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War of the Rosas

Using Pooled Income Funds in Divorce Planning

According to statistics 40-50 percent of all marriages end in divorce. To add insult to injury, tax reform eliminated the deductibility of alimony payments for divorce and separation agreements that are finalized or amended after December 31, 2018. This report shows how a pooled income fund might be used in divorce settlements.

Pooled Income Funds

The PIF is form of a charitable trust similar to a Charitable Remainder Trust (CRT) but unlike the CRT is taxed as a complex trust under the trust tax rates. It used to be known as the Poor Man's CRT, but it has a great tax and planning value to sophisticated taxpayers due to the manner that the income tax deduction is calculated for a PIF that is less than three years old. As a result, the PIF generates an income tax deduction that is two-three times higher than the tax deduction of a CRT. For cash contributions, the deduction is limited to 60 percent of AGI. For contributions of long-term capital gain property, the deduction is limited to 30 percent of AGI. Excess deduction can be carried forward for five additional tax years. The interest rate used to calculate the tax deduction is currently 2.2 percent and is likely to decrease in November 2020. This reduction will serve to increase the tax deduction for a contribution to a PIF.

Pooled Income Fund Deduction Chart

AGE	CURRENT RATE (%)	HYPOTHETICAL RATE IN NOV. 2020 (1.5%)
35	40.5	53.4
40	44.7	57.1
45	49.1	61
50	53.4	65
55	58.6	69.2
60	64	73.4

The taxpayer retains an income interest from the PIF for lifetime. This income interest can also be for multiple lifetimes. For example, the PIF income interest could pay an ex-wife or ex-husband for lifetime and revert back to the taxpayer for their lifetime. At the death of the income beneficiary, the trust remainder interest passes to a public charity which can include the taxpayer's donor advised fund.

The reality at least for tax purposes is that a spouse who is divorcing or separating might be more generous if there is a tax benefit. The PIF provides a current tax benefit to the spouse making the contribution to the PIF. The trustee of the PIF has the ability to sell an appreciated capital asset without any tax consequences and then reinvest the funds in a manner that provides for reinvestment of funds in a more tax efficient asset class.

Example 1

Mike Smith, age 55, is a successful business owner who is divorcing after thirty years of marriage. Mike's divorce agreement requires permanent alimony payments of $50,000. Mike has a commercial property worth $750,000 with net rental income of $75,000. Mike creates a new PIF and transfers ownership of a single member LLC which owns the commercial property. The charitable gift produces a tax deduction of $441,765 which may be taken up to 30 percent of adjusted gross income in the year of the donation.

Excess deductions may be taken in five subsequent tax years subject to the 30 percent AGI threshold. Mike's after-tax cost is $308,235. Mike's ex-wife agrees to this arrangement in lieu of alimony payments. In the event the property is sold in the future, the trustee will reinvest the capital gains attributable to the sale without tax consequences. In the event, the PIF higher income than the initial payment, Mike's ex-wife will benefit from the higher payment coming from the PIF.

Example 2

Richie Rich, age 45, is involved in a legal separation from his wife. Under the terms of the agreement, he must provide child support payments of $2,000 per month for the next eighteen years. He must also provide alimony payments of $100,000 per year for life. The total payments between child and support is $124,000. Richie will transfer a two million portfolio of marketable securities to a new PIF. The deduction is $982,880. The portfolio is configured to produce a high level of current income – private equity mezzanine, REITs, direct lending that will comfortably generate the desired level of income.

Summary

The Pooled Income Fund is a creative tax planning technique to reduce the cost of divorce and settlement planning by incorporating a mechanism which can be used to create a large tax deduction on the front end, sell or retain a capital asset with the structure without any tax gain, and provide an income to the ex-spouse over a lifetime. For more information, schedule an appointment with Gerry Nowotny to see how the Pooled Income Fund for divorce planning can work in your situation.