ESTATE PLANNING COUNCIL OF NORTHERN NEW JERSEY
MAY 9, 2018 MEETING

Till Divorce Do Us Part: A Practical Guide to Estate Planning for Marital Dissolution

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CASE STUDY

World-famous cardiac surgeon Cora Nary is married to cardiologist Perry Cardium. They have two young children, Maia and Eppie. They live in a cooperative apartment in New York City which they bought with money they earned from their practices during their marriage. Each earns a substantial salary; they live on Cora's income because Perry contributes all of his earnings to a series of charitable remainder trusts which will ultimately go to the American Heart Association. The AHA has committed to using the funds to construct room-sized models of the human heart in every McDonalds located in the state of New Jersey.

They own a vacation home in Southampton worth $20 million through a limited liability company called "Auricle LLC." Cora also owns another valuable vacation home on Long Beach Island, New Jersey, acquired prior to the marriage through a separate limited liability company called "Ventricle LLC."

Cora has several million dollars of assets that she acquired prior to her marriage to Perry through sales of her best-selling book, "Mending a Broken Heart—Repairing Torn Aortic Valves in Recently Divorced Individuals."

Perry's parents have created a trust for his benefit which will be distributed to him in 5 years when he reaches age 50. It was funded with shares in Plaque-Attack, a company that manufactures a highly specialized drug used to reduce blockages in the left pulmonary artery. The shares in the trust are now worth several million dollars. While the trust is in existence the Trustees have the discretion to use trust assets for Perry's benefit—its primary stated purpose being to fund quarterly electrocardiograms for him and his children.

The marriage unravels after Perry begins having an affair with his brilliant but impoverished lab assistant, Sarah Bellum. Cora sues Perry for divorce, demanding among other relief that he transfer to Cora his 50% interest in Auricle principally because of her fondness for the heart-shaped pool that they built in the backyard. She also wants to transfer her interest in Ventricle to Maia and Eppie through the use of a qualified personal residence trust for estate tax-savings purposes.

The author thanks his colleague, Bridget A. Harris, Esq. for her assistance in preparing these materials.

Meanwhile, Perry and Sarah begin living together with a view towards ultimately marrying after the divorce is finalized. After getting initial advice from his lawyer, Anna Littical, Perry has dinner with Sarah during which he tells her that he wants her to sign a prenuptial agreement. He presents her with a draft of the agreement. Sarah screams, hits Perry with the draft and proceeds to throw it into the fireplace.

Perry returns to Anna and asks for additional advice.

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I. INTRODUCTION – The Importance of the Topic

A. According to a 2009 survey by the U.S. Bureau of the Census, approximately 90% of Americans had married at least once by age 60.[1]

1. In 2014, there were over 2,100,000 marriages in the United States.[2]

B. *Divorce Rates*

1. In 2014, there were over 800,000 divorces and annulments.[3]

2. In 2009, over 35% of the United States population aged 50 to 70 had been divorced at least once.

3. Approximately 41% of first marriages, 60% of second marriages, and 73% of third marriages end in divorce.[4]

4. The probability of a first marriage ending in separation or divorce within five years is 20%. After 10 years, the probability is 33%.[5]

5. The probability of a second marriage ending in separation or divorce within five years is 23%. After 10 years, this figure goes to 39%.[6]

6. According to one source, one in four divorced couples are over the age of 50, while one in ten divorces occur in couples aged 65 and older.[7]

7. Rates of divorce appear to be somewhat correlated with certain other demographic factors, such as income and education. For example, one longitudinal study by the Department of Labor found that over 50% of marriages of people who did not complete high school end in divorce, compared with approximately 30% of marriages of college graduates.[8]

C. For further reading on the intersection of estate planning and marital dissolution, see Appendix A, *Top Ten Things Matrimonial Lawyers Should Know About Trusts and Estates*.

II. THE PRE-GAME – Planning Prior to the Marriage

A. *Equitable Distribution* – In the United States, a state is either a community property state or an equitable distribution state.

1. In general, in community property states, any property acquired during the marriage is automatically divided equally between the spouses, although a few jurisdictions permit an uneven distribution of community property based on the court's discretion.[9]

2. By contrast, in equitable distribution states, in general, property is divided according to a set of principles and tests enumerated in statutes.[10]

3. Equitable distribution statutes tend to come in two "flavors".

a. In some states, the divorce court includes all property owned by the spouses, including property acquired before the marriage, property acquired by gift, inheritance and descent, in one "pot" to be divided between the divorcing parties.[11]

b. In other states, courts divide property between marital property and separate property.

(i) In general, marital property is property acquired during the marriage.

(ii) In general, separate property is property acquired prior to the marriage (or subsequent to the conclusion of the marriage) and also generally includes gifts, bequests and inheritances (even if received during the marriage).

c. There are a variety of different approaches in category (ii) – for example, in Colorado, marital property includes the increase in value of separate property.[12] In New York and New Jersey, by contrast, the increase in value of separate property remains separate property, except to the extent that it is due to the contributions of the other spouse.[13]

d. Even community property states show a lack of uniformity in property division. Compare and contrast California and Washington with regard to separate property. Washington includes all the parties' property, both community and separate, in the divisible "pot", and allows the court to make dispositions as shall appear just and equitable.[14]

e. In the past, property held in trust created either by the marrying spouse or members of his or her family for his or her benefit was traditionally treated as beyond the scope of any marital settlement. Increasingly, however, non-beneficiary divorcing spouses have been seeking to make claims on trust properties under a number of different theories.

f. Divorcing spouses are also potentially entitled to alimony, and the children of the marriage are entitled to child support.[15]

B. *Spousal Rights on Death* – In all states except Georgia, a surviving spouse has certain rights in the property of the deceased spouse.

1. These rights can take the form of a statutory intestate share of the estate in the event that a deceased spouse dies without a will.[16]

2. These can also take the form of elective share or similar rights if a spouse dies with a will but leaves the surviving spouse less than certain statutorily mandated minimums.[17]

3. These rights are generally <u>dramatically different</u> than the rights of a divorcing spouse. They typically extend to a share of <u>all</u> of the deceased spouse's assets, not just assets acquired during marriage. Contrast this with the protection of pre-marital property under most equitable distribution and community property regimes.

