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Using Trust and Tax Solutions in Divorce Mediation

By Gale Allison and Vale Gonzalez

In the United States, according to Holmes' and Rahe's social readjustment scale, divorce is regarded as the second most stressful life event after the death of a spouse.¹

This article will examine the use of trusts in divorce mediation, the use of specialized mediators, how to avoid gift tax traps and four basic trust types that lend themselves well to divorce mediation.

WHY TRUST SOLUTIONS FOR SOLVING COMMON DILEMMAS?

Trusts offer attractive incentives for divorcing spouses. In a high-stakes divorce and even in a more medium-asset divorce, one party or the other often has justifiable anxiety over the ultimate use and destination of the marital estate funds. Concerns that the marital estate will never make it to the children of the marriage, or other family, upon the deaths of the divorcing spouses is frequently an issue. Divorcing parties with children often want certainty that the children will ultimately inherit what has been built together. The right trust design will get the divorcing couple there.

At least one, and possibly both parties will often want to find a way to ensure the marital assets do not find their way into the hands of the next spouse. (Predictably, that's because the next spouse just might be waiting in the wings to swoop in and even run off with a substantial chunk.) Property and support settlements that include trusts can solve these problems and act as excellent built-in prenuptial contracts for both parties without the misery of actually having to bring up the words "prenuptial contract" with the next spouses. Prenuptial contracts are still fighting words in our society, while, "I am the beneficiary of this trust that I can never give to you," simply ensures the love is real ... or demonstrates it is not.

Sometimes a divorcing spouse is trying desperately to get away from a controlling person and there is anxiety over being controlled forever. Dealing with a disinterested trustee is most often a far preferable alternative to the monthly "check is in the mail" misery.

Many an ex-spouse has dealt with constant financial uncertainty. The well-designed trust brings greater certainty to an experience fraught with uncertainty, and it also often will involve a favorable tax solution as well.

Then there is the case of the spouse who is profligate with money or the big-time gambler, an increasing issue in Oklahoma today. A trust can be used to ensure there will be money to sustain a soon-to-be-ex spouse regardless of what the other ex does later, as soon as the ink is dry.

A strong advantage of a trust solution is that funds are permanently set aside for distribution to an ex-spouse in the future; this eliminates uncertainty for that supported spouse. The ex-spouse who is to pay the support has no means to control future financial payments through manipulation of income or by playing the "check is in the mail" game. This certainty is often the true advantage of a trust with a disinterested corporate trustee. A true separation of the spouses can be



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achieved both emotionally and monetarily. It can be a joy to communicate with a trustee about money instead of an ex-spouse.

The trust solution to solve a divorcing conundrum can go way beyond the obvious simplistic issues discussed above. For example, the vacation home can be a substantial cause of disagreement. One spouse may want to retain the vacation home or timeshare to continue family vacations for the children. The other spouse wants to do the same, but the rub is how to deal with the property. Neither spouse wants the other to have outright ownership of the vacation home and often, both would rather sell it than let the other have it which ripples through the whole settlement agreement causing additional issues to arise.

A skilled mediator can introduce the concept of a trust to transfer a term-interest in the property which can be a perfect fit for this situation. The property can be transferred to a trust, which can say anything that works for the divorcing couple – from a series of rules to ensure that both exes can continue to use the property separately for an agreed-upon term of years to having it benefit only one. After the term, the property can be sold with the proceeds being distributed amongst the parties as negotiated. By such a mediated agreement, the sales proceeds can be distributed once the property is sold. The application of a trust allows a better structured divorce settlement and allows the parties to receive a benefit they never knew was available.

THE SPECIALIZED MEDIATOR AND INDEPENDENT RESOURCE EXPERT – THE KEYS TO TRUST AND TAX SOLUTIONS

Mediation will be attempted in almost every divorce. Today, there is a growing trend for mediators to specialize in specific types of mediations for which they have special skills, and this type of mediation is undoubtedly one of those areas.

