MARITAL AGREEMENTS AND ESTATE PLANNING:

FOCUSING ON ESTATE PLANNING ISSUES AND TRUSTS IN DIVORCE OR AT DEATH

DENVER ESTATE PLANNING COUNCIL

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I. WHY HAVE A MARITAL AGREEMENT?

There are many good reasons for couples to consider having a marital agreement. Among them:

- **Create certainty with respect to the disposition of property at the end of the marriage.** Every state imposes default rules upon married people with respect to the division of property at the end of a marriage. These statutory rules vary dramatically from state to state. Furthermore, each state's courts are charged with the responsibility for interpreting the statutory default rules that have been put in place by the legislature. The courts' interpretations of any given rule may change over time, resulting in rules regarding the disposition of property that could not have been anticipated when the decision to marry was made. Moreover, the disposition of property for a couple who is married in one state but later moves to another will be governed by the law of the state where they reside at the time of death or divorce. Few couples bother to educate themselves about these rules as they move from one geographic location to another.

  Marital agreements allow couples to establish certainty with respect to how their property will be handled in the event of death or divorce, and to reach agreements regarding their property that reflect their values and ideals. This contractual agreement between the parties can completely waive the state law rules that would apply in the absence of the agreement, and can establish the rules that will govern the disposition of property. By reaching such an agreement, a couple can avoid the variations in different states' laws, and the uncertainty of evolving judicial interpretations, thereby creating certainty with respect to each spouse's financial well-being.

A marital agreement should be viewed as an important tool in an estate planner's tool box because unlike wills and other dispositive documents, a marital agreement cannot be changed by one spouse without the knowledge and consent of the other. Marital agreements therefore present a more certain planning device as far as the surviving spouse is concerned.

- **Protect family-owned or closely held businesses in the event of death or divorce.** Marital agreements can serve as a mechanism for avoiding expensive and time-consuming battles over the valuation of a business or partnership interest by specifying the disposition of such business interests irrespective of value. The litigation that surrounds business interests in the context of divorce proceedings can be incredibly disruptive to the business operations, and can have the effect of dragging family members into the litigation. Additionally, many family members appreciate the assurance that they will not end up being forced into business arrangements with another family member's spouse. This concern can be addressed through buy-sell agreements among the company's owners, but can also be incorporated into a marital agreement.

- **Protect family legacies and provide assurance to older generations who have accumulated wealth.** Many families who have accumulated wealth want to insure that their money is available for many future generations. The more that they can keep their wealth for the benefit of their lineal descendants, the longer the family money is likely to last. Family members who are related by marriage, rather than blood, are seldom afforded the same access to family wealth. Marital agreements can serve an important role in implementing an extended family's wealth preservation objectives.

- **Provide for and protect the interests of children from prior marriages.** This concern is particularly acute in later marriages where one or both spouses have children from a prior marriage. A marital agreement can serve the purpose of assuring the children that their inheritances will remain intact despite a new spouse on the scene. Conversely, a marital agreement can also help to document and solidify a party's intentions with respect to providing for their surviving spouse, despite the existence of children from previous marriages, thereby minimizing the chances of later disputes between family members.

- **Provide security and benefits to a "less-propertied" spouse.** Marital agreements do not need to be "all or nothing" contracts. Marital agreements can provide a measure of financial security for a less-propertied spouse, which can ease a common concern that they will be left out in the cold after a long marriage.

- **Simplify and reduce the bitterness and expense that often accompanies divorce.** Because the couple has the opportunity to agree on what is "fair" to them at a time when they are getting along, and because they can create

certainty with respect to issues that are often litigated in the course of divorce proceedings, marital agreements can reduce the complexity, bitterness, and expense that can often accompany divorce proceedings.

- **Keeping family wealth out of the hands of lawyers.** There are many legal issues that provide fodder for attorneys who wish to pursue zealous advocacy. Litigation of these issues (some of which are discussed below), can be extremely expensive.

II. UNIFORM PREMARITAL AND MARITAL AGREEMENT ACT: FOUR DIFFERENT TYPES OF AGREEMENTS.

Effective July 1, 2014, the Uniform Marital & Premarital Agreement Act ("UMPAA") became law in Colorado, replacing the Colorado Marital Agreement Act, which had been in effect since 1986.

As its name suggests, there are now distinctions between "marital" and "premarital" agreements that did not exist before. The following types of agreements are now recognized:

Marital Agreement: A Marital Agreement is an agreement between two people who are already married and who intend to remain married, which affirms, modifies, or waives one or more marital rights (a) during the marriage, (b) in the event of a legal separation or dissolution of marriage, (c) at the death of one of the spouses during the marriage, or (d) upon the occurrence or non-occurrence of some other event. C.R.S. §14-2-302(2) (UPMAA)[1].