4. Generally, elective share statutes automatically provide a surviving spouse with a share of the deceased spouse's assets. Unlike in equitable distribution, there is no application of judicial discretion.

C. *The Prenuptial Agreement* – Prenuptial agreements are generally recognized as legal and enforceable.[18]

1. A well drafted prenuptial agreement must deal with <u>both</u> the implications of divorce and the consequences of a death during the marriage.

2. Creative planning, including estate and tax planning, can be used to solve issues and bridge gaps in the negotiation of the Agreement.

D. *The Terms of a "Typical" Prenuptial Agreement.*

1. The spouses agree that they will, except as expressly provided by the Agreement, not make claims to any of the separate property of the other spouse. Separate property is generally defined as including all assets generally considered separate property in equitable distribution states that distinguish between separate and marital property (rather than the "one pot" approach),

a. <u>plus</u> the appreciation on growth of income generated by such assets and any assets into which such premarital assets are converted.

b. Post-marital appreciation in separate property is separate property even when created by the skills or efforts of non-owner spouses during the marriage.

c. If there are trusts which have been created by or for the benefit of the spouse, it is important to make specific reference to these trusts and include them within the definition of separate property.

2. Provisions for Alimony.

3. Provisions for Marital Residences – a separate and special category of property.

a. Consider provisions returning property for down payment and mortgage payments, if any, to contributing spouse, or proportionately if spouses contribute in different proportions.

b. Consider mutual buy-out rights and rights of first refusal.

(i) For example, one spouse may negotiate for the right to purchase the primary marital residence (or any other marital residence, such as a vacation home) for a price calculated based on the spouses' respective contributions to the initial purchase of such property. If that spouse does not exercise the right within a certain period, the other spouse may then have the same right.

(ii) Alternatively, one spouse may receive the residence, with the other spouse maintaining a right of first refusal if the spouse receiving the residence ever wishes to sell it.

(iii) Consider how mortgages should be dealt with.

c. Consider allowing primary caretaker spouse to remain in residence until youngest child of the marriage reaches a certain age or level of schooling.

4. Post-Death Provisions

a. Often, spouses who are unwilling to share separate property with each other in the event of divorce are willing to share such property in the event that a spouse dies during the marriage.

b. However, this property could be an interest in a business developed by one spouse or property gifted by or inherited from other family members that constitute "legacy assets" intended to remain within that spouse's family.

c. The use of trusts can be helpful in providing that the other spouse is protected with the use of some or all of these assets during the surviving spouse's lifetime, but a subsequent spouse of the recipient spouse and such spouse's creditors cannot make claims against the assets (see discussion of discretionary trusts below).

(i) The separate property-owning spouse can agree to create a credit shelter or QTIP Trust for the benefit of the surviving spouse with some or all of the property-owning spouse's separate assets. The trust will provide that at the death of the surviving spouse, the remaining property in the trust reverts to the children of the marriage (or the children of the property-owning spouse's previous marriage(s)), or other family members selected by the property-owning spouse.

(ii) Many elective share statutes do not allow the deceased spouse to use trusts to satisfy the elective share obligation in whole or in part.[19]

(iii) A property-owning spouse's agreement to leave property valued at or in excess of the elective share amount in a trust for the surviving spouse can be offered in return for a waiver of the surviving spouse's outright elective share rights.

d. Life Insurance. Life insurance can be used in lieu of agreements to bequeath spouse's own assets.

(i) Particularly for younger couples in good health, substantial amounts of life insurance can be purchased with relatively low cost premiums.

(ii) Negotiations will often occur to determine to what extent such insurance should be term insurance to protect the spouse for a particular number of years or some form of permanent insurance that protects the spouse indefinitely.

(iii) These types of insurance can be used creatively – for example, there can be agreement to use term insurance for a number of years during which the premiums are economical, followed by an agreement to leave a certain percentage of assets outright or in trust for the surviving spouse once the term insurance becomes too expensive.

(iv) Life insurance can go outright to the surviving spouse or can be held in an insurance trust for the benefit of the surviving spouse.

(v) Use of a life insurance trust can, as in other estate plan situations, protect the proceeds of the life insurance from estate tax in both the insured and the surviving spouse's estate.

(vi) Use of the life insurance trust also insures that at the death of the surviving spouse, any remaining proceeds come back to the children of the marriage or other selected beneficiaries of the insured spouse.

(vii) It is important to consider and decide upon trustee selection. This will often be a major point of negotiation.

(1) The insured spouse will want to select at least a co-trustee to maintain some control over how assets are distributed from the trust.

(2) The recipient spouse will also want to select a trustee to ensure input into and veto power over decision making concerning the trust.

(viii) Trustee selection ideally should be provided for in the prenuptial agreement. With respect to the trust's other terms, provide that they will be agreed upon as part of the discussions or after a certain fixed period of time since the marriage was solemnized.

(ix) DO NOT state merely that any insurance will be "in trust."

5. Plan for Portability

a. Deceased spouse's unused exemption ("DSUE") can be transferred to surviving spouse to protect surviving spouse's assets from estate and gift tax on his or her own eventual death.[20]

b. The wealthier spouse should be certain to include DSUE provisions requiring the less wealthy spouse to direct his or her executor to make the portability election.

c. The potential for a DSUE is an <u>asset</u>. The less wealthy spouse should use it as a negotiating tool; i.e., agree to direct executor to transfer it to the wealthier surviving spouse (who can use it to protect his or her own larger estate and save significant estate taxes) in return for other property/insurance.

E. *Non-Marital Agreements*

1. Couples who cohabitate or own a residence together but do not plan to get married may still benefit from a non-marital agreement.

2. Consider how property that is accumulated over the course of the relationship should be divided if the relationship ends, and how each party should provide for the other via his or her estate plan.

