

## Estate Planning for the Second Marriage

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### Agenda

- Who do you represent?
- Understanding Financial and Family Information and the Current Plan
- Background – Estate and Gift Tax
- Property law
- Pre-Marital Considerations
- Estate Planning Challenges
  - Obligation to Prior Spouse(s)
  - Elective Share Issues
  - Adequate Resources for the Spouse
  - Blended Families
  - Wealth Disparity
  - Age Disparity
  - Disposition of the Residence
  - Disposition of Tangible Personal Property
  - Inter Vivos QTIP Trust
  - Testamentary QTIP Trust
  - Tax Apportionment
  - Beneficiaries of Retirement Accounts and Life Insurance
- Conclusion

### Who Do You Represent? Ethical Considerations

- Need carefully drafted engagement letter
  - Disclaim any representation or responsibility for children
  - Model engagement letter on ACTEC website
- ABA Model Rules of Professional responsibility
- Joint representation v. representation of one spouse – Model Rules of Professional Conduct Rule 1.7
  - A lawyer shall not jointly represent clients if (1) the representation of one client will be adverse to the other or (2) there is a significant risk that the representation of one client will be materially limited by the lawyer's responsibilities to the other client.
- There is a non-waivable conflict in the joint representation of parties to a pre-nuptial
- Cover who you represent in the engagement letter

### Understanding Financial and Family Information and the Current Plan

- No "one size fits all"
- Obtain personal and financial information and objectives
- Requires balancing the spouse's divergent interests
- Most issues should be addressed before the marriage

### Background – Estate and Gift Tax

- \$5.43 million estate, gift and generation skipping tax exemption
- Portability of estate and gift tax exemption
  - Doesn't apply to generation skipping tax
- Federal estate tax not an issue for most couples
- Income tax planning important for most couples
  - Basis planning is important

### Property Law

- Separate property
- Community property

### Property Law

- General Rule – law of state where spouses reside at time either of them acquires title to an asset controls nature of ownership of that asset
- Character of property follows spouses as they move from state to state
- Community property states – regardless of how title is taken, it belongs to the marital partnership in the absence of a written agreement to the contrary
- Common law states – property acquired during marriage is deemed to be the separate property of the spouse who acquired it

### Property Law

- Separate property
  - Owned by spouse before marriage
  - Acquired during marriage by gift, devise or inheritance
  - Income, increase or profits of separate property
  - Assets acquired during marriage with separate funds or with the proceeds of the sale of separate assets

## Property Law

- Separate property
  - Owner-spouse retains full ownership of his/her separate property in the event of a divorce and retains ability to dispose of such property at death
    - Exception: a different distribution of the separate property is otherwise required under a marital property agreement

## Property Law

- Community property
  - All property acquired during marriage that is not separate property
  - Results of spouse's labor during marriage
  - Is owned equally by spouses during the marriage
  - At death, deceased spouse may dispose of his half of the community property
    - A non-pro rata division of the community estate upon the death of the first spouse should be authorized in the deceased spouse's will
  - Not automatically divided equally between the spouses in the event of a divorce
    - equitable distribution
  - Spouses can override community property provisions in a marital property agreement
  - Presumption – all assets acquired during marriage by either spouse presumed to be community property
    - Thus, the need for adequate records
    - Burden on spouse claiming property is not community property

## Property Law

- Summary – spouses must:
  - Understand the basics of community property
  - Understand what happens to property:
    - At death,
    - Upon divorce,
    - Who manages property during marriage,
    - For liability purposes i.e. creditor claims
    - How the assets are taxed

## Property Law - Death

- Probate property passes by will
  - 100% of separate property and decedent's one-half of community property
- No will – probate property passes by intestacy
  - Separate property – see intestacy statute
  - Community property – one half to surviving spouse, balance per intestacy statute
- Non-probate property
  - Joint property – to surviving joint tenant(s) by operation of law
  - POD – named beneficiary
  - Retirement assets, life insurance – to named beneficiary
  - Revocable trust – according to trust terms

## Property Law

- Have a marital property agreement – recommended alternative
  - Clarifies the character of the property and the income generated by the property
  - What is separate and what is community property
  - Provide manner of property division in event of death or divorce