Unfortunately, divorce attorneys most often will not be comfortable delivering any tax advice during a divorce. Not surprisingly, many divorce attorneys explicitly disclaim any responsibilities regarding tax and estate planning in their engagement letters. In some cases, spouses engaged in a divorce settlement are leaving the negotiation table with thousands of dollars left behind, ignorant of the actual tax result, due to poorly constructed agreements from a tax perspective. For example, it is not uncommon for an ex-spouse to discover that death taxes are due upon the payment of life insurance proceeds paid pursuant to a divorce settlement. The discovery is often that the receiving spouse must pay the death tax bill, not the estate. Pursuant to current tax laws that life insurance death benefit may be subject to a 40 percent tax at the federal level. This negative result is easily avoided where neither the ex-spouse nor the deceased spouse's estate would owe any death tax.

If trusts were utilized to implement tax solutions, both sides might be able to benefit from an increased pool of funding and a mediation agreement capable of distributing assets creatively. Combining mediation with trust and tax solutions can present a valuable opportunity for a mediator to leave both spouses with a more livable and tax-efficient agreement.

So how can it work? Increasingly, mediation involves the utilization of a resource specialist. If there is any trust confidence or "good faith" left between the parties, they can even agree to use their prior estate planning tax attorney. Such a resource would not represent either side, but instead, serve as a knowledgeable resource for both of them. Alternatively, a new, independent estate planning tax professional can be engaged to serve both sides. At the very least, both sides can bring their estate planning tax attorneys to ensure the solution and the tax ramifications are well understood by the parties during the process and to serve as the draftsmen of the trust solutions.

Financial planners are also available as specialized resources to be sure the moneys are structured from a financial planning perspective for each spouse. Such a financial planner will have received specialized training in this area. The certified divorce financial analyst (CDFA) designation is issued by the Institute for Divorce Financial Analysts (IDFATM), a premier national organization dedicated to the certification, education and promotion of the use of financial professionals in the divorce arena.

THE BASIC TAX RULE – DON'T GET CAUGHT IN THE GIFT TAX

Property transfers can create inopportune situations if not conducted properly. Quite apart from what trust solution gets used, significant gift tax traps exist when transferring any asset, whether it be through a trust or outright. I.R.C. §2512 states that a transfer of property is considered a gift unless the property "transferred [is made] for less than an adequate and full consideration in money or money's worth." Avoiding §2512 is crisis critical, and it is important that the divorce decree include the transfer of the property. If the transfer is not in the divorce decree, to protect against gift tax traps, I.R.C. §2516 provides an exception for property settlements. Applying the property settlement exception satisfies the requirement for adequate and full consideration necessary for I.R.C. §2512 to not apply.

To satisfy the exception, a written marital agreement connected to the divorce must be implemented "within a 3-year period beginning on the date 1 year before such agreement is entered into." Either the transfer occurs to settle marital or property rights of one spouse, or the transfer is "to provide a reasonable allowance for the support of issue of the marriage during minority."² One would think this is easy to comply with, but many have found themselves paying gift taxes on these transfers. This is the first tax issue that shows care must be taken to ensure compliance.

UNLIMITED TRUST DESIGNS AVAILABLE FOR DIVORCE SETTLEMENT AGREEMENTS

Numerous types of trusts exist, and the designs within each general type are limited only by the skill and imagination of the draftsman. Each kind will have tax benefits and/or detriments depending on which spouse you represent.³ Since, in this short article, it is impossible to cover all types of trusts that might be utilized in divorce settlements, much less get into the byzantine tax rules associated with each, the following is a brief review of the top four trusts that can be used to settle divorces. All of these trusts protect the assets from going to the next spouse, can provide creditor protection for the beneficiaries and can limit who will inherit the proceeds on the death of the spouse beneficiary. The transferring spouse can control who gets the remainder of the trust upon the beneficiary spouse's death or the divorcing spouses can agree on a limited power of appointment to allow the beneficiary spouse to take a second look through estate planning instruments within set limits. For example, allowing transfers only to the couples' descendants or only in certain further trust formats are two methods that can alter the outcome at the beneficiary spouse's death.

Irrevocable Life Insurance Trusts

Irrevocable life insurance trusts are one of the most common, vanilla-type estate tax devices used by estate planners to avoid death taxes in the estates of couples regarding life insurance death benefits. In the divorce context, the irrevocable life insurance trust ensures that neither spouse will ever have to use the funds to pay death taxes associated with the death benefit upon the death of the insured.