3. A non-marital agreement may avoid the obligation to pay "palimony", the colloquial term for alimony- or equitable division-like payments based on actions and understandings during a non-marital relationship, such as a promise by one party to support the other. [But *See* N.J.S.A. 25:1-5.h, which requires a palimony agreement to be in writing.]

F. *Marital Agreements, aka Post-Nuptial Agreements*

1. These are agreements entered into between spouses <u>during</u> the marriage. The agreement may deal with a pre-existing issue that was not settled in a prenuptial agreement, or with a new issue that arises during the marriage.

2. In New York, marital agreements are explicitly permitted by statute.[21] In some other states, their validity is governed by case law and is less clear.

3. As a practical matter, the party desiring the marital agreement may have less leverage than he or she would have had prior to the marriage. However, a marital agreement may still be feasible and may be a good way to deal with issues like an unexpected inheritance of a family business, or one spouse's commitment at the other's request to take time away from the workplace.

III. IN-GAME AND POST-GAME PLANNING – Planning for Divorce During the Marriage

Assuming there is no pre-nuptial agreement or that it does not deal comprehensively with the consequences of divorce or a death during the marriage, several factors have to be taken into account.

A. *Presumptions*

Most states by statute or case law have rules that modify a former spouse's rights under at least some estate planning instruments.

1. Almost all states provide that a divorce automatically revokes any disposition to a spouse in a will. The divorced spouse is deemed to have predeceased the testator.[22]

2. The Uniform Probate Code (the "UPC") and many state statutes also automatically revoke any disposition to a relative of the testator's former spouse, provisions concerning powers of appointment for the former spouse or relative, and the nomination of the former spouse or relative as an executor, trustee, conservator, agent or guardian.[23]

3. The UPC and the statutes of a number of states also apply the "revocation" concept to other revocable testamentary dispositions such as life insurance policies, property held with right of survivorship, annuities, and retirement benefits.[24]

4. In contrast, most states do not have any automatic "revocation on divorce" rule governing a spouse's interest in an irrevocable trust. Accordingly, if during the marriage spouses are creating trusts for each other, they should consider including provisions in irrevocable trusts that deal with the possibility of divorce.

a. For example, consider including provisions that eliminate the spouse as beneficiary and trustee in the event of divorce.

(i) Sample provision: "Notwithstanding any other provision of this instrument, my spouse shall be treated as living only while my spouse is Qualified, as defined in this section. My spouse shall be "Qualified" (i) during my life, while (a) my spouse and I remain married to each other, (b) no proceedings to dissolve my marriage to my spouse are pending, and (c) my spouse and I are not separated from each other by reason of marital discord, and (ii) after my death, if my spouse was Qualified immediately before my death. If at any time my spouse is not Qualified, my spouse shall be treated for all purposes of this instrument as having died on the first date on which my spouse was no longer Qualified. If, following any period during which my spouse is not Qualified, my spouse becomes Qualified again, my spouse shall be treated as living for all purposes of this instrument beginning on the first date on which my spouse became Qualified again, subject to the foregoing provisions of this section."

(ii) This type of provision may need to be modified. For example, if the spouse will hold *Crummey* withdrawal rights in the trust, consider protecting the integrity of those withdrawal rights by providing that such rights continue to be exercisable after divorce.

(iii) If any dispositions are made for the benefit of the spouse's family members, consider whether those should also be revoked.

b. It is also important to keep in mind that the "revocation on divorce" statutes only apply in the event of a <u>final judgment</u> of divorce. They are <u>not</u> triggered by separation or marital discord. It is important if divorce proceedings are begun or threatened to take appropriate steps:

(i) Review estate planning and asset titling.

(ii) Eliminate, to the extent possible (subject to elective share statutes), provisions for spouse in estate plan.

(iii) Change and eliminate designation of spouse as trustee or other powerholder such as powers of appointment.

(iv) Change powers of attorney.

(v) Change health care proxies and health care directives.

(vi) Consider applicability of elective share statutes in certain states to separation situations. For example, New Jersey's elective share statute disqualifies the spouse from electing against the will if, at the time of the decedent's death, the couple was separated under circumstances that would give rise to claim for divorce.[25]

(vii) Change beneficiary designations for life insurance and retirement benefits. However, the spouse's consent is required to change beneficiary under an ERISA qualified plan.[26]

(viii) If there are minor children of the marriage, it is vital that the spouses agree on who to name as guardian in their wills in the event that both spouses pass away. This issue can be a major source of friction and anxiety if not resolved, and a mismatch in appointments could even lead to a custody battle in the event of simultaneous or close-in-time deaths.

B. *Use of Trusts in Divorce*

1. As in premarital planning, trusts can be useful tools in divorce. Trusts allow the settlor:

a. To retain more control over the assets

b. To provide more financial security for the recipient spouse

c. To minimize future contacts with an ex-spouse

2. Gift tax consequences are mitigated or eliminated by Code section 2516, which deems certain transfers made between spouses pursuant to divorce settlements to be made for full and adequate consideration, *i.e.* not gifts. See Appendix B, *Selected Sections of the Internal Revenue Code*, for the text of this and other statutes mentioned in this outline.

3. One or both spouses may wish to take advantage of gift-splitting while still married to make gifts to their children or other beneficiaries, outright or in trust.

a. Code section 2513, which allows spouses to treat gifts made by one spouse as made one-half by each spouse, provides a limited window of time in which to do this: spouses may make such split gifts if they are married at the time of the gift <u>and</u> neither spouse remarries during that calendar year.

b. If one spouse is significantly wealthier than the other, this may be a point of negotiation, since the wealthier spouse has more to gain by splitting gifts with the less wealthy spouse.

4. Irrevocable life insurance trusts ("ILITs")

a. Divorce often requires one spouse to maintain life insurance in order to ensure payment of alimony and child support obligations. The separation agreement should permit or require the insurance to be owned by an ILIT for the benefit of spouse, children or both.

b. Ownership by an ILIT provides more control over how the life insurance proceeds are used to benefit spouse and children in accordance with the terms and spirit of the separation agreement, and also facilitates removal of the proceeds from the insured spouse's estate for estate tax purposes.

c. Be careful if using a pre-existing ILIT. They often have provisions that eliminate spouse or beneficiary upon divorce.