## Pre-Marital Considerations

- 40% of marriages are entered into with a “pre-owned” spouse
- Clients in second marriages most likely have accumulated substantial assets
- Use a prenuptial agreement or post-nuptial agreement
- Uniform Premarital Agreement Act – Adopted by Arizona
  - Adopted in 27 states
  - Provisions differ from state to state
- Prenuptial agreement requirements - in general:
  - Independent counsel – Barry Bond’s pre-nup invalid – wife didn’t have atty
  - Timing
  - Financial disclosure

### Pre-Marital Considerations - Support Obligations

- Basic necessities
- Property settlement in divorce
- Statutory forced share
- Importance of a pre-nuptial agreement
  - What spousal rights are waived
  - Property subject to the waiver
  - Property or other rights to be provided to spouse in the event of divorce or death
  - Other issues
- Post-marital agreement
  - In the event a pre-nuptial agreement wasn't entered into

### Pre-Marital Considerations

- Review estate plan for necessary changes
- State law may revoke will or certain provisions in favor of former spouse upon divorce
  - UPC §2-804 revokes will provisions in favor of a decedent's former spouse, and revokes any disposition of property, grant of a power of appointment, nomination as a fiduciary in favor of the decedent's former spouse or a relative of the former spouse under any governing instrument, including beneficiary designations executed by the decedent prior to the divorce.
- Review/change former spouse's designation as executor/personal representative, attorney-in-fact, health care agent, trustee, beneficiary of retirement plan/life insurance
  - Trusts may be needed to protect interests of minors e.g. minor as IRA beneficiary
- Does state law revoke a will upon remarriage?



### Pre-Marital Considerations

- Remove assets from reach of future spouse
- Transfer securities, real estate or business interests to FLP or LLC and make gift of partnership or LLC interests to children
- If personal residence is valuable asset, create QPRT to remove it from reach of future spouse
- Are there any obligations, liens, judgments or agreements that would affect your financial future
  - Tax liabilities
  - Student loan
  - Health issues
  - Obligation to support wife and children

### Pre-Marital Considerations

- Specific property rights to consider
  - Alimony and spousal support
  - Waiver of child support, custody and visitation not permitted by UPAA
  - Equitable distribution of property on divorce or death
  - Residence
  - To receive damages for wrongful death or loss of consortium
  - Interests in retirement plans
    - Rights to certain qualified plan benefits cannot be waived in a prenuptial agreement
    - Prenuptial agreement should include a provision requiring the parties to execute a confirmation of a timely waiver after the wedding
    - If spouse agrees to waive rights after marriage and doesn't do so, have a clause that other provisions for spouse's benefit are reduced by the value of the retirement benefits received
    - If a client is obligated by a prior agreement to maintain a former spouse as the beneficiary of a qualified plan, the new spouse's waiver may still be required.
  - Rights against the will
    - To elect against the will and take statutory forced share
    - Rights as intestate successor
    - Rights as pretermitted spouse
    - Family allowance rights
    - Homestead rights
    - To serve as executor or trustee

## Pre-Marital Considerations

### CONSIDER THE TAX AND LEGAL CONSEQUENCES

- Gifts before marriage are subject to gift tax
  - Example: \$9 million, 2.5 carat blue diamond engagement ring
  - Taxable gift
  - Sales tax issue
  - Deliver coupon redeemable for ring after wedding?

## Pre-Marital Considerations

### PRESERVE TAX-FREE TREATMENT UNDER §1041 and §2516

- Premarital agreement should have provision to include financial provisions of prenuptial agreement in the divorce agreement so the financial provisions of the prenuptial agreement will be non-taxable under §1041 and §2516
  - For property transfers made more than a year after divorce, §1041 requires the property settlement be covered by the divorce agreement
  - For §2516 to apply, the property settlement must be in the divorce decree and the agreement must be executed one year prior to or two years after the divorce agreement

### Pre-Marital Considerations - Portability

- \$5.43 million exemption per person, \$10.86 million exemption per couple
- Permanent
- Grows with inflation
- If exemption not used, it is portable
- Must file estate tax return to be entitled to portability
- Takes most estates out of a taxable situation
- Want to address portability election in estate planning documents
  - Whether the election will be made
  - Who will have authority to make the election
  - Who will bear cost associated with filing the portability election
  - Providing for portability in prenuptial agreement

### Pre-Marital Considerations - Portability

- Think of the DSUE amount as an asset
- Disclosure of lifetime taxable gifts to determine the amount of the DSUE

