WHEN ESTATE PLANNING AND MARITAL AGREEMENTS COLLIDE (PART 2)

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There is much to be gained from cross-discipline collaboration between matrimonial and estate planning attorneys when planning for our clients. Divorce is an aspect of planning for the modern family that cannot be ignored or downplayed. Part 1 of this article, which appeared in the October 2022 issue of The Practical Lawyer, examined how a client's premarital agreement may be drafted to account for a possible future divorce. Part 2 of this article examines pre-divorce estate planning instruments, including trusts, as well as ways to plan for the possibility of a beneficiary's divorce in a senior generation's estate plan.

GENERAL CONSIDERATIONS

When estate planning counsel represents both spouses, ethical obligations typically preclude unilateral assistance to one of the parties with regard to pre-divorce planning. Once it becomes clear that an individual is heading toward divorce, he or she should have his or her estate plan, asset titling, and beneficiary designations reviewed. It may be appropriate to remove the spouse as fiduciary and/or modify other provisions in an existing plan that grant the spouse the ability to remove and appoint fiduciaries or exercise powers of appointment.

In addition, for an irrevocable trust instrument that provides the spouses to be deemed automatically deceased upon the filing of a divorce action or separation, the options and desired outcomes for whether that should be changed in some way (e.g., via the exercise of powers of appointment or decanting) should be considered before filing the action.

A party should proceed with caution in taking unilateral steps before a divorce action is filed. A spouse should avoid an obvious prohibition such as a fraudulent conveyance. While married, in many states, each spouse is considered a fiduciary to the other and, as such, would be subject to fiduciary duties.

Some states have automatic temporary restraining orders that are imposed upon the filing and/or service of a divorce action. California's restrictions, for example, restrain:

> both parties from cashing, borrowing against, canceling, transferring, disposing of, or changing the beneficiaries of insurance or other coverage, including life, health, automobile, and disability, held for the benefit of the parties and their child or children for whom support may be ordered; both parties from creating a nonprobate transfer or modifying a nonprobate transfer in a manner that affects the disposition of property subject to the transfer, without the written consent of the other party or an order of the court.[1]

Exceptions to the restraints include the:

> (1) Creation, modification, or revocation of a will; (2) revocation of a nonprobate transfer, including a revocable trust, pursuant to the instrument, provided that notice of the change is filed and served on the other party before the change takes effect; (3) elimination of a right of survivorship to property, provided that notice of the change is filed and served on the other party before the change takes effect; (4) creation of an unfunded revocable or irrevocable trust; and (5) execution and filing of a disclaimer pursuant to Part 8 (commencing with Section 260) of Division 2 of the Probate Code.[2]

These sections are important for estate planners. The client can create a trust, but cannot fund it. They can only revoke a trust with notice. They can draft a new will, but it will likely be temporary. Perhaps they can draft a pour-over will to fund the new trust.

Other states allow for, or do not prohibit, many kinds of planning during a divorce. Additionally, planners should keep in mind that there is a difference between planning that may alter a spouse's statutory property interests, and planning that does not modify rights on death, or that designates a spouse as a presumptive fiduciary, such as medical powers of attorney.

It is also critical to understand whether the relevant state has a revocation-upon-divorce statute and how it is applied. There are approximately two dozen states that have revocation of probate and nonprobate assets upon divorce statutes. A majority of the statutes are based on section 2-804 of the Uniform Probate Code (UPC). The most notable section of the revocation statutes based on UPC section 2-804 is that if the revocation statute is preempted by federal law, the former spouse who remains named as the beneficiary or survivor "is obligated to return that payment, item of property, or benefit, or is personally liable for the amount of the payment or the value of the item of property or benefit, to the person who would have been entitled to it were this section or part of this section not preempted."[3]

TRUSTS

Challenging legal issues arise when one spouse involved in a divorce is also the beneficiary of an irrevocable trust. As a preliminary matter, the rules concerning the treatment of trusts when dividing up marital property are substantially different than those that apply to the division for support purposes. The resolution of property division and support claims are largely based on state law, public policy, and the terms of the trust. All trusts should be reviewed to determine what powers exist, by whom they are held, and whether changes are possible and appropriate, not only as to fiduciary designations but also as to dispositive provisions. There is generally no revocation on divorce of an ex-spouse's interest in an irrevocable trust. Does the trust dictate what occurs if the parties divorce or legally separate? What powers does a spouse have as a fiduciary? Are the dispositive provisions in favor of the spouse mandatory or discretionary? How do the trusts benefit the children? How might the trusts be considered in any future support obligations? Are there any letters written by the trustee, giving insight as to the trustee's intent with respect to future distributions? While spendthrift trusts are generally beyond the claims of creditors, courts often recognize the expenses of supporting a beneficiary to include the legal obligation to support a spouse and children. If changes may be made, what changes (removal and replacement of trustees, exercise of a power of appointment, conversion to a unitrust, modification, decanting, or severing into multiple trusts) might be recommended?