5. Insurance provisions in separation agreements generally terminate or wind down when the alimony and child support obligations terminate or as alimony and child support obligations decrease over time.

a. If the insurance policy reverts to the insured spouse upon the termination of the alimony obligations, this may result in the proceeds of the policy being includible in the deceased spouse's estate, whether the insured owns the policy or the spouse owns the policy.[27] However, the insured's estate may be entitled to an estate tax deduction.[28]

C. *QTIP Trusts*

As in the prenuptial setting, divorce agreements may provide for the transfer of assets from one spouse to the other. Often, the transferor spouse is reluctant to part permanently with the assets, recognizing that some or all of those assets may ultimately end up in the hands of a divorced spouse's new spouse or in other hands the transferor spouse considers undesirable. Use of a QTIP Trust to hold such property can mitigate this issue.

1. In order to avoid gift tax consequences, the transfer of the property into the QTIP Trust must occur before the final judgment of divorce.

a. This can create logistical issues that must be addressed.

b. For example, the separation agreement can provide that the property will be transferred into the QTIP Trust immediately or in a very short period of time prior to the divorce, thus obviating the transferor spouse's concern that the trust, which is irrevocable, will be created and the beneficiary spouse will subsequently refuse to go through with the divorce.

D. *Alimony Trusts*

In an alimony trust arrangement, property is held in trust for the benefit of the divorced spouse, with income paid to him or her in lieu of direct alimony payments from the transferor spouse.

1. These trusts can protect the assets from debts or insolvency of the payor spouse.

2. They also give the payor the assurance that the remaining corpus of the transferred property will ultimately pass to the desired remainder beneficiary

3. The trust can be managed by a third party.

4. This arrangement potentially avoids alimony recomputation under Code section 71(f), which penalizes the payor spouse for excessively front-loaded alimony arrangements.

E. *Tax Considerations*

1. Code section 682 provides that any income to which a beneficiary ex-spouse is entitled under an alimony trust is taxable to the beneficiary ex-spouse and not to the grantor of the trust (*i.e.*, the payor ex-spouse). This avoids the general grantor trust rules that could otherwise require the transferor spouse to include the income of the trust in his or her taxable income.

a. Under the grantor trust rules, the grantor is treated as holding any powers that are held by the grantor's spouse at the time of the creation of the power, even if the parties are subsequently divorced.[29] (The "once a spouse, always a spouse" rule.) If the spouses were married at the time the trust was created, then the transferee spouse's distributions of income would generally be included in the taxable income of the transferor spouse.[30]

b. However, under Code section 682(a), if the spouses are divorced or legally separated under divorce decree or separated under a written separation agreement, any income that one of the spouses receives or is entitled to receive from the trust will be included in the receiving spouse's income, rather than the income of the transferor spouse. This is true even if the trust was created before the parties were divorced or separated.[31] Keep in mind, however, that if the income is distributable to satisfy child support obligations rather than spousal maintenance, then it remains taxable to the grantor.[32]

c. The Tax Cuts and Jobs Act of 2017 strikes Section 682 for any divorce or separation instrument executed after December 31, 2018 and any divorce or separation instrument executed on or before December 31, 2018 that is modified after such date if the modification expressly provides that the change in the law applies to such modification.

IV. BLOCKING AND TACKLING – Attacking and Defending Pre-Existing Trusts in the Context of Marital Dissolution

A. Types of Trust

1. Some key terms:

a. Spendthrift Trust – a trust that restrains voluntary and involuntary alienation of all or any of the beneficiary's interests.[33]

b. Discretionary Trust – a trust in which distributions to the beneficiaries are left fully to the discretion of the trustee and not governed by a standard.

c. Support Trust – a trust in which the trustee has power to pay the beneficiary only so much of the trust income as is necessary for support, education, maintenance and health, or another ascertainable standard.

2. It is important to note that the difference between discretionary trusts and support trusts may be disappearing. The Restatement (Third) of Trusts does not distinguish between the two, viewing a support trust as a discretionary trust with a support standard.[34]

3. Variations in protection.

a. Discretionary trusts generally put sufficient limitations on the beneficiary's interest that the interest does not qualify as a property right subject to attachment or invasion by creditors. The argument is that if the beneficiary cannot compel a distribution from the trustee due to the trustee's discretion over distributions, then a creditor should not be able to obtain access to the assets in the trust either.[35]

b. In general, the courts will only compel a distribution when the beneficiary (or creditor) can show that there has been an abuse of discretion by the trustee. As a practical matter, this is a very difficult showing for a beneficiary or a creditor to make.

c. Support trusts are arguably less protected than discretionary trusts, since the existence of a support standard gives the beneficiary better footing to compel a distribution from the trust, if the distribution is necessary. However, it would seem that at most, a creditor could only gain access to such a trust to the extent that it can be shown that a particular portion of the trust is necessary to provide for the beneficiary's support or otherwise meet the standard.[36]

d. Spendthrift provisions support and underscore the protective nature of discretionary trusts. They generally invalidate any effort by the beneficiary to transfer his or her interest in the trust. Again, if the beneficiary cannot control his or her interest in the trust, the creditors should not be able to obtain access to it.

B. Structuring Trusts to Withstand Invasion by Spouses

1. Discretionary trusts are clearly preferable, since they offer the highest degree of creditor protection.[37]

2. While somewhat unusual, provisions in trusts can set out the settlor's intent that the trust not be used to satisfy any claims of a spouse or a child in a divorce.[38]

3. The Uniform Trust Code (the "UTC") illustrates the conflict inherent in this question. On one hand, Section 504 of the UTC is very protective of discretionary trusts; Section 504 protects a discretionary trust from invasion even if the beneficiary is the trustee and even if there is an ascertainable standard for distribution set out in the trust. On the other hand, Section 503 exists for the purpose of creating statutory exceptions to spendthrift provisions in trusts, and provides that a spendthrift provision is unenforceable against "(1) a beneficiary's child, spouse, or former spouse who has a judgment or court order against the beneficiary for support or maintenance; (2) a judgment creditor who has provided services for the protection of a beneficiary's interest in the trust; and (3) a claim of this State or the United States to the extent a statute of this State or federal law so provides". Thus, public policy considerations can be viewed as in conflict with the general goal of honoring a settlor's intent in creating a trust.

