revenue Code following a divorce or legal separation, in light of the repeal of Code Section 682.

Notice 2018-37 states that the Department of the Treasury and the Internal Revenue Service intend to issue regulations providing clarification of the application of the effective date provisions concerning the repeal of Code Section 682, enacted on December 22, 2017, by P.L. 115-97 (the 2017 Act).

ACTEC is a professional organization of approximately 2,500 lawyers from throughout the United States. Fellows of ACTEC are elected to membership by their peers on the basis of professional reputation and ability in the fields of trusts and estates and on the basis of having made substantial contributions to those fields through lecturing, writing, teaching, and bar activities. Fellows of ACTEC have extensive experience in providing advice to taxpayers on matters of federal taxes, with a focus on estate, gift and GST tax planning, fiduciary income tax planning, and compliance. ACTEC offers technical comments about the law and its effective administration, but does not take positions on matters of policy or political objectives.

ACTEC's comments and recommendations are set forth in the attached memorandum.

If you or your staff would like to discuss the comments or recommendations, please contact Beth Shapiro Kaufman, Chair of the ACTEC Washington Affairs Committee,

at (202) 862-5062 or bkaufman@capdale.com, or Deborah McKinnon, ACTEC Executive Director, at (202) 684-8460 or domckinnon@actec.org.

Respectfully submitted,

Charles D. Fox IV
President

Enclosures

COMMENTS OF THE AMERICAN COLLEGE OF TRUST AND ESTATE COUNSEL ON APPLICATION OF CODE §§ 672(e)(1)(A), 674(c), 674(d), 676 AND 677 AFTER THE REPEAL OF CODE § 682

The American College of Trust and Estate Counsel (ACTEC) is pleased to submit these comments in response to Notice 2018-37, 2018-18 I.R.B. 392, released on April 13, 2018. The Notice requests comments on whether guidance is needed regarding the application of §§ 672(e)(1)(A), 674(d), and 677 of the Internal Revenue Code (Code) following a divorce or legal separation, in light of the repeal of Code § 682.

Notice 2018-37 states that the Department of the Treasury and the Internal Revenue Service intend to issue regulations providing clarification of the application of the effective date provisions concerning the repeal of § 682, enacted on December 22, 2017, by P.L. 115-97 (the 2017 Act).

BACKGROUND

Part I of Subchapter J of the Code deals with the income taxation of trusts. The potential income tax consequences for the grantor of a trust are addressed in Subpart E of Subchapter J and in § 682, which is part of Subpart F of Subchapter J. When Subpart E applies to the grantor of a trust, the grantor is treated under § 671 as the owner of a portion or all of a trust and takes into account in computing his or her income tax all of the income, deductions, and credits that are attributable to the portion of the trust treated as owned by him or her.[1]

Section 11051 of the 2017 Act repealed § 682, effective for taxpayers whose divorce or separation instruments are executed after December 31, 2018.

Code § 682. As in effect prior to the 2017 Act, § 682 provided rules describing how the income[2] of a trust is taxed if it is payable to a spouse or a former spouse of the trust's grantor from whom the taxpayer is divorced or legally separated under a decree of divorce or separate maintenance or under a written separation agreement.[3] Under § 682 this income was includible in the gross income of the grantor's former spouse and was not includible in the grantor's gross income, despite any other provision of Subtitle A of the Internal Revenue Code, including the normal rules of Subpart E.[4]

[1] A trust that is treated as owned by its grantor is generally referred to as a "grantor trust." Subpart E, § 678 also treats some trust beneficiaries who have or had unilateral withdrawal rights over trust property as the owner of a portion or all of a trust. The issues discussed in these comments could affect these beneficiaries in a manner similar to the way they affect grantors. For convenience, these comments refer to any affected taxpayer as the "grantor" of the trust.

[2] 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. It is unclear what the term income means for purposes of former § 682, which was in Subpart F of Subchapter J.

[3] References in these comments to "former spouse" include existing spouses from whom the grantor is separated under a decree of separate maintenance or a written separation agreement.

[4] Treas. Reg. § 1.682(a)-1(a)(1) provides "under section 682(a) income of a trust— (i) [w]hich is paid, credited, or required to be distributed to the wife in a taxable year of the wife, and (ii) [w]hich, except for the provisions of section 682, would be includible in the gross income of her husband, is includible in her gross income and is not includible in his gross income."