### Pre-Marital Considerations - Portability

- Problem – Husband's child from prior marriage is executor of the estate.
- Child and step-mother don't get along
- Child refuses to make the portability election

### Pre-Marital Considerations - Portability

- Solution – agree in pre-nuptial/marital agreement that each spouse's estate is required to file a Federal estate tax return and elect portability if requested by the surviving spouse
- To ensure that there will be a DSUE amount remaining for the surviving spouse, the pre-nuptial agreement should provide that (a) any future use by one spouse of his/her lifetime gift tax exclusion amount requires the consent of the other spouse and (b) the executors of the first spouse must set aside a prescribed minimum amount of unused exclusion amount for the surviving spouse
- To facilitate the election, Wife could agree to add provision requiring her to pay all costs relating to the filing of the estate tax return for the Husband's estate.

## Pre-Marital Considerations - Portability

### PORTABILITY AND QTIP ELECTION

- Leave assets to QTIP, remainder to kids from prior marriage
- Gives surviving spouse a larger portable amount
- Agree in prenuptial agreement that portability election will be made if the surviving spouse agrees to waive reimbursement right under §2207A
- QTIP won't be reduced by estate taxes attributable to increase in surviving spouse's gross estate due to inclusion of QTIP
- Otherwise, surviving spouse could make gifts of his/her assets to his/her own heirs using the deceased spouse's DSUE amount

## Estate Planning Challenges – Obligations to Prior Spouse(s)

- Obtain and review any and all marital agreements
  - Avoid clients like Mickey Rooney (8), Liz Taylor (8), Larry King (8), Jerry Lee Lewis (7), Billy Bob Thornton (6), Kenny Rogers (5), Geraldo Rivera (5), Martin Scorsese (5), Frank Sinatra (4), Louis Armstrong (4), Cheryl Tiegs (4), Christie Brinkley (4)
- Ensure client complies with support obligations owed to prior spouse and/or children from prior marriage and marital property agreements
  - Estate planning attorneys should make sure obligations from a prior marriage are incorporated into the current estate planning documents.
    - Establishing and funding any required trusts
    - Purchasing any necessary insurance
    - Designating beneficiaries of life insurance and retirement plans
    - Complying with contractual provisions of separation and marital agreements

### Estate Planning Challenges – Obligations to the First Spouse

- Johnson v. Johnson
  - Divorce decree provided Mr. Johnson leave percentage of his estate to his children by a prior marriage
  - He and his ex-wife made “extra judicial modification” to the decree
  - He left entire estate to his third wife, Barbara
  - Children eventually received over \$100 million
  - Barbara brought malpractice claim against draftsman claiming, in part, that they knew or should have known that, under local law, a modification of a divorce decree not entered as a judgment was invalid