A divorcing spouse's enforceable right to the assets in the trust makes it much more likely that the assets will be part of the marital estate. If an interest in an asset is determined to be a mere expectancy, on the other hand, those assets are much less likely to be included in the marital estate of the divorcing parties. Fully discretionary trusts offer the greatest level of protection to a beneficiary; the beneficiary typically has no present, enforceable interest in the trust property, cannot compel distributions, and must rely on the trustee's exercise of discretion. Community property states will not treat property in trusts as community property if they were inherited or gifted, although some community property states treat the interest and dividends as community property.

An irrevocable trust is not always set in stone. Many of these trusts (even domestic asset protective trusts (DAPTs)) are drafted to be flexible. If sufficiently flexible, or if it can be modified, the trust may become a useful vehicle for carrying out the terms of the premarital agreement. Any trust should be reviewed for the following flexible provisions:

- Anyone holds a power—either under the trust instrument or pursuant to applicable state law—to "decant" the trust (i.e., distribute its assets into another trust with different terms);
- The trust can be modified under state law by consent of certain parties or upon petition to an appropriate court;
- The trust's situs can be moved to a jurisdiction that permits decanting or modification by consent;
- Anyone has the power to add beneficiaries;
- Anyone has a power of appointment;
- Anyone has the power to remove and replace an uncooperative trustee;
- Anyone has the power to substitute trust assets for assets of equivalent value (a "swap" power); and
- A trust-owned life insurance policy can be sold from the existing trust to a new life insurance trust with different terms.

TRUSTS ESTABLISHED DURING THE MARRIAGE BY THE MARRIED COUPLE

Insurance trusts

Insurance trusts are commonly established by married couples. Since dissolution settlements often include insurance requirements, existing trusts and coverage should be reviewed to determine if still feasible to use, or adapt, for this purpose, and whether modification of the insurance coverage may result in reduced premiums. If the flexibility is inadequate, new insurance, and perhaps new trusts, may have to be considered.

Survivorship insurance will often become unnecessary post-divorce as a result of the division of the estate. If the trust provides for sufficient flexibility, the divorcing couple may wish to keep a policy in force to benefit the children or other designated heirs. If this is done, then the property settlement agreement (PSA) should address payment of future premiums. Even if the policy is converted into a paid-up policy, the possibility of additional premium payments should be addressed (e.g., if the policy underperforms the projections).

Qualified personal residence trust

A qualified personal residence trust (QPRT) is often used to leverage a gift of a valuable primary residence or vacation home to the next generation. Divorce is rarely considered when drafting these trusts. In the event of divorce several issues arise that will have to be addressed; the threshold issue will be whether it is economically feasible to retain the home.

Because the QPRT is an irrevocable trust, it cannot easily be changed. Court approval might be available in a matrimonial context, especially if the home is the primary asset and settlement and financial protection of minor children is not possible without unwinding the trust. If an independent buyer is not feasible or desired (e.g., because one spouse will retain the house), then it can perhaps be sold to the ex-spouse for a note. The note might then be distributed out of the QPRT as part of the PSA. This approach, while not intended or perhaps recommended, may not be a red flag to the IRS because the taxpayers will have used the applicable exclusion on funding without any benefit if the QPRT is terminated. The ex-spouses may prefer the loss of the applicable exclusion given their new financial situation resulting from the divorce, the desire to conclude a property settlement, the reduction in their taxable estates as a result of the divorce, and the currently high exclusion. The only potential claimants in the early termination of a QPRT would be the children. If adults, they may be persuaded to consent to the termination, or, if minors, a court might confirm their parents' consent on their behalf. While the IRS might argue that the children made a gift of their remainder interest in the QPRT to the parents, this may be a cost worth incurring, if necessary, to complete the property settlement.