Code § 682(b) also applied for purposes of computing the taxable income of the trust and the taxable income of the grantor's former spouse to whom § 682(a) applied. It provided that the grantor's former spouse was considered the beneficiary of the trust for purposes of Part I of Subchapter J (§§ 641-685).

The predecessor of § 682 was § 171 of the Internal Revenue Code of 1939 (the "1939 Code"). It entered the Code as part of the Revenue Act of 1942. The legislation also provided an income tax deduction for the periodic payments a husband made to his wife under a decree of divorce or separate maintenance in discharge of a legal obligation imposed on him because of the marital relationship ("alimony"). It required the wife to include the alimony payments in her gross income.[5]

The alimony inclusion provision, § 22(k) of the 1939 Code, also required a wife who received periodic payments attributable to property transferred in trust or otherwise to include the payments received in her gross income if the property was transferred in discharge of an obligation imposed on the husband on account of the marital relationship. Payments so included would be excluded from the gross income of the husband.

The narrow purpose of § 171 was to give the husband who had created a trust or was the beneficiary of a trust created before his divorce or separation the income from which was payable to his wife the same tax treatment that § 22(k) gave the husband who created a trust in connection with his divorce.[6] It required the wife who was divorced or legally separated from her husband under a decree of divorce or separate maintenance to include in her gross income the amount of income paid to her from any trust that, in the absence of § 171, would have been taxable to the husband. It also provided that the husband could exclude this income from his gross income whether or not the income would ordinarily be taxable to him under §§ 166 or 167 of the 1939 Code or any other provisions of the income tax law.

Sections 166 and 167 were the only provisions of the grantor trust rules that were in existence in 1942. Section 166 was the predecessor of current § 676. Section 167 was the predecessor of § 677. In 1942, neither of these sections was triggered by the existence of an interest in or power over a trust in a grantor's spouse. Each of these sections is discussed more fully below.

Sections 22(k), 23(u) and 171 were imported into the 1954 Code as §§ 71, 215, and 682. The scope of these sections was changed in 1986. One of the changes to § 71 eliminated the requirement that a spouse include in his or her gross income periodic payments from property transferred in discharge of an obligation imposed on the other spouse on account of the marital relationship. It also eliminated the exclusion from gross income that benefitted the other spouse. But § 682 was left in place to fill the gap. Until its repeal, § 682 protected a spouse who would otherwise be taxed on trust income under the grantor trust rules or otherwise from taxation to the extent trust income was payable to his or her former spouse.

[5] 1939 Code §§ 22(k) and 23(u). The 1939 Code referred to the payor of alimony as the husband and the recipient as the wife because in 1939 the obligation to make alimony payments was imposed only on the husband.
[6] J. Seidman, Legislative History of Federal Income Tax and Excess Profits Tax Laws 1953-1939, 1275-85 (1954).

The 2017 Act repealed § 682, as well as § 215, the section that permitted a taxpayer to deduct his or her alimony payments made to the other spouse. One of the conforming amendments to the repeal of the alimony deduction was the repeal of § 71, the section that required the recipient of alimony payments to include the payments in gross income. The 2017 Act described the repeal of § 682 as an additional conforming amendment to the repeal of § 215.

Given the original purpose of § 682, its repeal in connection with the repeal of the alimony deduction is not surprising. Section 682 was originally intended to protect a grantor from a requirement to include trust income payable to his former wife in his gross income if the trust principal or income could revert to him within the meaning of current §§ 676 or 677. But the scope of the grantor trust rules in Subpart E has expanded substantially since 1942. As a result, the role of § 682 had become more robust. Under current law, the grantor trust rules apply to a trust not only when trust income can be used for the benefit of the grantor, but also when the income can be used for the benefit of the grantor's spouse and when the grantor, the grantor's spouse, or certain others have certain controls over the trust.

Code § 672(e)(1)(A): the Spousal Unity Rule. Subpart E of Subchapter J of the 1954 Code as originally enacted referred to the grantor's spouse in only two provisions. Section 672(c) provided that the term "related or subordinate party" includes any nonadverse party who is the ***grantor's spouse if living with the grantor***. Section 674(d) addresses the power to control the beneficial enjoyment of the corpus or the income of a trust held by trustees none of whom is the grantor ***or spouse living with the grantor***, if the power is limited by a reasonably definite external standard. As described below, amendments to the Code in 1969 and 1986 expanded the circumstances in which the possession of an interest or power by the grantor's spouse triggered the grantor trust rules.