QTIPS: Qualified Terminable Interest Property Trusts

A qualified terminable interest property (QTIP) trust requires that all the income of the trust must distribute to the spouse beneficiary.⁴ Both divorcing spouses benefit tax-wise from using it. Transferors benefit by reducing their overall estate tax liability by not having funds subject to death taxes in their estates. Instead, federal estate taxes apply when transferee spouses die, but only if each individual's assets exceed \$11,200,000 (however this figure will change for cost of living adjustments until 2025 when the congressional estate tax law tweaking will begin again, if not before). In a mediation application, a QTIP can serve to provide the transferee spouse an income for life with no interference from the ex. This scenario can be particularly useful in situations where the divorce is occurring after the second marriage, and the transferor spouse wants the assets to benefit the children from a previous marriage. The assets within the trust get a step-up in basis at the death of the beneficiary spouse, which is very useful to the remainder beneficiaries. The downside for some is that the trust income does not stop being paid when the beneficiary spouse remarries. However, this design can involve a change in other terms upon remarriage; it simply cannot stop the payout of the income.

Retirement Benefit Trusts

Possibly the most complex trust that could be used from a tax standpoint, the retirement benefit trust is used for several purposes. This trust helps to extend the payouts on IRAs, 401(k)s and the like and this prevents the income taxation of the benefits until paid out from the retirement fund to the trust. This trust also allows for the remaining retirement assets to go on to children or others on an irrevocable basis.

Credit Shelter (Bypass Trusts)

A bypass trust allows a more flexible approach for transferor spouses who find their soon-to-be ex-spouse's remarriage an issue. Unlike a QTIP where a transferee spouse must receive income for life, a bypass trust can terminate the transferee spouse's interest at any time, upon any contingency desired. The bypass trust does come with certain disadvantages. In a QTIP, a step-up in basis on all the trust assets occurs when the transferee spouse dies. That does not happen in a bypass trust. Another issue is that the federal gift transfer tax exemption from the transferor spouse may be used, rather than that of the transferee spouse. Although this may not be an issue for most divorces, it can be an issue in high-stake divorces where maximizing tax exemptions is critical.

In a mediation context, a bypass trust is useful for a transferor spouse to create contingencies. Other common contingencies used in a bypass trust are setting a year limit of support to the transferee spouse or, if the transferee spouse acquires an inheritance from someone else, terminating it. In mediation, entertaining the use of a bypass trust could allow the transferor spouse to gain more control of the assets instead of using a QTIP. In exchange for the transferee spouse agreeing to the offer, the transferee spouse can require additional spousal support or child support. The children can also be beneficiaries of these trusts.

CONCLUSION

Divorce mediation that utilizes tax and trust solutions can help dissolve the emotional and financial barriers that exist between divorcing spouses. By emphasizing favorable tax and permanent irrevocable trust solutions that will ultimately benefit the spouses and their children, efficient and livable settlements can be made. Having a judge decide for the spouses how assets are divided will always fail to take advantage of federal tax exemptions and deductions. Maintaining the well-being of children and reducing or transferring the tax liabilities amongst the spouses is always going to be the best method of settling the divorce. Divorce mediation using tax and trust solutions will get you there.

ABOUT THE AUTHORS

Gale Allison has four decades of estate, trust and tax experience as an estate and trust lawyer and consultant on tax aspects of divorce. Mediation certifications include family and divorce from the Mediation Institute and litigated cases and elder care from Pepperdine. A former litigator for the federal government and estate tax attorney for the IRS, now in private practice, she mediates exclusively through Dispute Resolution Consultants in Tulsa.

Vale Gonzalez is a second-year law student at the TU College of Law, with a BA in criminology from the University of Texas. Fluent in Spanish and English, he has worked in military family utility services, the oil and gas industry and has researched and written for Department of Homeland Security staff.

1. See generally Holmes & Rahe, "The Social Readjustment Rating Scale," 11 *J. Psychomatic Research* 213 (1967) (analysis of over 5,000 medical patient records and how stress affects illness in the United States).

2. I.R.C. 2516.

3. For an excellent, albeit long (60 pages!) article, on the many tax implications of divorce settlement trusts and the byzantine tax rules that trap the unwary see Carlyn S. McCaffrey, "The Use of Trusts to Structure Divorce Settlement," 27 *J. Am. Acad. Matrimonial Laws.* 29 (2015).

4. I.R.C. 2056(b)(7).

5. See Carlyn S. McCaffrey, "The Use of Trusts to Structure Divorce Settlement," 27 *J. Am. Acad. Matrimonial Laws.* 29 (2015).

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