Premarital Agreement: A Premarital Agreement is an agreement between two people who intend to marry, which affirms, modifies, or waives one or more marital rights (a) during the marriage, (b) in the event of a legal separation or dissolution of marriage, (c) at the death of one of the spouses during the marriage, or (d) upon the occurrence or non-occurrence of some other event. C.R.S. §14-2-302(5) (UPMAA).

Civil Union Agreement: A Civil Union Agreement is an agreement between two parties to a civil union, and the UMPAA governs such agreements, irrespective of whether they are entered into before the civil union or during it. C.R.S. §14-2-303.5 (UPMAA).[2]

Cohabitation Agreement: A Cohabitation Agreement is an agreement entered into between two adults who are living together in an intimate relationship, but who are not married or civil union partners, and who have no present intention of marrying or entering into a civil union. Cohabitation agreements are not governed by statute but by ordinary principals of contract law.

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[2] With the 2015 Supreme Court ruling on same sex marriages in *Obergefell v. Hodges*, there has been some discussion that states may eliminate civil union statutes as no longer necessary.

The UMPAA does <u>not</u> apply to: (1) agreements that require court approval to become effective, or (2) agreements signed in anticipation of a divorce or legal separation signed when proceedings are anticipated or pending (*e.g.*, separation agreements).[3] C.R.S. § 14-2-303(3) (UPMAA). These types of agreements are beyond the scope of this presentation.

III. <u>DIVORCE AND TRUSTS – FRAMING THE ISSUE IN COLORADO LAW</u>

Colorado statutes provide that all property acquired by either spouse subsequent to the marriage, with a few exceptions, is marital property. C.R.S. §14-10-113(2). One applicable exception is property acquired by gift, bequest, devise, or descent. The statute was revised in 2002 to clarify that for purposes of determining marital property, "property" or "an asset of a spouse" shall not include an interest a party may have under a donative third party instrument which is amendable or revocable. C.R.S. §14-10-113(7)(b).

The development of the law in Colorado regarding treatment of interests in trusts as property for purposes of property division in a dissolution proceeding has been quite varied and, at times, inconsistent. To understand where current Colorado law is on treatment of trust interests as property, it is helpful to review the Colorado courts' determinations as to when beneficial interests in trust are property. The issue has arisen not only in dissolution cases, but also in tax lien and garnishment cases.

<u>Bottom Line</u>: Your client should have a prenuptial agreement if he or she is the beneficiary of trusts.

Chronological List of Treatment of Interests in Trusts as Property under Colorado Law: Whether an Interest in a Trust is Property.

1. **<u>In re Question Submitted By the Tenth Circuit, 1976.</u>**

2. **<u>Kaladic v. Kaladic, 1978.</u>**

3. **<u>In re Marriage of Rosenblum, 1979.</u>**

4. **<u>In re Marriage of Jones, 1991</u>.**

5. **<u>University National Bank v. Rhoadarmer, 1992</u>.**

6. **<u>In re Marriage of Pooley, 1999</u>.**

7. **<u>In re Marriage of Balanson (Balanson II), 2001</u>.**

8. **<u>In re Marriage of Gorman, 2001</u>.**

9. **C.R.S. §14-10-113(7)(b), 2002.**

10. **<u>In re Marriage of Mohrlang, 2003</u>.**

11. **<u>In re Marriage of Dale, 2003</u>.**

12. **<u>In re Marriage of Guinn, 2004</u>.**

13. **<u>In re Marriage of Milias, 2014</u>.**

IV. MARITAL AGREEMENTS IN THE CONTEXT OF DIVORCE

Why should a room full of estate planners, CPAs, wealth managers, and financial advisors care about what happens in the event of divorce? Because your best planning may be derailed if one of your clients (or their children) finds themselves in divorce proceedings, and because there are things that you can do to plan around those issues.

A. Three Case Studies

1. Crummy Powers. Joe is a trust beneficiary. Joe is entitled to mandatory distributions of trust income on a quarterly basis and distributions of principal within the trustee's sole discretion. Joe also has a noncumulative limited power of withdrawal with respect to the principal, "provided, however, that the total of such withdrawals with respect to any calendar year shall not exceed the greater of Five Thousand Dollars ($5,000) or five percent (5%) of the principal of the trust estate valued at the end of the calendar year." (This limited power of withdrawal is sometimes referred to as a 5 x 5 power.) If Joe fails to exercise this power of withdrawal in any calendar year, the power lapses.