Section 672(e)(1)(A) (the "spousal unity rule") provides that, for purposes of Subpart E of Subchapter J, a grantor is treated as holding any power or interest held by any individual who was the grantor's spouse at the time of the creation of the power or interest. As originally enacted by the Tax Reform Act of 1986, the text of § 672(e) was as follows:

> (e) Grantor Treated as Holding Any Power or Interest 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.

An amendment in the 1988 Act to § 672(e) changed its scope by providing that the rule also applies (1) to any power or interest held by an individual who became the spouse of a grantor after the creation of the power or interest (but only after the marriage), and (2) whether or not the grantor and his or her spouse were living together at the time of the creation of the power or interest. The amendment also provided that the rule does not apply to any power or interest created in the spouse if, at the time of the creation of the power or interest, they are legally separated under a decree of divorce or of separate maintenance.

There are a number of provisions in Subpart E the operation of which depend on whether a particular individual is the grantor's spouse. The impact of § 672(e) on the application of many of

these provisions when that individual is the grantor's former spouse has long been unclear. Section 672(e) itself says nothing about the application of the spousal unity rule if the spouses divorce or legally separate after the creation of the power or interest.

Some commentators believe that § 672(e)(1)(A) is applicable in any situation in which a grantor is treated as the owner of a portion of a trust in Subpart E of Subchapter J on account of a spousal interest or power, even following divorce. The support for this belief is the failure of § 672(e) to address directly the question of whether the spousal unity rule ends when the marriage ends.[7]

The 1988 Act amended two other provisions of Subpart E, §§ 674(c) and 675(3). Section 674(c) addresses the power to control the beneficial enjoyment of the corpus or the income of a trust held by trustees when "none of whom is the grantor." Section 675(3) addresses situations in which the grantor has borrowed the corpus or income of a trust and has not completely repaid the loan before the beginning of the taxable year.

The 1988 Technical Corrections to the Tax Reform Act of 1986 added a sentence to the end of both § 674(c) and § 675(3) providing that "[f]or periods during which an individual is the spouse of the grantor (within the meaning of section 672(e)(2)), any reference in this subsection to the grantor shall be treated as including a reference to such individual." With respect to § 674(c), this language suggests that the spousal unity rule should apply only if the spouses are married during the period of time the grantor's spouse is serving as a trustee. However, as discussed below, § 672(e) could be applied in a manner inconsistent with the sentence added by the 1988 Technical Corrections. The statutes do not resolve this apparent inconsistency. .

As noted above § 674(d) addresses a power to control the beneficial enjoyment of trust income or principal held by trustees none of whom is the grantor or grantor's spouse **living with the grantor**, if the power is limited by a reasonably definite external standard. This provision has not been modified since it became part of Subpart E in 1954 and seems to look to the marital status of a trustee at the time he or she is serving as a trustee.

It seems clear from the language added in 1988 and from § 674(d) that, if an individual is legally separated from his or her spouse under a decree of divorce or of separate maintenance (or not living together with respect to § 674(d)), the spousal unity rule should not be applied for purposes of §§ 674(c), 674(d), and 675(3). This is illustrated by the following examples.

> **Example 1**. If a power held by the grantor's spouse prevents the § 674(c) exception to grantor trust treatment under § 674(a) from applying, after the date of the grantor's divorce the fact that the grantor's former spouse continues to hold that power will no longer cause the grantor to be treated as the owner of the trust.
>
> **Example 2**. If a power held by the grantor's spouse who is living with the grantor prevents the § 674(d) exception to grantor trust treatment under § 674(a) from applying, after the date of the grantor's divorce the fact that the grantor's former spouse continues to hold that power will no longer cause the grantor to be treated as the owner of the trust.

[7] Professor Jeffrey N. Pennell notes that "[c]uriously, § 672(e) does not indicate whether spousal unity ends when the marriage does." Footnote 36, Chapter 5 of Casner & Pennell, Estate Planning.

Example 3. If, after the date of the grantor's divorce, the grantor's former spouse borrows the corpus or income from a trust created by the grantor and has not completely repaid the loan before the beginning of the taxable year, the grantor will not be treated as the owner of the trust by reason of § 675(3).