### Estate Planning Challenges – Elective Share Issues

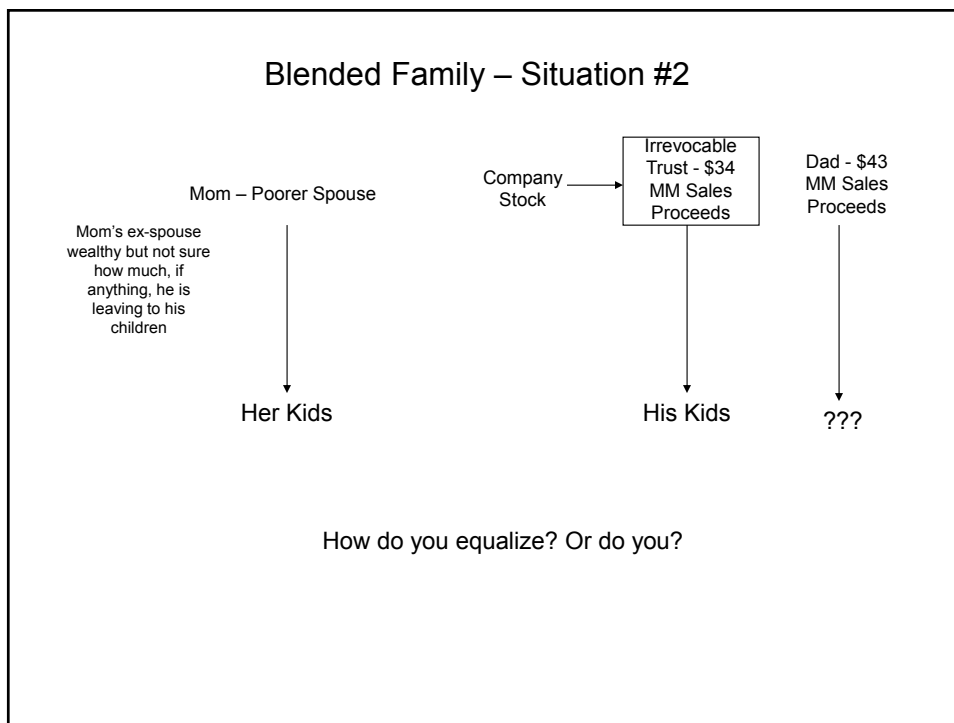
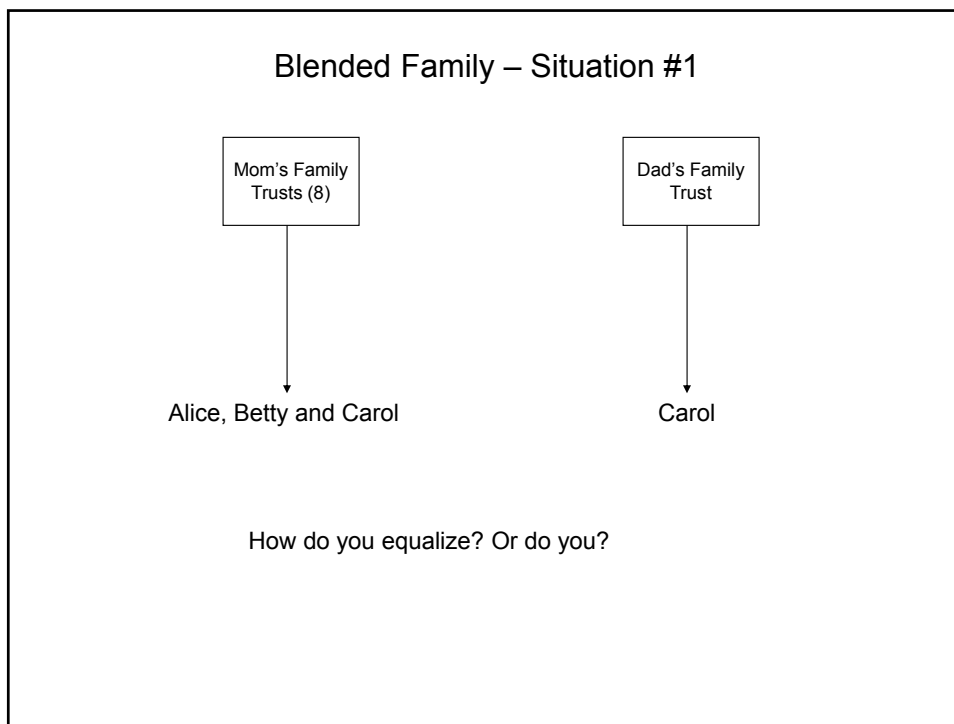
- Statutory forced share
- Amount differs state to state
- Uniform Probate Code Sections 2-202 through 2-209 uses the concept of an “augmented” estate
- Surviving spouse’s exercise of elective share can upset the dispositive provisions of an estate plan
- Drafting attorney should formulate an estate plan that disincentivizes or precludes the surviving spouse from exercising his/her elective share rights
  - Waiver in a pre-nuptial agreement may be the only certain method ensuring that a surviving spouse will not exercise his/her elective share rights

### Estate Planning Challenges - Adequate Resources for the Spouse

- Provide for adequate resources under the estate plan
- Ensure that assets not needed for spousal support pass to your descendants
  - Avoid outright transfer of assets to spouse
  - Use a trust

### Estate Planning Challenges – Blended Families

- The Brady Bunch
- Obtain an understanding of the family dynamics
  - Relationships between spouse's children from prior marriage, and children from current marriage
  - Children may not want step-parent to be trustee of their trust
- What resources are available to each child?
- Will children from a prior marriage receive a substantial inheritance from a client's ex-spouse or the ex-spouse's family?
- Any agreements in place that obligates former spouse to make specific provision for children in his/her estate plan?
- Consider life insurance to fund step-children's inheritance





### Estate Planning Challenges – Blended Families

- Guardianships for minor children
  - Who can designate guardians?
  - Can “custodial parent” name his/her second husband as guardian?