4. Pre-marital planning. In some states, settlors can create trusts prior to marriage, and the assets of those trusts are not subject to the claims of spouses.[39] Particularly in situations in which a prospective spouse is not willing to sign a pre-nuptial agreement, consideration should be given to placing substantial assets in trusts in such states prior to marriage.

C. Restructuring Pre-Existing Trusts

Married couples create a variety of trusts for each other's benefit and the benefit of their families. These trusts may have to be reconsidered if the couple divorces.

1. Examples

a. GRATs. A GRAT often provides that remaining balance of the trust, if any, after all annuity payments have been made, will be held in continuing trust for benefit of the grantor's spouse and/or issue.

b. Spousal Limited Access Trusts (SLATs) – often, the grantor's spouse is the primary beneficiary during his or her lifetime.

c. Qualifying Personal Residence Trusts (QPRTs)

2. Do-Over Methods for Dealing with Existing Trusts

a. Reformation. This is clearly allowed by the UTC[40] and by statutory and common law in many states. In certain circumstances, the UTC allows reformation and modification without judicial approval.[41]

b. Division. The ability to divide a trust into two or more separate trusts can be particularly helpful in negotiating a marital settlement agreement. For example, if both spouses want to control a trust for the benefit of their children, the trust can be divided into two, one trust to be controlled by each of the spouses. The UTC gives trustees broad powers to divide trusts.[42]

c. Decanting. At least 21 states have enacted decanting statutes. At least four other states have case law that appears to recognize a trustee's ability to decant assets.[43]

d. Dissolution of trust by distribution of remaining assets to the beneficiary spouse as part of a divorce settlement.

e. Restructuring approaches:

(i) If one spouse is serving as trustee, he or she may resign and the other spouse can be appointed as trustee if appropriate.

(ii) If the beneficiaries of a trust include all the issue of one of the spouses, the trust can be restructured so that it includes only issue of this particular marriage, to avoid the possibility that children born of a later marriage will be included within the beneficiary class.

f. Keep in mind tax consequences. For example, as set forth above under Code Section 672(e), the grantor still may be treated as the owner of the trust for income tax purposes regardless of the restructuring due to the "once a spouse, always a spouse" rule. The separation agreement should take this into account by, e.g., incorporating an agreement that the non-grantor spouse will reimburse the grantor spouse for any tax liability.

3. Specific Approaches

a. Inter Vivos QTIP Trust

(i) Dissolve the trust.

(ii) Grantor-spouse can purchase assets from the trust that are inappropriate to keep in the QTIP trust, e.g., interest in a grantor's family business.

b. QPRT

(i) QPRT rules make it challenging to restructure trust in many cases.

(ii) It may be possible to transfer a QPRT interest from one spouse to the other, but be careful of spendthrift provisions that might disallow such a transfer. Consider other modification techniques described above.

(iii) Make sure that any transfer is protected by Code section 2516 to avoid gift tax issues.

(iv) Grantor-spouse may still be liable for taxes on trust income. Consider reimbursement provision as discussed above.

c. GRAT

(i) Dissolution is prohibited by tax regulations.

(ii) Most restructures will also be prohibited.

(iii) Consider whether the "back-end" provisions setting forth the disposition at the conclusion of the GRAT term can be modified if one of the spouses is a potential beneficiary.

d. Charitable Remainder Trusts (CRUTs and CRATs)

(i) Divide charitable remainder trust into two separate trusts, one for each spouse.

(ii) The IRS has issued numerous private letter rulings concluding that division of the charitable remainder trust should not be subject to income tax, either because it is protected under Code section 1041 or because it was a non-taxable division of assets between joint owners.[44]

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[8] Aughinbaugh, Alison, Robles, Omar, and Sun, Hugette, *Marriage and Divorce: Patterns by Gender, Race, and Educational Attainment*, Bureau of Labor Statistics Monthly Labor Review, October 2013.
[9] *See*, *e.g.*, West's Ann. Cal. Fam. Code, section 2550; Vernon's Texas Stat. and Codes. Ann., Family Code, section 7.001.
[10] *See, e.g.,* N.J.S.A. 2A:34-23.1; McKinney's DRL, Section 236.
[11] *See, e.g.,* Connecticut General Stat. Ann. Section 46b-81; Massachusetts General Laws Ann. Ch. 208, Section 34.
[12] West's Colorado Rev. Stat. Ann., Section 14-10-113.
[13] N.J.S.A. 2A:34-23.1; McKinney's DRL, Section 236.
[14] West's Rev. Code of Washington Ann. Section 26.09.080.
[15] N.J.S.A. 2A:34-23.1; McKinney's DRL, Section 236; Connecticut General Stat. Ann. Sections 46b-82, 46b-84.