Because similar amendments were not made to other provisions of Subpart E, the operation of which depend on whether a particular individual is the grantor's spouse, it is not clear whether § 672(e)(1)(A) will cause these provisions to continue to apply after the grantor and the grantor's spouse are divorced. To illustrate, consider the following examples:

Example 4. Code § 673 treats the grantor as the owner of any portion of a trust in which the grantor has a reversionary interest in either the corpus or the income if, at the time of the transfer to the trust, the reversionary interest has a value exceeding 5% of the value of the portion that may revert. Because of § 672(e)(1)(A), if the grantor's spouse has a remainder interest in the trust that exceeds 5% of the value of the trust at the time of the transfer to the trust the grantor will be treated as the owner of the trust.[8] Will grantor trust status continue if the grantor and the grantor's spouse are divorced?

Example 5. Code §§ 674(a), 675(1) and (2), 676(a), and 677(a) treat the grantor as the owner of any portion of a trust if the grantor or a non-adverse party (or both) have a certain power described in the section. Because of § 672(e)(1)(A), a power described in each of these sections held by the grantor's spouse will trigger grantor trust status whether or not the grantor's spouse has an adverse interest. Will this status continue if the grantor and the grantor's spouse are divorced?

Example 6. Code § 674(b)(3), (c), and (d) contain exceptions to the rule creating grantor trust status when nonadverse parties hold a power to alter the beneficial enjoyment of trust property. These exceptions apply for certain powers held by persons other than the grantor. Because of § 672(e)(1)(A), a power held by the grantor's spouse described in one of these sections will be treated as held by the grantor. Will this status continue if the grantor and the grantor's spouse are divorced? In the case of § 674(c) and (d), explicit language limiting the exception to "periods during which the individual is a spouse of the grantor" or periods when the individual is living with the grantor suggest that the spousal unity rule should not apply.

Example 7. Code § 677 treats the grantor of a trust as its owner if the grantor or any person other than an adverse party has the power to distribute income to or accumulate income for future distribution to the grantor or the grantor's spouse. Similarly, § 676 treats the grantor

[8] In his treatise, Federal Income Taxation of Estates, Trusts, and Beneficiaries, Professor Mark L. Ascher notes that § 672(e) was enacted in 1986 to curtail the use of "spousal remainder trusts." A spousal remainder trust pays trust income to a beneficiary (e.g., the grantor's child) for a term of years and, at the end of the term, the remainder passes to the grantor's spouse. Prior to 1986, the trust's income was taxed to the beneficiary because the trust was not treated as a grantor trust under Subpart E, because the grantor did not hold a reversion in the trust. The General Explanation of the 1986 Act provides: "In addition, many tax practitioners took the position that the application of the prior law grantor trust provisions could be avoided by having the prohibited powers or interests become effective in the spouse of the grantor (e.g., the spousal remainder trust)."

of a trust as its owner if the grantor or any person other than an adverse party has the power to revest title to trust property in the grantor. If the possibility that trust income might be distributed to an individual or that title to trust property might be revested in that individual is treated as an interest in the trust, § 672(e) could cause a trust the income or principal of which is payable or potentially payable to a grantor's former spouse to be treated as owned by the grantor if the grantor was married to the former spouse at any time that the power existed.

IMPACT OF THE REPEAL OF CODE § 682

The repeal of § 682 exacerbates existing problems with the other provisions of Subpart E that apply when a grantor's former spouse has an interest in the trust. The application of § 682 to trusts that make payments to their grantors' former spouses eliminated much of the need to determine whether § 672(e) continues to apply to a grantor's spouse after a divorce by protecting the grantor from gross income inclusion when trust income was payable to a former spouse.

Section 682, in effect, overrode the grantor trust rules in Subpart E of Subchapter J (§§ 671-679) and established different rules for the treatment of distributions from grantor trusts to the grantor's former spouse that some believe might have been taxed to the grantor under §§ 676 or 677 because of the application of § 672(e)(1)(A).[9] The primary focus of these comments is on the interplay of those provisions. The repeal of § 682 highlights the importance of clarifying the consequences of a grantor's divorce or legal separation for purposes of applying these provisions of the grantor trust rules under Subpart E of Subchapter J.

The repeal of § 682 will have no effect on the impact of most of the provisions referred to above. This is true because § 682 operated only to shift the taxability of income payable to a former spouse from the grantor to the former spouse. It did not stop the operation of the grantor trust rules. For example, the repeal will have no effect on the application of the grantor trust rules to the extent grantor trust status is caused by the mere existence of a power held by a spouse or former spouse.