### Blended Families - Estate Planning Issues

- Inequity of having adult children from first marriage who have already received financial assistance (e.g. college) and minor children by second marriage. How do you equalize?
- Tax-favored spousal options for retirement plan assets may lead to children by first marriage losing out e.g. leave retirement assets O/R to wife, she rolls to IRA and names as beneficiaries those other than Husband’s children by the first marriage.
- Both spouses have children by other marriages – how to treat children equally, especially if children of one spouse may be beneficiaries of a trust that does not include children of the other spouse.
- Power of attorney language allowing attorney in fact to alter principal’s estate plan – dangerous in a blended family
  - Perhaps agent should account to a third party if principal becomes incapacitated

### Estate Planning Challenges – Wealth Disparity

- How to take advantage of poorer spouse's \$5.43 million gift and estate tax exemption
- Portability makes this less of a problem
- Does wealthier spouse spend more lavishly on his/her children than the less wealthy spouse?
- Balancing credit shelter trust v. portability
  - Asset protection
  - Utilize state estate tax exemption
  - Spouse not capable of managing assets
  - Second marriage, blended family
  - Exclusion from estate of surviving spouse
  - Allocation of GST exemption

### Estate Planning Challenges – Age Disparity

- Trophy spouse syndrome
- Perception of a “gold digger” – resentment by children
  - Chuck Yeager
- Spouse may be same age or younger than other spouse's children
- Better chance of undue influence
- Computation of minimum required distributions for IRAs
- Example: litigation arising from marriage of 89 year-old billionaire J. Howard Marshall to 26 year-old Vickie Lynn Marshall (a.k.a. Anna Nicole Smith)

### Estate Planning Challenges – Age Disparity

- Normally, children's inheritance is protected by using a QTIP trust
- May be no need for QTIP given the large estate tax exemption
- Age disparity may make QTIP trust inadvisable
  - Adult children of the older spouse won't want to wait until the death of the younger spouse to receive their inheritance
- Alternatives to a QTIP trust
  - Outright inheritance to children
  - ILIT fbo children
  - QTIP capped at fraction of the estate

### Estate Planning Challenges - Disposition of the Residence

- Cover in marital property agreement or pre-nuptial agreement
- Divorce
  - Separate property, owned by spouse as separate property
    - Right of reimbursement if community property funds or separate property funds of non-owner spouse used to benefit the residence
  - Community property – determined by court
- Death
  - Separate property, owned by spouse as separate property
    - Right of reimbursement if community property funds or separate property funds of non-owner spouse used to benefit the residence
  - Community property – each spouse has testamentary control over his share
    - Right of reimbursement if spouse's separate property used to benefit the residence

### Estate Planning Challenges - Disposition of Tangible Personal Property

- Typically left to surviving spouse in first marriage
- May not work in second marriage due to the client's descendant's emotional or sentimental value
- Consider transferring to intended beneficiary during life

### Estate Planning Challenges - Inter Vivos QTIP

- Technique to use poorer spouse's estate tax exemption but allow the wealthier spouse to retain control of the remainder interest
- Wealthier spouse transfers assets to an inter vivos QTIP fbo the poorer spouse
- Also allows grantor to use the poorer spouse's unused GST exemption
  - If skip persons are remaindermen of the QTIP trust, distributions passing to remaindermen at poorer spouse's death will be deemed to have been made by the poorer spouse so the poorer spouse's GST exemption can be used

### Inter Vivos QTIP – Statutory Requirements

- Spouse is a U.S. citizen
- Spouse has a qualifying income interest for life in the trust principal payable annually per Section 2523(f)(2)
- Spouse not required to have any rights over principal
  - Grantor can give trustees discretion to distribute discretionary principal to spouse
  - Typically, spouse is given a special testamentary power of appointment
- Funds transferred to trust qualify for the gift tax marital deduction under Section 2523(a)
- Trust is included in the spouse's gross estate under Section 2044
- Election must be made to qualify trust as a QTIP trust by filing a gift tax return in the year the transfer to the trust is made. Section 2523(f)(4).
- Election, once made, is irrevocable