Issues:

a. Whether Joe's beneficial interest in the Trust principal, or any portion thereof, is "property" as defined by statute and case law and therefore subject to the jurisdiction of this Court under C.R.S. §14-10-113.

b. Whether Joe's beneficial interest in distributions of Trust income, or any portion thereof, is "property" as defined by statute and case law and therefore subject to the jurisdiction of this Court under C.R.S. §14-10-113.

c. If a determination is made that Joe's beneficial interest in the Trust principal or in distributions of income gives rise to a "property" interest, whether such interest constitutes "separate" or "marital property" as defined by C.R.S. §14-10-113 and Colorado case law.

d. Whether the "5&5" power set forth in the Trust Agreement gives rise to a property interest, and if so whether that property interest is "separate" or "marital" property.

2. Renounced Interest. Mark is a beneficiary of a trust established by his grandfather. The trust is located in Texas and is administered by a Texas trustee. Mark is entitled to discretionary distributions of income and "net increment to corpus." At age 25, Mark was entitled to withdraw 1/3 of the trust corpus. Other than this right of withdrawal, Mark is not entitled to any distributions of the trust's original corpus during her lifetime. When Mark attained age 25, he (like all of his grandfather's other grandchildren) signed a document waiving his right to the 1/3 distribution, electing instead for the assets to remain in trust. This renunciation was signed five (5) years before Mark's marriage.

Issues:

a. Does Mark have a "property" interest in the trust?

b. If so, is it a "separate" or "marital" property interest?

c. Was Mark's renunciation valid and/or effective?

- Does a Colorado divorce court have jurisdiction to decide whether the renunciation was effective?

- Do the Trustee or the other grandchildren have to be joined as parties before a determination of the renunciation's validity can be made?

- Should the validity of the renunciation be determined under Colorado or Texas law?

d. Should the 1/3 share be analyzed as a "self-settled" trust? And if so, should Colorado or Texas law apply to determine the effect of that determination on the "property" question?

e. Does it matter whether the renunciation was signed prior to or during the marriage?

3. Barriers to Divorce Resolution. John is a beneficiary of multiple trusts created by various relatives, which are administered in Illinois and Missouri. He is the primary beneficiary of three (3), with a combined value of approximately $2 million, from which he is entitled to purely discretionary distributions of income and principal. John's descendants are also beneficiaries of those three trusts. John's mother is the primary beneficiary of the remaining trusts, and is entitled to mandatory distributions of income and discretionary distributions of principal from each of them during her life. John (and his siblings and their descendants) is entitled to discretionary distributions from some of them during his mother's lifetime, but is entitled to nothing from others until his mother has died. At his mother's death, John (and his siblings) will receive the remainder of three (3) trusts. Collectively, those trusts have increased in value by $30 million during the marriage. John, the consummate "trust fund baby," is unemployed, lives beyond his means, is heavily in debt, and has a net worth of approximately $500,000 outside of trust.

Issues:

The parties agree that John has a property interest in the three trusts in which he has a remainder interest; that his interests in those trusts are his separate property; and that the $30 million increase in value of those trusts is marital property. Nevertheless, the following issues exist:

a. How much discovery is wife entitled to concerning her mother-in-law's health and use of the trust assets? How much discovery may she obtain regarding administration of the trusts and distributions made to other beneficiaries (of which there are 20)?

b. If there is $30 million in marital property, what can the Court award to Wife?

c. If the Court reserves jurisdiction to make an award of marital property, will it value John's interests in the trusts now or when his mother dies?

d. If the Court awards Wife maintenance based on discretionary distributions to Husband, what assurances does Wife (or the Court) have that those distributions will continue to be made?

e. Can the trustees be joined in the Colorado divorce proceedings?

f. If Wife obtains a judgment against Husband for $15 million, can she enforce it against the trustees? Will she have to go to Missouri or Illinois to do so?

g. How can John settle the case when he has only $500,000 in assets? Alternatively, how can he fund the litigation?

All of these issues, which affect the entire family, could have been avoided had these trust beneficiaries entered into marital agreements! Each of these cases cost hundreds of thousands of dollars in attorneys' fees to resolve.

V. DIVORCE: ESTATE PLANNING WORKAROUNDS IF YOUR CLIENT CAN'T OR WON'T SIGN A PRENUPTIAL AGREEMENT

A. Colorado Self-Funded Trusts – Imperfect Protection

Under Colorado law, a client may self settle a trust. The statute provides:

C.R.S. §38-10-111. Trusts for use of grantor void against creditors. All deeds of gift, all conveyances, and all transfers or assignments, verbal or written, of goods, chattels, or things in action, or real property, made in trust for the use of the person making the same shall be void as against the *creditors existing* of such person. The statute implies, but does not confirm, that transfers to a self-settled trust are protected against future creditors. Note that the Bankruptcy Court for the District of Colorado has

considered the statute in the bankruptcy context and concluded that spendthrift provisions are invalid in self-settled trusts in Colorado. See In re Gary Lee Bryan, 415 B.R. 454 (2009).