[16] Connecticut General Stat. Ann. Section 45a-437; N.J.S.A. 3B:5-3; McKinney's EPTL, Section 4-1.1.
[17] Connecticut General Stat. Ann. Section 45a-436; N.J.S.A. 3B:8-1 *et seq*.; McKinney's EPTL, Section 5-1.1-A.
[18] Connecticut General Stat. Ann. Section 46b-36a *et seq.*; McKinney's General Obligations Law, Section 3-303; N.J.S.A. 37:2-31 *et seq.*; *see also* Uniform Premarital and Marital Agreements Act, Uniform Law Commission (2012), available at http://www.uniformlaws.org/Act.aspx?title=Premarital%20and%20Marital%20Agreements%20Act.
[19] *Cf.* McKinney's EPTL Section 5-1.1-A(a)(4), reducing the surviving spouse's entitlement by amounts that pass "absolutely" to the surviving spouse, but not by amounts that pass in trust, with N.J.S.A. 3B:8-17, valuing the surviving spouse's life estate in any trust at one-half the total value of the trust.
[20] IRC section 2010(c)(4), (5).
[21] McKinney's DRL, Section 236(B)(3).
[22] Connecticut General Stat. Ann. Section 45a-257c; McKinney's EPTL, Section 5-1.4; N.J.S.A. 3B:3-14.
[23] *Id.*
[24] McKinney's EPTL, Section 5-1.4; N.J.S.A. 3B:3-14.
[25] N.J.S.A. 3B:8-1.
[26] IRC sections 401(a)(11), 417.
[27] IRC section 2042(2).
[28] IRC section 2043(b).
[29] IRC section 672(e)(1).
[30] IRC section 677(a)(1), (2).
[31] Treas. Reg. section 1.682(a)-1(a)(2).
[32] IRC section 682(a).
[33] Restatement (Third) of Trusts, Section 58, General Comment (2003).
[34] R.3d Trusts, Section 60, Comment a.
[35] *See* Restatement (Second) of Trusts, Section 155.
[36] *See* R.2d Trusts, Section 154.
[37] *See, e.g.*, R.2d Trusts, Section 155(1); R.3d Trusts, Section 60, Comment e; *First Northwestern Trust Co. of South Dakota v. Internal Revenue Service*, 622 F.2d 387 (8th Cir. 1980); *Read v. U.S. ex rel. Dept. of Treasury*, 169 F.3d 243 (5th Cir. 1999); Dessin, Carolyn L., *Feed a Trust and Starve a Child: The Effectiveness of Trust Protective Techniques Against Claims for Support and Alimony*, 10 Ga. St. U. L. Rev. 691 (1993-1994).
[38] *Erickson v. Erickson*, 266 N.W.2d 628 (Minn. 1943).
[39] *See, e.g.*, South Dakota Codified Laws, Sections 55-16-1 *et seq.*; West's Delaware Code Ann., Sections 3570 *et seq.*
[40] Unif. Trust Code Sections 410, 411, 412.
[41] Unif. Trust Code Section 411.
[42] Unif. Trust Code Section 417 (amended 2010).
[43] *See, e.g.*, McKinney's EPTL Section 10-6.6; *Phipps v. Palm Beach Trust Co.*, 196 So. 299 (Fla. 1940); *Wiedenmayer v. Johnson*, 254 A.2d 534 (N.J. Super. Ct. App. Div. 1969).
[44] *See, e.g.*, PLR 201029002; PLR 200814003; PLR 200728026; PLR 200616008; PLR 200539008.

APPENDIX A
TOP 10 THINGS MATRIMONIAL LAWYERS SHOULD KNOW ABOUT TRUSTS & ESTATES

1. In many states, divorce revokes bequests in a will and certain other features of an estate plan – but not until the divorce is final, so the client should change his or her estate planning instruments immediately when divorce process starts.
   - This means will, revocable trust if any, advance directive for health care, and power of attorney.
     - Make sure the new power of attorney revokes all previous ones.

2. In addition, these state laws regarding revocation on divorce may not apply at all to irrevocable trusts or beneficiary designations, so alternate planning such as modifying or "decanting" these trusts may be necessary.
   - Beneficiary designations should be updated.
   - Irrevocable trusts created by either spouse (or both spouses together) must be evaluated by a trusts and estates attorney.

3. It is important to deal with retirement assets in a prenuptial agreement, but spousal rights in retirement plans governed by ERISA can only be waived during the marriage, so more than just the prenuptial agreement is necessary.
   - The agreement should include a "further assurances" provision in which the clients agree that after marriage, they will waive these rights, with penalties for noncompliance.

4. Assets that are in a trust created before marriage, or a trust created during marriage by a third party, are separate property upon divorce.
   - Thus, if a client's future spouse is not open to a prenuptial agreement, creating an irrevocable trust before marriage can be an alternative.

5. Clients should change their estate planning instruments immediately upon marriage. If a pre-marriage will is not changed after the marriage, and the pre-marriage will does not provide for the spouse, state law may provide for such a "pretermitted spouse" in a different way than the client would want to. Also, there may be no help for a spouse who was not named as attorney-in-fact or health care representative, and thus such a spouse may not be able to handle an incapacitated spouse's assets or make medical decisions on his or her behalf.

6. If a prenuptial agreement calls for trusts, the terms of those trusts must be spelled out in the prenuptial agreement; it is not sufficient to describe a trust "for the benefit of" the spouse.
   - The particulars that must be spelled out include beneficiaries, distribution standards, trustees, trustee succession, and other features.
   - Otherwise, the client's goals may not be accomplished and the trustee may be in the position of having to manage a trust without any guidance as to the creator's wishes.
   - Run it by a trusts and estates attorney

7. Number 6 applies to separation agreements as well. If they call for trusts, the terms must be explicit and comprehensive, and must be approved by an attorney who regularly administers trusts.

8. Prenuptial agreements should deal with federal estate tax “portability”: the ability of a surviving spouse to use his or her deceased spouse’s unused estate tax exemption.
   - This is particularly important in a second marriage when both parties have children from a prior marriage. The unused exemption can be worth $2 million or more in the hands of the surviving spouse.
   - Portability is in the hands of the executor. If your client survives his or her spouse, and the deceased spouse’s executor is a child of the deceased spouse who does not have a good relationship with your client, the executor has the power to deny this valuable asset to your client and your client’s children.

9. In a prenuptial agreement or separation agreement, life insurance is an easy way to fund obligations on death.
   - However, make sure that it is the right kind of insurance, and that the client actually qualifies for and obtains the insurance.

10. Trusts are an essential tool in estate planning for second marriages, particularly if one or both of the spouses has children from a different relationship.
    - Trusts offer an opportunity for the client to provide for the current spouse while protecting the interests of the client’s own children. For example, a properly structured “QTIP” (qualified terminable interest property) trust can qualify for the valuable estate tax marital deduction while preserving the client’s ability to control what happens to the assets at the spouse’s death.
    - In general, the spouse must receive all the income from the trust. However, to decrease the potential for disputes between the spouse and the children over the investment of trust funds during the spouse’s life, the client can align those otherwise opposing interests by providing a “unitrust” interest instead of a straightforward income interest. This means the spouse receives a percentage of the total value of the trust’s assets each year, regardless of its actual income, so both the spouse and the children want to increase the principal of the trust.