### Inter Vivos QTIP – Tax Ramifications

- Grantor may reserve for himself/herself a lifetime interest in the trust in the event the poorer spouse predeceases the grantor, as long as the lifetime interest does not grant the grantor the power to alter, amend, revoke or terminate the trust. Reg. 25.2523(f)-1(d).
  - Grantor could retain secondary life estate, right to invade principal subject to an ascertainable standard and a special power of appointment
  - Risk: may be treated as self-settled trust reachable by creditors, meaning assets are includible in Grantor's gross estate as a constructive general power of appointment
- Filing deadline for making the QTIP election is fixed by statute
  - Limits IRS' discretion to grant extension of time to make election
- Under Section 672(e)(1)(A), inter vivos QTIP trust is a grantor trust
  - Grantor is treated as holding any power or interest granted to his/her spouse
- In the event of divorce, Section 682(a) provides that the income of the trust is thereafter includible in the beneficiary spouse's income
- The grantor may serve as trustee. Section 2523(f)(5) should not cause inclusion in the grantor's gross estate
  - May be included if the trust allows the grantor to make discretionary distributions of principal to the spouse.

### Inter Vivos QTIP – Tax Ramifications

- Provides for planning opportunities if funded with assets which may be discounted for lack of marketability or lack of control.
- At death of poorer spouse, assets held individually are valued separately from assets held in QTIP trust for his/her benefit. Estate of Mellinger v. Commissioner, 112 T.C. 26 (1999)
  - For example, if poorer spouse's gross estate contains real property part of which is held in the QTIP trust and part of which is held individually, both portions are deemed to be held independently and are thus eligible for separate valuation discounts.

### Inter Vivos QTIP – Divorce

- Individual may create a new QTIP trust for each spouse that he/she marries
- Inter vivos QTIP is not terminated by divorce
  - Former spouse will retain his/her income interest for the remainder of his/her life, even if he/she remarries
  - Trust may be drafted so that a trustee's discretionary right to invade principal for the benefit of the spouse is contingent upon being married to the grantor

### Inter Vivos QTIP – Tax Ramifications

- Upon death of donee spouse, assets get step-up in basis because they were included in the donee spouse's estate under §2044
  - Exception: if donee spouse dies within a year of the gift and the assets are returned to the donor. §1014(e).

### Testamentary QTIP

- Spouse is a U.S. citizen
- Spouse has a qualifying income interest for life payable annually
- Trustee can't distribute principal to anybody but spouse during his/her life
- Election must be made to qualify trust for estate tax marital deduction under Section 2056(b)(7)
- Trust is included in the spouse's gross estate under Section 2044

### Testamentary QTIP - Disadvantages

- Children must wait for step-mother or step-father to die before they can get distribution from the trust
- Surviving spouse's estate has power under Section 2207A to recover from the trust any estate tax due to the inclusion of the QTIP trust in the surviving spouse's estate
  - This could be significant and will reduce the amount ultimately available for the remaindermen
- In UPIA states, power to adjust may be used to increase the amount of income the spouse receives

### Testamentary QTIP - Advantages

- Provides surviving spouse with income interest for life and, if desired, discretionary rights to principal
- Grantor retains control over the remainder interest
- Qualifies for the Federal estate tax marital deduction



### QTIP - Estate Planning Issues

- Spouses unlikely to leave assets outright to each other and risk losing control – QTIP type trust likely to be employed
- Children from first marriage required to survive their stepmother in order to obtain their inheritance. Big deal if wife is in same (or lower) generation as the husband's children
- Children from husband's first marriage, as remainder beneficiaries of a QTIP trust, may challenge discretionary distributions from a QTIP trust
- If wife is trustee of QTIP trust, children from Husband's first marriage may challenge investment decisions – wife, entitled to mandatory income distributions, may weight investments to income producing assets.

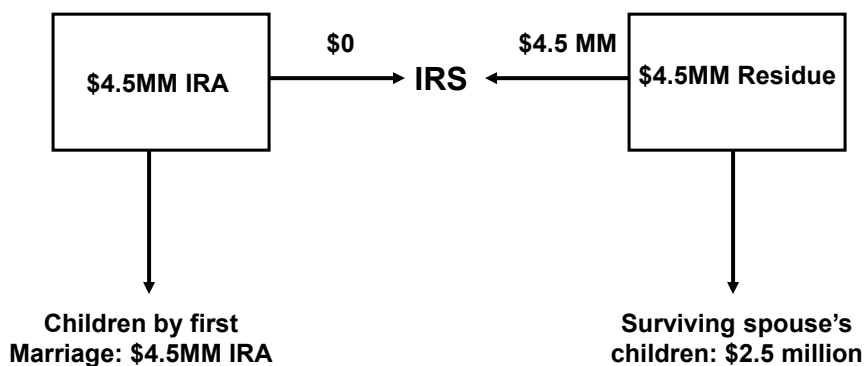
### QTIP - Estate Planning Issues - Solutions