There are two Colorado cases on point. In In re Marriage of Pooley, 996 P.2d 230 (Colo. App. 1999), wife transferred proceeds from a personal injury settlement to an irrevocable trust with the wife as beneficiary and wife's parents as trustees. Trustees were given "sole and absolute discretion" in making distributions of income and principal to the wife. When the couple later divorced, husband argued that the trust was funded with marital property. The Court of Appeals acknowledged that the proceeds from a personal injury settlement are generally marital property, but the court disagreed with the husband's argument that the trust property was martial property subject to division. The Pooley court distinguished Jones, stating that under Jones:

> "it is the extent of the beneficiary's right to or interest in the trust rather than the source of funding for the trust that determines whether the trust and the income from it are property. While the trust at issue here [in Pooley] was funded with settlement proceeds that would otherwise have been marital property, wife's interest in these funds after they were placed in a discretionary trust was no different from the interest of the wife/beneficiary in Jones."

Some commentators believe Pooley was decided on its facts as a "result driven" holding, given the wife's personal injury. (See Chorney, "*Trusts in Divorce and Property Divisions*," p. 48, 2009.)

In re Marriage of Kaladic, 589P. 2d 502 (Colo. App. 1978), involved the transfer of property by wife to an "irrevocable discretionary spendthrift trust." Wife was the beneficiary and her lawyer the trustee. The wife made the transfer of property without her husband's knowledge eleven months before filing for divorce. The Court of Appeals found that the wife's conveyance of the marital assets into the trust was "illusory and fraudulent" against the husband.

Obviously, these cases both involve transfers made after the marriage. It is possible that a client who transfers property into a trust prior to the marriage, will be protected by a self-settled trust which is purely discretionary and has a third party trustee. It is hard to imagine that a court would determine the conveyance to be fraudulent as to a future spouse, especially given the language of the statute, which specifically voids conveyances as to existing creditors.

Despite the language of the statute, one wonders whether a court would consider the timing of the transfer to a self-settled trust, given that the spouse is a reasonably known potential future creditor. Best to avoid a transfer on the eve of the wedding. What about a transfer of the eve of the engagement? These are questions, Colorado law simply does not answer, and another reason why a prenuptial agreement is the best planning option, if possible.

B. Alaska, Delaware, South Dakota, Nevada Self-Funded Asset Protection Trusts – More Protective than Colorado But Still Imperfect

If a prenuptial agreement is simply not workable for a client with very significant assets, the additional expense of forming a Delaware (rather than Colorado) self-settled trust may very well be a worthwhile investment for a wealthy client contemplating marriage.

Delaware has the Qualified Dispositions in Trust Act, 12 Del. C. Section 3570, which allows individuals to crate self-settled asset protection trusts which cannot be attached by future creditors, including future spouses, if certain conditions are met. The trust must be an irrevocable trust with a Delaware trustee. It must incorporate Delaware law and it must contain a spendthrift clause. The grantor cannot retain a general power of appointment over the assets, although a retained 5 and 5 power will not violate this rule. Certain administrative trustee functions must be performed in Delaware. If these simple requirements are satisfied, the Delaware courts will not enforce the judgment of a Colorado court to reach the trust property.

However, there are a few exceptions to the Delaware protection. Protection will not be granted if the judgment from another court relates to maintenance, child support or a property division order for a spouse who was married to the trust settlor at or before the time of the transfer of the assets into the trust.

So, again, this option is not perfect even if undertaken prior to the marriage, given that a Delaware court will enforce a judgment for maintenance granted by a Colorado court. If your client wants a maintenance waiver, he or she must obtain that in a marital agreement, subject of course to the unconscionability review at the time of the divorce.

C. Offshore Trusts

This type of trust would be similar to the Alaska, Delaware, Nevada or South Dakota Trust, but would have a Cook Islands or Cayman Islands or other offshore trustee. I have seen one of these trust work to protect assets in a divorce, even when the trust was settled and funded 11 days prior to the marriage.

D. As to Existing Trusts, Decanting

If your client is the beneficiary of existing trusts which may fall at the Balanson end of the spectrum, decanting is a possible estate planning technique which could be used if a prenuptial agreement is not an option.

Simply stated, decanting a trust means that a trustee is permitted to create another trust and transfer (i.e., decant) some or all of the assets of the old trust.