RECOMMENDATIONS

Code § 672(e). We recommend that Treasury and the IRS address the question of whether the spousal unity rule ends upon the grantor's divorce. We believe that the ambiguity in the current law gives Treasury and the IRS the authority to promulgate regulations clarifying the scope of § 672(e). We also believe the ambiguity should be resolved in favor of terminating the application of § 672(e) once the spousal relationship has been terminated by decree of divorce or legal separation or by the execution of a separation agreement. The spousal unity rule is presumably based on a belief that spouses form a single economic unit. When the end of the marriage separates the unit there is no longer a reason for the rule to apply.

If Treasury and the IRS conclude that they do not have the authority to prevent the application of the spousal unity rule to taxpayers who are no longer married to each other, we recommend that they issue regulations that prevent it from applying to those provisions in Subpart E that are affected by the repeal of § 682. The sections affected by repeal of § 682 are §§ 676 and 677,

[9] Technically, § 682 does not terminate grantor trust status. It simply provides an exception from ordinary grantor trust treatment for distributions to former spouses.

because these sections treat a trust as a grantor trust when distributions of trust income or principal must or may be made to the grantor's spouse. We also recommend the issuance of regulations that provide that the internal rules within §§ 674(c) and 674(d), dealing with the consequences of powers held by spouses, should override § 672(e).

Code § 674 (c) and (d). Code § 674(a) provides that the grantor will be treated as the owner of a portion of a trust if the beneficial enjoyment of that portion is subject to a power exercisable by the grantor or a nonadverse party without the consent of an adverse party. Application of the spousal unity rule to § 674(a) causes grantor trust status, because of the existence of the marital relationship, in any situation in which the grantor's spouse holds any powers that the grantor could not hold without causing grantor trust status. There are several exceptions in § 674 to the application of the rule to powers when their exercise does not require the consent of an adverse party. Code § 674(d) is one of the exceptions.

Code § 674(d) provides that § 674(a) does not apply to a power solely exercisable (without the approval or consent of any other person) by a trustee or trustees, none of whom is the grantor or a "spouse living with the grantor," to distribute, apportion, or accumulate income: (a) to or for a beneficiary or beneficiaries, or (b) to, for, or within a class of beneficiaries, if such power is limited in either case by a reasonably definite external standard that is set forth in the trust instrument. Whether this exception is applicable when a former spouse continues to hold a power held during marriage is unclear. The text of the provision suggests that it should not apply, at least if the grantor and the grantor's spouse are not living together. On the other hand, to some § 672(e) seems to operate without regard to present marital status by imputing any power held by a former spouse who held a power during marriage to the grantor. The apparent conflict between the text of §§ 674(d) and 672(e) creates an ambiguity that could be resolved by regulation. We recommend the issuance of a regulation that resolves the ambiguity by providing that a power held by a former spouse will not be imputed to the grantor for purposes of the § 674(d) exception.

Similarly, § 674(c) provides that § 674(a) does not apply to a power held by certain persons, none of whom is the grantor. It further provides that for periods during which an individual is the spouse of the grantor, within the meaning of § 672(e)(2), a reference to the grantor is to be treated as a reference to the spouse. Section 672(e)(2) provides that an individual legally separated from his spouse under a decree of divorce or separate maintenance shall not be considered as married. Whether the § 674(c) exception is applicable when a former spouse continues to hold a power held during marriage is unclear. We recommend the issuance of a regulation that resolves this ambiguity by providing that a power held by a former spouse will not be imputed to the grantor for purposes of the § 674(c) exception.

Code § 677. Code § 677(a) originally provided that the grantor would be treated as the owner of any portion of a trust if the income from that portion may, without the consent of an adverse party, be distributed to or accumulated for future distribution to the grantor.