- Carve out portion for Wife – dollar amount or percentage of estate
  - Distribute outright or in trust
  - Wife has complete dispositive discretion at her death
  - Husband's children are not remainder beneficiaries
  - Default beneficiaries are Wife's own children or beneficiaries of her choosing
- Use unitrust QTIP to avoid disputes over investing for income versus growth
- Alternatively, create an ILIT fbo Husband's children – gives them liquid assets at Husband's death. Balance of estate passes to Wife O/R or in trust
- Use an independent trustee to avoid accusation by Husband's children that wife (as trustee) favors income over remainder beneficiaries
  - Authorize independent trustee to make discretionary distributions
- Special planning needed for family business, vacation home
  - In trust fbo Wife for life, remainder to children
  - Wife has no dispositive authority at death

### Estate Planning Challenges - Tax Apportionment

- Draft tax apportionment provisions to ensure that one spouse's children are not inadvertently burdened with taxes attributable to property passing to their stepsiblings.
- Sections 2206 allows an executor to recover, pro rata, from the beneficiaries of any life insurance policies that are included in the gross estate
- Section 2207 allows an executor to recover, pro rata, from beneficiaries of property included in the gross estate by virtue of a decedent's power of appointment.
- Section 2207A allows the executor to recover from a QTIP trust any estate tax due to the inclusion of the QTIP property in the surviving spouse's gross estate absent a specific waiver in the surviving spouse's will
- Watch all tax from residue clauses

### \$9 Million Estate, All Tax From Residue, 50% FET



### Estate Planning Challenges – Beneficiaries of Retirement Accounts and Life Insurance

- IRA – See Uniform Probate Code
- Qualified plans – governed by ERISA

### Naming Beneficiary After Divorce CASE #1 - FACTS

- Wife named as beneficiary on husband's IRA
- Couples gets divorced
- Wife agrees she's not entitled to husband's assets
- Also waives any right she has in husband's assets
- Husband remarries
- Completes new paperwork for IRA but names no beneficiary
- Husband dies – ex-wife and new wife claim the IRA

Who Gets the IRA???

### Beneficiary After Divorce REASONING

- Wife #1's right in IRA was revocable prior to death
- At time of divorce, she had no property interest in IRA
- At time of divorce, Wife #1 had no rights to surrender
- At death, IRA beneficiary became irrevocable
  - Wife #1 was beneficiary

PaineWebber Inc. v. East, Maryland Court of Appeals (March, 2001)

### Naming Beneficiary After Divorce CASE #2 - FACTS

- Wife named as beneficiary of husband's pension
- Couple gets divorced
- Husband neglects to change pension beneficiary
- Husband dies 2 months after divorce
- State statute says divorce revokes beneficiary designation of ex-spouse
- Ex-wife and kids by previous marriage claim pension

Who Gets the pension???

### Beneficiary After Divorce REASONING

- ERISA preempts state law that revokes beneficiary designations
- ERISA says beneficiary is determined by state law
- Under state law (Washington), ex-wife was named the beneficiary

### The Ex-Wife

Egelhoff v. Egelhoff, United States Supreme Court, March 21, 2001

### Naming Beneficiary After Divorce Case #3 - Facts

- Wife named as beneficiary on husband's pension
- Couple gets divorced
- Wife gives up all rights to pension under divorce decree
- Husband neglects to change pension beneficiary
- Husband dies
- Estate sues claiming rights to plan benefits

**Who Gets the Pension???**

### Naming Beneficiary After Divorce Case #3 - Reasoning

- ERISA plan documents trump the waiver in the divorce decree
- Plan documents, of which beneficiary designation is part, govern who gets plan benefits
- Bottom line: plans documents govern who gets plan benefits
- Aside: estate may have contract claim against ex-wife

### The Ex-Wife

Kennedy v. DuPont, 555 U.S. \_\_\_\_ (2009)

### Beneficiary After Divorce MESSAGE

**AFTER DIVORCE,  
CHANGE THE BENEFICIARY!!!**

## Conclusion

- Who do you represent?
- Understanding Financial and Family Information and the Current Plan
- Background – Estate and Gift Tax
- Property law
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I'm Done  
Go Home