Colorado adopted a decanting statutes effective August, 2016, the Colorado Uniform Trust Decanting act, C.R.S. §15-16-901, et. seq.

Most older trusts do not have decanting language built into them, but you can use the new statute for such trusts, if the provisions of the statute allow, based on the structure of the trust.. In addition, many trusts created over the last 10 years will have decanting provisions, which may be broader than the new Colorado statute.

E. Use of Classic Estate Planning Trusts

A client who is unable to use a prenuptial agreement may consider using some classic estate planning techniques to provide some protection for a future spouse. These trust may provide the dual benefits of protection of assets in a divorce as well as gift/estate tax planning benefits. Consider whether the use of:

Grantor Retained Annuity Trust or Unitrust (GRAT or GRUT)

Qualified Personal Residence Trust (QPRT)

Charitable Remainder Annuity Trust or Unitrust (CRAT or CRUT)

VI. MARITAL AGREEMENTS IN THE CONTEXT OF DEATH PLANNING

A. Waivers of Surviving Spouse Rights

A marital agreement may govern the rights of the parties in the event of the termination of the marriage by death of either party. The agreement may include a partial or complete waiver of property rights arising at death. The agreement may also include a promise to provide for a substitute transfer of property to the waiving spouse. While both parties to a martial agreement may agree to waive – in whole or in part – their respective property rights arising at death, each party remains free to leave more property to the other than would be required by the agreement. In other words, the marital agreement may limit the right to inherit from a spouse without imposing a ceiling on the potential of one spouse to provide voluntarily for the surviving spouse in excess of the rights granted by the agreement.

A release and waiver of “all rights upon death” or equivalent language in a marital agreement encompasses the waiver of several statutorily granted spousal rights and priorities. These statutory rights and priorities include the right to a spouse’s elective share (sometimes referred to as the statutory or forced share), the right to receive the family allowance and exempt property allowance, and the priority to serve as personal representative, executor or administrator.

B. Status as Surviving Spouse During Divorce Action

A person who is divorced from a decedent or whose marriage has been annulled is not a surviving spouse. However a decree of separation does not terminate the status of husband and wife for death purposes. A husband and wife are considered married regardless of whether a divorce action has been instituted. So, if one spouse dies after an decree of separation has been entered or after a divorce action has been initiated, the survivor will likely have rights as a surviving spouse under most state laws.

A marital agreement can modify these provisions, stating specifically that a separation decree or the filing of an action for divorce terminates all surviving spouse rights.

C. Intestate Share of Surviving Spouse

If a person dies without a will, the decedent's property will be distributed in accordance with the applicable statute of intestate succession. Under many states, the surviving spouse's share of the intestate estate is dependent upon the circumstances of the parties, including whether there are adult or minor children of the marriage, whether the decedent has adult or minor children from another relationship, and whether the decedent is survived by one or both parents. Under the law of many states, the surviving spouse receives the entire intestate estate (1) when the decedent has no surviving descendants or ancestors or (2) when all of the decedent's surviving descendants are also descendants of the surviving spouse and there are not other descendants of the surviving spouse who survive the decedent (i.e., it was likely a first marriage for both spouses). The surviving spouse's share tends to be diminished if the decedent had children from other marriages.

D. Spouse's Elective or Statutory Share

Absent a marital agreement, the surviving spouse has the right to an elective share of the augmented estate. In Uniform Probate Code states, such as Colorado, have adopted a right to elect to take 50% of the marital property portion of the augmented estate. Under the Uniform Probate Code, the percentage of the marital property portion of the augmented estate to which the surviving spouse is entitled is determined by the length of time the spouses were married, but is essentially as follows:

IF THE DECEDENT AND THE SPOUSE WERE MARRIED TO EACH OTHER:	THE MARITAL PROPERTY PORTION OF THE AUGMENTED ESTATE IS:
Less than 1 year	Supplemental amount only.
1 year but less than 2 years	10% of the augmented estate.
2 years but less than 3 years	20% of the augmented estate.
3 years but less than 4 years	30% of the augmented estate.
4 years but less than 5 years	40% of the augmented estate.
5 years but less than 6 years	50% of the augmented estate.
6 years but less than 7 years	60% of the augmented estate.
7 years but less than 8 years	70% of the augmented estate.
8 years but less than 9 years	80% of the augmented estate.
9 years but less than 10 years	90% of the augmented estate.
10 years or more	100% of the augmented estate.

E. Augmented Estate

The augmented estate is comprised of property owned by the decedent at death as well as certain pre-death gifts to the surviving spouse and to third parties. The

augmented estate is a statutory concept created to prevent disinheritance of a spouse through transfers to others while at the same time equitably accounting for inter vivos and testamentary transfers to the spouse.