Code § 677(a) was amended in 1969 to provide that a grantor is also treated as the owner of any portion of a trust if income from the trust may be distributed to the grantor's spouse, or accumulated for future distribution to the grantor's spouse. This provision was described by the Staff of the Joint Committee on Taxation in its general explanation as follows:

> The Act further provides that in the case of a trust created by a taxpayer for the benefit of his spouse, the trust income which may be used for the benefit of the spouse is to be taxed to the creator of the trust as it is earned. However, this provision does not apply where another provision of the Code requires the wife to include in her gross income the income from a trust.[10]

The Treasury regulations under § 677, which are consistent with the Joint Committee Staff explanation, state that § 677(a) affects income payable to the grantor's spouse "solely during the period of the marriage of the grantor to a beneficiary." Treas. Reg. § 1.677(a)-1(b)(2).[11]

Treas. Reg. § 1.677(a)-1(b)(2) was promulgated 15 years prior to the enactment of § 672(e)[12] and Congress would have been aware of these regulations in 1985 and 1988. If § 672(e) is deemed to have overruled this regulation, then the repeal of § 682 is likely to have serious and often unexpected consequences to divorced taxpayers who created trusts during their marriages for the benefit of now former spouses.

Moreover, § 672(e) is applicable only if the grantor's spouse holds an interest in or a power over a trust. In contrast, the operation of § 677 depends not on the possession of an interest or power by the grantor's spouse, but on the existence of another person's power to make distributions to the spouse. It is not clear, therefore, that § 672(e) was intended to apply for purposes of § 677. We recommend the issuance of a regulation that clarifies the scope of § 672(e) by providing that it does not apply for purposes of § 677. Instead, the continued application of the existing regulations under § 677, which limit its application to income payable to the grantor's spouse during the marriage, should be confirmed.[13]

Code § 676. Code § 676 provides that the grantor of a trust will be treated as the owner of any portion of a trust if the grantor or a nonadverse party has the power to revest title to that portion of the trust in the grantor.

If, during the grantor's marriage, the grantor's spouse acquired the power to revest title to a portion of the trust in the grantor, § 672(e) should apply to cause the trust to be treated as a grantor trust. Moreover, after divorce, if the former spouse continues to have this power, the trust should be treated as a grantor trust *unless* the former spouse has an interest in the trust that is adverse to his

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[10] JCS-16-70 at page 119.

[11] Treas. Reg. § 1.677(a)-1(b)(2) also provides "[i]n the case of divorce or separation, see sections 71 and 682 and the regulations thereunder." This is merely a cross reference and does not mandate treatment under the Treasury regulation as being contingent on the continued application of §§ 71 and 682.

[12] T.D. 7148, 36 FR 20749, Oct. 29, 1971, as amended by T.D. 8668.

[13] If this recommendation is accepted, we also recommend a change to Example 10 in Treas. Reg. § 1.1361-1(k)(1). This example, which affects the eligibility of a trust for qualified subchapter S trust treatment, focuses on whether a trust created during a grantor's marriage that was treated as a grantor trust under section 677 because of required payments to the grantor's spouse will continue to be treated as a grantor trust after the grantor and the spouse are divorced. The example concludes that "[u]nder 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." The conclusion that the trust is no longer a grantor trust should be the same, but the basis of the conclusion should be the regulations under § 677 rather than the operation of § 682.

or her exercise of the power. We recommend the issuance of a regulation that confirms this conclusion.

As is the case with § 677, the operation of § 676 depends on the existence of another person's power to make trust distributions to the grantor or the grantor's spouse, not on the actual possession of any power or interest by the grantor or the grantor's spouse. Section 677's focus is on the power to distribute income while § 676's focus seems to be on the power to distribute the trust's original principal. Although an individual in whose favor a trustee can exercise such a power could be viewed as holding an interest in the trust, if this kind of power is treated as conferring an interest on the spouse for purposes of § 672(e), § 672(e) could cause § 676 to apply to a grantor because of a power of invasion exercisable in favor of a former spouse. After the repeal of § 682, trust income paid to the former spouse of a grantor would be taxed to the grantor. We believe it unlikely that this result was intended after the economic unity of the spouses is terminated with the termination of the marriage. We recommend the issuance of a regulation under § 672(e) that provides either (1) that a power held by a nonadverse party to transfer trust property to a spouse or former spouse of the grantor should not be treated as conferring the kind of *interest* in the trust that § 672(e) was intended to reach or (2) that § 672(e) does not apply to a § 676 spousal interest after the grantor and the grantor's spouse are no longer spouses within the meaning of § 672(e)(2).

CONCLUSION

ACTEC appreciates your consideration of these Comments in response to Notice 2018-37. ACTEC would be pleased to answer any questions and to work with the drafters in developing solutions to the issues raised in these Comments.