APPENDIX B
SELECTED INTERNAL REVENUE CODE SECTIONS

NB The Tax Cuts and Jobs Act of 2017 strikes Sections 71, 215 and 682 for any divorce or separation instrument executed after December 31, 2018 and any divorce or separation instrument executed on or before December 31, 2018 that is modified after such date if the modification expressly provides that the change in the law applies to such modification.

§ 71. Alimony and separate maintenance payments

(a) General rule.--Gross income includes amounts received as alimony or separate maintenance payments.

(b) Alimony or separate maintenance payments defined.--For purposes of this section--

(1) In general.--The term "alimony or separate maintenance payment" means any payment in cash if--

(A) such payment is received by (or on behalf of) a spouse under a divorce or separation instrument,

(B) the divorce or separation instrument does not designate such payment as a payment which is not includible in gross income under this section and not allowable as a deduction under section 215,

(C) in the case of an individual legally separated from his spouse under a decree of divorce or of separate maintenance, the payee spouse and the payor spouse are not members of the same household at the time such payment is made, and

(D) there is no liability to make any such payment for any period after the death of the payee spouse and there is no liability to make any payment (in cash or property) as a substitute for such payments after the death of the payee spouse.

(2) Divorce or separation instrument.--The term "divorce or separation instrument" means-

(A) a decree of divorce or separate maintenance or a written instrument incident to such a decree,

(B) a written separation agreement, or

(C) a decree (not described in subparagraph (A)) requiring a spouse to make payments for the support or maintenance of the other spouse.

(c) Payments to support children.--

(1) In general.--Subsection (a) shall not apply to that part of any payment which the terms of the divorce or separation instrument fix (in terms of an amount of money or a part of the payment) as a sum which is payable for the support of children of the payor spouse.

(2) Treatment of certain reductions related to contingencies involving child.--For purposes of paragraph (1), if any amount specified in the instrument will be reduced--

(A) on the happening of a contingency specified in the instrument relating to a child (such as attaining a specified age, marrying, dying, leaving school, or a similar contingency), or

(B) at a time which can clearly be associated with a contingency of a kind specified in subparagraph (A),

an amount equal to the amount of such reduction will be treated as an amount fixed as payable for the support of children of the payor spouse.

(3) Special rule where payment is less than amount specified in instrument.--For purposes of this subsection, if any payment is less than the amount specified in the instrument, then so much of such payment as does not exceed the sum payable for support shall be considered a payment for such support.

(d) Spouse.--For purposes of this section, the term “spouse” includes a former spouse.

(e) Exception for joint returns.--This section and section 215 shall not apply if the spouses make a joint return with each other.

(f) Recomputation where excess front-loading of alimony payments.--

(1) In general.--If there are excess alimony payments--

(A) the payor spouse shall include the amount of such excess payments in gross income for the payor spouse's taxable year beginning in the 3rd post-separation year, and

(B) the payee spouse shall be allowed a deduction in computing adjusted gross income for the amount of such excess payments for the payee's taxable year beginning in the 3rd post-separation year.

(2) Excess alimony payments.--For purposes of this subsection, the term “excess alimony payments” mean the sum of--

(A) the excess payments for the 1st post-separation year, and

(B) the excess payments for the 2nd post-separation year.

(3) Excess payments for 1st post-separation year.--For purposes of this subsection, the amount of the excess payments for the 1st post-separation year is the excess (if any) of--

(A) the amount of the alimony or separate maintenance payments paid by the payor spouse during the 1st post-separation year, over

(B) the sum of--

(i) the average of--

(I) the alimony or separate maintenance payments paid by the payor spouse during the 2nd post-separation year, reduced by the excess payments for the 2nd post-separation year, and

(II) the alimony or separate maintenance payments paid by the payor spouse during the 3rd post-separation year, plus

(ii) $15,000.

(4) Excess payments for 2nd post-separation year.--For purposes of this subsection, the amount of the excess payments for the 2nd post-separation year is the excess (if any) of--

(A) the amount of the alimony or separate maintenance payments paid by the payor spouse during the 2nd post-separation year, over

(B) the sum of--

(i) the amount of the alimony or separate maintenance payments paid by the payor spouse during the 3rd post-separation year, plus

(ii) $15,000.

(5) Exceptions.--

(A) Where payment ceases by reason of death or remarriage.--Paragraph (1) shall not apply if--

(i) either spouse dies before the close of the 3rd post-separation year, or the payee spouse remarries before the close of the 3rd post-separation year, and

(ii) the alimony or separate maintenance payments cease by reason of such death or remarriage.

(B) Support payments.--For purposes of this subsection, the term “alimony or separate maintenance payment” shall not include any payment received under a decree described in subsection (b)(2)(C).

(C) Fluctuating payments not within control of payor spouse.--For purposes of this subsection, the term “alimony or separate maintenance payment” shall not include any payment to the extent it is made pursuant to a continuing liability (over a period of not less than 3 years) to pay a fixed portion or portions of the income from a business or property or from compensation for employment or self-employment.

(6) Post-separation years.--For purposes of this subsection, the term “1st post-separation years” means the 1st calendar year in which the payor spouse paid to the payee spouse alimony or separate maintenance payments to which this section applies. The 2nd and 3rd post-separation years shall be the 1st and 2nd succeeding calendar years, respectively.

(g) Cross references.--

(1) For deduction of alimony or separate maintenance payments, see section 215.

(2) For taxable status of income of an estate or trust in the case of divorce, etc., see section 682.

§ 215. Alimony, etc., payments

(a) General rule.--In the case of an individual, there shall be allowed as a deduction an amount equal to the alimony or separate maintenance payments paid during such individual's taxable year.