If it is necessary to sell the residence as part of the dissolution settlement, it can be sold by the QPRT. Since a QPRT is structured for federal income tax purposes as a grantor trust, the $250,000 per person ($500,000 for a couple filing a joint return) home sale gain exclusion may be available.[4]

Another option for a house held by two QPRTs, one for each ex-spouse, would be for them to jointly sell the home pursuant to terms set forth in the PSA, exclude gain to the extent feasible, and then use the proceeds in their respective QPRTs towards the purchase of new separate residences. If the net proceeds to each QPRT are insufficient to purchase a new home, each spouse could own part of his or her respective new residence as a tenant in common with his or her QPRT. Another alternative would be for an ex-spouse to contribute additional funds to his or her QPRT, which would be treated as an additional gift to the trust. The QPRT would then use the combination of the new funds and the sale proceeds to purchase a new home. If the sale proceeds exceed the amount reinvested, or the ex-spouse chooses not to reinvest the proceeds in a new residence, those proceeds would be paid as a periodic annuity to the ex-spouse beneficiary for the remainder of the QPRT term under the qualified annuity trust provisions of the QPRT document. When both ex-spouses are equal beneficiaries of their respective trusts, each having previously owned a one-half interest in the marital residence, then each ex-spouse would receive an annuity payment for the remaining term of the trust, which should be factored into the calculations of maintenance and support.

Trusts for children

Families frequently establish trusts to benefit children and grandchildren. These trusts typically are intended (whether expressly stated or not) to provide for educational benefits for the children. In the event of a later divorce, these trusts can be used to meet education and perhaps other financial needs of the children (depending on the trust agreement, the terms of the settlement agreement, and the financial needs of the post-divorce family). When negotiating the terms of such arrangements the provisions of the trust will have to be analyzed: Are distributions mandatory or discretionary? By whom and to what extent? Who are the beneficiaries—solely the children of the marriage or a "pot" trust including other beneficiaries as well? These terms may be argued by either ex-spouse as supporting or detracting from the right to count these funds in the settlement or to mandate their use. The courts are likely to consider these funds as available to meet the needs of a minor child.

Inter-vivos qualified terminable interest property (QTIP) trusts

When one spouse has substantially greater assets, an inter vivos QTIP trust may be established to ensure that if the "poorer" spouse predeceases the wealthier spouse, sufficient assets will be available to make use of that spouse's applicable exclusion amount. In the event of a later divorce, a number of options may be considered. If feasible under the QTIP agreement, some or all of the corpus may be distributed to the spouse/beneficiary as part of a PSA. More likely, the QTIP trust will be continued and treated as cash flow to the ex-spouse/beneficiary and factored into the property settlement. One party may seek modification of the trust instrument (e.g., resignation of an unfavorable trustee, conversion into a total return trust, etc.) in an attempt to preserve the corpus for the remainder beneficiaries.

A court may consider the anticipated mandatory income distributions from a QTIP as income available to the spouse/beneficiary for purposes of meeting living expenses and maintenance. The investment flexibility, asset composition, and other provisions of the QTIP trust should be evaluated by counsel for the ex-spouse beneficiary to identify discretion that could be used to adversely impact distributions. For example, if income has historically been distributed monthly, but the QTIP trust agreement permits annual or more frequent distributions, can the trustee's discretion be controlled to prevent the trustee from delaying distributions post-divorce as a punitive measure?

SELF-FUNDED TRUSTS ESTABLISHED DURING THE MARRIAGE

It is not uncommon for one spouse to establish a trust for himself or herself during the marriage. This might be done for a host of reasons by one or both spouses. The following is a discussion concerning the most common self-settled trusts.

Revocable trusts

Revocable trusts are frequently established by both spouses (in some jurisdictions as a single trust) to facilitate probate avoidance, management of assets in the event of disability, and other objectives. Since the grantor spouse has an unfettered right to revoke or modify the trust, there should be no particular impact of a revocable trust on a future divorce. However, if a spouse has inherited assets or received gifts of assets that are separate property, a common technique is to isolate these assets in a revocable living trust for identification purposes, to avoid commingling and preserve the separate property character.

Spousal lifetime access trust (SLAT)

A SLAT is an inter vivos irrevocable trust created for the benefit of a grantor's spouse. The trust is not intended to qualify for the gift or estate tax marital deduction (which would result in inclusion of the trust assets in the spouse's estate); rather, the SLAT is designed to remove the trust assets from both the grantor and grantor spouse's estate.