F. Priority to Serve as Personal Representative or Executor

In many states, the priority to serve as personal representative or executor is established by the decedent's will. However, in the absence of a will or if the will fails to nominate someone who can act in such position, the surviving spouse has priority to act. Thus, absent a marital agreement, if a decedent dies intestate or if all persons nominated in the will fail to qualify, the spouse would have priority to serve as personal representative or executor even if that was not the decedent's wish. This priority to serve can be waived in a marital agreement.

G. Federal Law Rights to Retirement Plan Assets

The survivorship rights in and benefits under qualified retirement plans are governed by federal law, including ERISA and other provisions of the Internal Revenue Code, it is federal law, and not state law, that governs when and how a participant may obtain a valid waiver of survivorship rights and interests in such plans. A participant in a retirement plan cannot obtain a valid waiver of spousal survivorship rights prior to the parties' marriage. Thus, the general waivers of "all rights upon death" or even a specific waiver of rights to a retirement plan, will not constitute an effective waiver of spousal survivorship rights in a retirement plan. Notwithstanding this fact, marital agreements often include waivers of surviving spouse rights to retirement assets. These waivers must be coupled with mutual promises to execute separate retirement plan waivers after the parties are married.

H. Community Property Waivers

Generally, community property is owned by both spouses equally. Community property does not include property owned by a spouse prior to marriage, property gifted from one spouse to the other, property inherited by a spouse or property which was separate property prior to the time the spouses moved to the community property jurisdiction. The titling of property is not determinative of its status. Earned income of the spouses is community property. Income from separate property is community property in some jurisdictions and not in others.

Frequently, parties execute a marital agreement in one state and move to another jurisdiction. All practitioners should be careful to draft waivers of rights upon death broadly enough to cover rights granted in any jurisdiction. A well drafted waiver of rights upon death will include a specific waiver of any property rights based on the laws of community property.

From an estate planning perspective, one benefit of preserving community property is that the entire property receives a step-up in basis at the death of the first spouse. I.R.C. 1014 (b)(6). Under Section 1014(b)(6), even though only the decedent spouse's one-half interest is includable in his gross estate, the entire community

property obtains a stepped up basis. This is perhaps the greatest advantage of community property. Because of this advantage, a lawyer preparing a marital agreement for clients in a community property state or clients who have migrated from a community property state will want to consider whether to retain the community property character of certain assets for estate planning purposes.

VII. SUBSTITUTE TRANSFERS IN EXCHANGE FOR WAIVERS OF SURVIVING SPOUSE RIGHTS

A. Federal Gift Tax Marital Deduction Issues

1. Gifts to a Spouse During Marriage. Transfers to the spouse during the marriage will qualify for the unlimited deduction for gift tax purposes, so long as such transfers are made outright to the surviving spouse or to a qualifying trust. I.R.C. §2523. A gift of a life estate or terminable interest will not qualify for the gift tax marital deduction, unless such transfer is a qualified terminable interest as described in . I.R.C. §2523(f). Outright gift transfers are obviously simplest from the perspective of qualifying for the gift tax exclusion. However, clients may be adverse to such outright transfers and may wish to make transfers in trust for the spouse.

If an inter vivos trust is created for the spouse, be sure the trust qualifies as a QTIP trust. If a QTIP trust is created and funded during the marriage, be sure to make a timely QTIP election. The IRS provides no relief for a late filed QTIP election for an inter vivos QTIP trust.

There are several significant advantages of a lifetime QTIP trust in a marital agreement setting. First, it allows the wealthier spouse to provide an income stream to the less wealthy spouse during the marriage and after the wealthier spouse's death. Second, at the death of the beneficiary spouse, regardless of the order of deaths, the trust assets will pass to the beneficiaries selected by the wealthier spouse (presumably the children from the first marriage). The unified credit and GST exemption of the less wealthy spouse can be fully utilized, saving the wealthier spouse's beneficiaries estate tax.

2. Cautions. Be wary of provisions which transfer a property to the less wealthy spouse during the marriage, such as title to a residence, but provide that if a divorce were to occur the residence shall revert to the wealthier spouse. This may be attractive from an estate planning perspective and it may be attractive to the less wealthy spouse because she will hold the residence outright (rather than in a marital trust) at the wealthier spouse's death. However, this arrangement may not qualify for the gift tax deduction as an outright transfer to the less wealthy spouse. Rather it will likely be treated as a terminable interest because the interest transferred to the less wealthy spouse will terminate or fail upon an event (the divorce) and because the donor retains in himself an interest in such property (the right of the property to revert to the donor upon a divorce). I.R.C. §2523(b).