(b) Alimony or separate maintenance payments defined.--For purposes of this section, the term “alimony or separate maintenance payment” means any alimony or separate maintenance payment (as defined in section 71(b)) which is includible in the gross income of the recipient under section 71.

(c) Requirement of identification number.--The Secretary may prescribe regulations under which--

(1) any individual receiving alimony or separate maintenance payments is required to furnish such individual's taxpayer identification number to the individual making such payments, and

(2) the individual making such payments is required to include such taxpayer identification number on such individual's return for the taxable year in which such payments are made.

(d) Coordination with section 682.--No deduction shall be allowed under this section with respect to any payment if, by reason of section 682 (relating to income of alimony trusts), the amount thereof is not includible in such individual's gross income.

§ 682. Income of an estate or trust in case of divorce, etc.

(a) Inclusion in gross income of wife.--There shall be included in the gross income of a wife who is divorced or legally separated under a decree of divorce or of separate maintenance (or who is separated from her husband under a written separation agreement) the amount of the income of any trust which such wife is entitled to receive and which, except for this section, would be includible in the gross income of her husband, and such amount shall not, despite any other provision of this subtitle, be includible in the gross income of such husband. This subsection shall not apply to that part of any such income of the trust which the terms of the decree, written separation agreement, or trust instrument fix, in terms of an amount of money or a portion of such income, as a sum which is payable for the support of minor children of such husband. In case such income is less than the amount specified in the decree, agreement, or instrument, for the purpose of applying the preceding sentence, such income, to the extent of such sum payable for such support, shall be considered a payment for such support.

(b) Wife considered a beneficiary.--For purposes of computing the taxable income of the estate or trust and the taxable income of a wife to whom subsection (a) applies, such wife shall be considered as the beneficiary specified in this part.

(c) Cross reference.--

For definitions of “husband” and “wife”, as used in this section, see section 7701(a)(17).

§ 1041. Transfers of property between spouses or incident to divorce

(a) General rule.--No gain or loss shall be recognized on a transfer of property from an individual to (or in trust for the benefit of)--

(1) a spouse, or

(2) a former spouse, but only if the transfer is incident to the divorce.

(b) Transfer treated as gift; transferee has transferor's basis.--In the case of any transfer of property described in subsection (a)--

(1) for purposes of this subtitle, the property shall be treated as acquired by the transferee by gift, and

(2) the basis of the transferee in the property shall be the adjusted basis of the transferor.

(c) Incident to divorce.--For purposes of subsection (a)(2), a transfer of property is incident to the divorce if such transfer--

(1) occurs within 1 year after the date on which the marriage ceases, or

(2) is related to the cessation of the marriage.

(d) Special rule where spouse is nonresident alien.--Subsection (a) shall not apply if the spouse (or former spouse) of the individual making the transfer is a nonresident alien.

(e) Transfers in trust where liability exceeds basis.--Subsection (a) shall not apply to the transfer of property in trust to the extent that--

(1) the sum of the amount of the liabilities assumed, plus the amount of the liabilities to which the property is subject, exceeds

(2) the total of the adjusted basis of the property transferred.

Proper adjustment shall be made under subsection (b) in the basis of the transferee in such property to take into account gain recognized by reason of the preceding sentence.

§ 2042. Proceeds of life insurance

The value of the gross estate shall include the value of all property--

(1) Receivable by the executor.--To the extent of the amount receivable by the executor as insurance under policies on the life of the decedent.

(2) Receivable by other beneficiaries.--To the extent of the amount receivable by all other beneficiaries as insurance under policies on the life of the decedent with respect to which the decedent possessed at his death any of the incidents of ownership, exercisable either alone or in conjunction with any other person. For purposes of the preceding sentence, the term “incident of ownership” includes a reversionary interest (whether arising by the express terms of the policy or other instrument or by operation of law) only if the value of such reversionary interest exceeded 5 percent of the value of the policy immediately before the death of the decedent. As used in this paragraph, the term “reversionary interest” includes a possibility that the policy, or the proceeds of the policy, may return to the decedent or his estate, or may be subject to a power of disposition by him. The value of a reversionary interest at any time shall be determined (without regard to the fact of the decedent's death) by usual methods of valuation, including the use of tables of mortality and actuarial principles, pursuant to regulations prescribed by the Secretary. In determining the value of a possibility that the policy or proceeds thereof may be subject to a power of disposition by the decedent, such possibility shall be valued as if it were a possibility that such policy or proceeds may return to the decedent or his estate.

§ 2043. Transfers for insufficient consideration

(a) In general.--If any one of the transfers, trusts, interests, rights, or powers enumerated and described in sections 2035 to2038, inclusive, and section 2041 is made, created, exercised, or relinquished for a consideration in money or money's worth, but is not a bona fide sale for an adequate and full consideration in money or money's worth, there shall be included in the gross estate only the excess of the fair market value at the time of death of the property otherwise to be included on account of such transaction, over the value of the consideration received therefor by the decedent.

(b) Marital rights not treated as consideration.--

(1) In general.--For purposes of this chapter, a relinquishment or promised relinquishment of dower or curtesy, or of a statutory estate created in lieu of dower or curtesy, or of other marital rights in the decedent's property or estate, shall not be considered to any extent a consideration “in money or money's worth”.

(2) Exception.--For purposes of section 2053 (relating to expenses, indebtedness, and taxes), a transfer of property which satisfies the requirements of paragraph (1) of section 2516 (relating to certain property settlements) shall be considered to be made for an adequate and full consideration in money or money's worth.

<u>§ 2516. Certain property settlements</u>

Where a husband and wife enter into a written agreement relative to their marital and property rights and divorce occurs within the 3-year period beginning on the date 1 year before such agreement is entered into (whether or not such agreement is approved by the divorce decree), any transfers of property or interests in property made pursuant to such agreement--

(1) to either spouse in settlement of his or her marital or property rights, or

(2) to provide a reasonable allowance for the support of issue of the marriage during minority,

shall be deemed to be transfers made for a full and adequate consideration in money or money's worth.