At the drafting stage, spousal trust rights in the event of a divorce should be, but are not often, addressed. Existing SLATs should be reviewed to understand the impact of divorce set forth in the document, and taking into consideration spousal rights in pre- and postnuptial agreements.

Because a spouse is a beneficiary, a SLAT is taxed as a grantor trust;[5] the grantor must recognize and pay income tax on the trust's income as part of his or her personal income. In addition, the so-called "spousal unity rule" provides that the grantor is considered to hold any power or interest held by any individual receiving trust distributions who was the grantor's spouse at the time of the creation of the power or interest, even if later divorced.[6] As a result, even after divorce, distributions to a former spouse will continue to trigger grantor trust status as to the grantor.

The SLAT agreement may directly address divorce by including a provision that terminates any spousal trust rights upon legal separation or divorce. It could define the spouse as the individual then married to the grantor rather than naming a specific spouse, to allow for distributions to subsequent spouses. It could also require that, in the event of divorce, an adverse trustee must consent to distributions to the former spouse, eliminating grantor trust status under IRC §677 (but care still needs to be taken that the trust is not a grantor trust under other sections of the Code). Not all SLATs contain these provisions. In such cases, the former spouse may retain spousal trust rights post-divorce, unless addressed in a subsequent agreement or PSA.

To allow the grantor to avoid paying income tax, the trust could be distributed to the beneficiary with a corresponding distribution to the grantor spouse, eliminating later income tax consequences to the grantor. Or the PSA could require the beneficiary of the SLAT to reimburse the grantor for income tax paid.[7]

The self-funded domestic asset protection trust (DAPT)

The use of a self-funded DAPT is becoming increasingly common for those concerned about asset protection. Often in the case of an impending divorce, a parent or spouse may attempt to protect assets by conveying them to a DAPT. Either by statute or case law, however, the general rule is that a DAPT established by the named beneficiary remains subject to the claims for support and alimony. If a transfer is made of marital assets to a DAPT, consideration of how a court would view the transfer during a later divorce is critical. If both spouses are beneficiaries, then whether and how the trust can be modified or operated in the future will have to be addressed.

If the DAPT is structured with an institutional trustee or distribution committee, perhaps the PSA can include an instruction letter to the trustee or distribution committee concerning future distributions. While unlikely to be binding on an independent trustee governed by a previously established irrevocable trust agreement, the trustee may be willing to give considerable weight to such a directive in making any future distribution decisions. If only one spouse is a beneficiary, perhaps such a distribution instruction could be given addressing distributions to children of the marriage. However, an irrevocable transfer to a DAPT, occurring before any divorce proceeding, may be beyond the reach of a court, especially one located in another jurisdiction from that in which the trust is established. In this situation, the non-beneficiary ex-spouse may persuade the court to deem that the beneficiary ex-spouse receive certain distributions from the trust in determining a property settlement.

Traditionally, states have not allowed individuals to fund spendthrift trusts to benefit themselves. That is, the grantor of a trust was not allowed to set up a trust against which his creditors (including a divorcing spouse) could not make claim. As a result, many clients have created domestic, and even overseas, asset protection trusts to restrict the claims of future creditors. A number of states, including Alaska, Delaware, Nevada, South Dakota, and Wyoming have changed their spendthrift trust rules to allow limited protection for a self-funded irrevocable trust.

While a comparison of the state and foreign trust rules is beyond the scope of this outline, such trusts may be created in lieu of or as part of a premarital agreement.[8]

MODIFICATION OR UNWINDING OF PRIOR TRUST PLANNING

Most trusts used in estate planning are irrevocable, so change is limited. The general rule is that a trust, once established, ordinarily cannot be altered, amended, revoked, or terminated in mid-course except pursuant to its own provisions.[9] Nevertheless, a trust may be rescinded or reformed if there was fraud, duress, undue influence, or mistake when the trust was set up. For example, if one spouse transferred a house to an irrevocable trust, making a gift of jointly owned property without the other spouse's knowledge, perhaps it can be argued that the trust was fraudulently formed and therefore void. Under both the Uniform Voidable Transactions Act[10] and its predecessor the Unform Fraudulent Transfer Act,[11] a transfer can be voided if it was made with actual intent to hinder, delay, or defraud any creditor of the transferor. A spouse can be a creditor.