Also be wary of drafting provisions which require the wealthier spouse to make transfers during the marriage or upon termination of the marriage to the children of the less wealthy spouse. Such contemplated gifts should qualify for the gift tax annual exclusion (currently $13,000 or $26,000 if the spouses will gift split) or the exclusion for payment of certain educational or medical expenses. I.R.C. §2503.

3. Gift Splitting. A marital agreement may request the less wealthy spouse to agree to gift splitting during the marriage, thereby allowing the wealthier spouse to maximize gifting to descendants. Be specific about whether the less wealthy spouse is consenting to gift splitting for annual exclusion gifts only or whether he/she is also consenting to use of his or her lifetime gift tax exemption.

B. Federal Estate Tax Marital Deduction

The substitute transfer of property described in a marital agreement should qualify for the federal estate tax marital deduction. If the form of the transfer qualifies for the unlimited marital deduction, the property transferred will pass free of the federal estate tax at the transferring party's death. When a martial agreement provides for a marital deduction qualifying transfer, such as a QTIP trust, the agreement should explicitly allocate liability for the estate tax arising at the survivor's death (presumably, but not necessarily, from the assets of the QTIP trust). The following common forms of testamentary spousal transfers will qualify for the unlimited marital deduction.

1. An outright, unrestricted transfer of property;

2. A transfer for a qualified terminable interest property (QTIP) trust;

3. A transfer to an estate trust or a power of appointment trust ;

4. A transfer to a qualified domestic trust (QDOT) for a non-citizen surviving spouse;

5. A transfer of the right to unitrust or annuity payments from a charitable remainder trust.

C. QTIP Trusts

Estate planners frequently use QTIP trusts to provide for a second spouse, particularly when a party wishes to preserve wealth for children of a prior marriage. A testamentary marital trust, created under the decedent's will or revocable trust will qualify for the marital deduction as a QTIP trust if:

1. Property passes from the decedent to the QTIP trust;

2. The governing instrument requires all income to be distributed at least annually to the surviving spouse;

3. No other beneficiary may have any rights in the trust during the surviving spouse's lifetime; and

4. The personal representative or executor makes the corresponding election on the federal estate tax return filed for the decedent's estate. I.R.C. §2056(b)(7).

The obvious benefit of the QTIP trust is that the surviving spouse need not be given a general power of appointment over the trust and therefore may be prevented from disinheriting the remainder men of the trust (presumably, the deceased spouse's children from a prior marriage). This is the best method of "handcuffing" the inheritance of the surviving spouse while at the same time qualifying the transfer for the marital deduction.

Another advantage of the QTIP trust is that if the surviving spouse has a minimal estate of his or her own, the unified credit of that less wealthy surviving spouse can be utilized for the benefit of the wealthier spouse's beneficiaries. The same is true of the less wealthy surviving spouse's generation skipping transfer tax (GST) exemption. Since the beneficiary spouse is considered the transferor of the QTIP trust for estate tax purposes, that surviving spouse's GST exemption may be allocated to the trust thereby insulating the trust (or a subdivided portion of the trust) from GST tax.

a. Standards and Guidelines for Principal Distributions. Provided that the surviving spouse is entitled to the income from the trust, at least annually, the surviving spouse need not be given any other beneficial interests to the principal of the trust. Additional access to principal, however, is frequently given to the surviving spouse for health, support, and maintenance. Many times the marital agreement will specify under what circumstances principal may be accessed by the surviving spouse.

b. Selection of Trustees. The marital agreement may specify that a third party will serve as sole trustee or as co-trustee with the surviving spouse to ensure better protection to the trust assets for the remainder beneficiaries. "Neutral" trustees and successor trustees are generally advisable. The surviving spouse as sole trustee generally provides less protection to principal than the deceased spouse may want. On the other hand, a child of the decedent (the step-child of the surviving spouse) as trustee may cause family discord. A suriving spouse might be allowed to select a trustee among a group of mutually agreeable potential trustees. Or, a surviving spouse could be authorized to appoint an institutional trustee.

c. Selection of Assets. The marital agreement may provide specific directions with regard to what assets will be directed into the QTIP trust for the benefit of the suriving spouse. If there is a closely held business, both spouse's may favor terms prohibiting such closely held stock from passing to the QTIP trust. If the wealthier spouse holds promissory notes from children, the less wealth spouse may want to include a provision specifically prohibiting those types of assets from being used to fund the QTIP trust.

d. Residence. Frequently, the marital agreement will address the use and disposition of the residence by the non-owner spouse after the death of the owner spouse. If the residence is transferred to the QTIP trust, it will be important to include provisions in the QTIP trust so that the surviving spouse's rights to the residence will constitute the necessary qualifying income interest (i.e, the surviving spouse must have the right to demand that unproductive property be made productive).

D. Use of Life Insurance in Conjunction with a Marital Agreement

Some parties to a marital agreement favor a waiver by the less wealthy spouse of all rights upon death of the wealthy spouse coupled with a death benefit paid to the suriving spouse pursuant to a life insurance policy. If the wealthy spouse owns the policy and designates his or her spouse as the beneficiary, the policy proceeds will be included in the decedent's estate, by will qualify for the estate tax marital deduction. If the surviving spouse is both the owner and the beneficiary of the policy, the policy proceeds will not be included in the decedent's gross estate.

The parties to the marital agreement may want to address specifically what type of policy is to be acquired to satisfy the provisions of the agreement. Term insurance will obviously be less expensive, but if the marital agreement requires the insured spouse to maintain such insurance until death, a term policy may become impractical or unaffordable at some point. If the marital agreement requires the insured spouse to carry insurance until death, the agreement should require that permanent insurance be acquired.

The parties to the agreement also may want to specify that the beneficiary spouse be the owner of the policy. This will prevent the insured spouse from changing the beneficiary, cancelling the policy or borrowing against the policy without the beneficiary spouse's consent.

The agreement should specifically address which party will have the obligation to pay the premiums.

If you represent the beneficiary spouse in the prenuptial process, consider drafting a backstop provision which will give the surviving spouse a right to claim against the decedent's estate if, for any reason, such insurance is not in place at the death of the spouse whose life was to be insured.

Consider using a QTIP trust or an irrevocable life insurance trust as the beneficiary of the insurance policy if the wealthy spouse wishes to have the policy proceeds remaining after the surviving spouse's death pass to his or her children from a previous marriage.

E. Joint Tenancy

Clients should be advised regarding the implications of joint tenancy and the possibility of defeating all of the careful planning for death in the marital agreement by holding property as joint tenants with rights of survivorship.

Consider including a provision in the marital agreement which gives the wealthier spouse credit for joint tenancy transfers against any required devises to the surviving spouse. Consider the following language:

> *"Effect of Jointly Held Property, Beneficiary Designation Property, or Transfer on Death Property Payable to Joe*. If Jane predeceases Joe, the obligation to provide Joe with an outright disposition of cash or marketable securities having a fair market value of $1,000,000 under paragraph ______ shall be deemed satisfied to the extent of the date of death value of any cash or marketable securities passing by beneficiary designation or transfer on death designation and to the extent of one-half of the date of death value of cash or marketable securities passing by joint tenancy or tenancy by the entireties as a result of Jane's death.
>
> If Jane predeceases Joe, the obligation to provide Joe with $2,000,000 in a marital trust under paragraph ____ shall be deemed satisfied to the extent of the date of death value of any property passing by beneficiary designation or transfer on death designation and to the extent of one-half of the date of death value of joint tenancy or tenancy by the entireties property passing to Joe as a result of Jane's death. If the value of property passing to Joe by beneficiary designation, transfer on death designation, joint tenancy or tenancy by the entireties should exceed the required amount payable to Joe pursuant to paragraphs _____, then Jane's estate shall have no further obligation to Joe under this Agreement, nor shall Joe have any obligation to return funds to Jane's estate."

VIII. COORDINATION OF ESTATE PLANNING DOCUMENTS WITH THE MARITAL AGREEMENT

A. Maintenance of Testamentary Documents

If the marital agreement requires that wills, trusts, beneficiary designations, deeds, or other documents be prepared to reflect the agreement reached, this can be done by one of two methods: (1) the marital agreement can be drafted as a specific roadmap which will contain the essential terms of the documents that will be prepared at a later date, or (2) the marital agreement can include concurrently prepared and executed documents as exhibits to the agreement.

If the parties execute a marital agreement which provides a general waiver or "all rights upon death" or similar language, be sure to advise your client to maintain updated estate planning documents after the marriage if your client does in fact wish to leave property to the spouse.

B. New Estate Planning Clients – Verify Whether a Marital Agreement Exists

New estate planning clients may not mention the existence of an old marital agreement. Estate planning attorneys should specifically confirm with clients whether or nor a marital agreement exists, and if one does, obtain a copy.

C. Estate Planning Clients with Adult Children

When preparing estate planning documents for wealthy clients with grown children, consider having a discussion with those clients regarding whether the children have or should have marital agreements in place. This may affect whether a client decides to leave property outright or in a lifetime trust to an adult child.