Trusts may be drafted to include provisions allowing for modification, which should be considered when negotiating a divorce settlement. When modifying or unwinding prior trusts, the trustee must keep in mind his or her fiduciary duties to the other trust beneficiaries. While trustees and estate planning counsel are very familiar with working within the confines of this broader focus, divorce attorneys have only one person's interest in mind—their client's. The court in a divorce case only has two people in front of it, and therefore a trustee's fiduciary duty to other beneficiaries can get "lost" in the proceeding unless kept in the forefront by the trustee.

Ex-spouse removal clauses

If the trust agreement contains specific terms relating to a spouse, such as a requirement that the spouse and the grantor be married (or married to each other at the time of the grantor's death) for the spouse to benefit, divorce may be grounds for termination of the agreement. An ex-spouse removal clause might turn out to be disadvantageous in the event of divorce. For example, if a spouse is removed as a beneficiary of an insurance trust, and the PSA requires insurance to be maintained for his or her benefit, the removal clause could require the purchase of additional insurance.

Use modification provisions in existing trusts to meet divorce requirements

It is increasingly common to incorporate provisions to allow drafting flexibility to address changed circumstances in the trust agreement. If a trust provides for discretion by the trustee (or other fiduciary) to modify provisions of a trust, this power may be used to modify the trust to accommodate the post-divorce family needs, to meet provisions of a PSA, and to minimize post-divorce friction. For example, individual trustees could be replaced or succeeded by other individuals or an institutional trustee.

The trust agreement may contain a provision allowing the trustee to terminate the arrangement under certain circumstances, which may include divorce. If termination is not feasible, it may be possible to negotiate a release of certain rights under the trust, such as the right to serve as trustee. Termination might be accomplished if a trust protector has the authority to terminate without restriction, or only in specified circumstances (such as the purpose of the trust having been satisfied).

If a trustee has been given the power to make unlimited principal distributions, that power may be exercised to effectively terminate the trust. Alternatively, there may be the ability to take advantage of an express power to terminate in the event that the trust is uneconomical to operate. These provisions may be a double-edged sword, however. In the event of a divorce, a spouse may use these provisions to encourage a court to order the termination of the trust, or to treat trust assets as fully reachable by the beneficiary/ex-spouse payee.

It may also be possible under the applicable state's principal and income act to convert an income-only trust into a total return trust that makes an annuity payment based on a specified percentage of principal. This approach might provide greater certainty to the ex-spouse payee and eliminate discretion that the trustees might have over investments, which could be used to reduce distributions to the ex-spouse payee/beneficiary.

Trust decanting

Decanting allows the trustee of an otherwise irrevocable trust with broad discretionary powers to transfer the trust assets into a new trust with different terms. Decanting can be used to deal with changed circumstances, to fix drafting errors, to optimize tax treatment, or facilitate trust administration. But it can also be used to move trust property presumed to be subject to distribution in a divorce beyond the reach of the divorce court's jurisdiction. Uses of decanting include limiting or eliminating a beneficiary's rights, removing and replacing a trustee, and changing investment or distribution policies.

Ferri v. Powell-Ferri is a recent example of the power of decanting in the divorce context. This case involved a Connecticut divorce and a trust governed by Massachusetts law, where decanting was used to successfully move assets out of reach of a divorcing wife.[12] However, the Connecticut Supreme Court considered the trust assets to be subject to its equitable powers for the purpose of setting maintenance.[13]

Note that about half the states provide statutory authority to decant.[14] Most states require that notice be given to beneficiaries. In *Ferri*, the decanting occurred without the husband's permission, knowledge, or consent, which would not be permitted in many of the states that otherwise permit decanting.

Rather than rely on state law default decanting provisions, it is preferable to include decanting provisions in a trust instrument to maximize a trustee's flexibility. If drafting a new trust, a broad decanting power might provide, in part, as follows, depending on the laws of the jurisdiction, the limits of public policy in which the trust is created, and the intent of the grantor:

> <u>Trustee's Power to Decant</u>. Grantor specifically authorizes and empowers the Independent Trustee, in his or her sole discretion, to distribute any or all of the principal and accumulated but undistributed income of any trust created under this Agreement, at any time and without the knowledge or consent of the beneficiary, in further trust for the benefit of the beneficiary and in the beneficiary's best interest, as may be permitted under the laws of the jurisdiction governing the administration of this trust at such time, and regardless of whether such laws existed at the time of execution of this trust.
>
> In exercising the powers to distribute principal hereunder, the Independent Trustee may distribute outright to, or to an existing or new trust for the benefit of, any one or more of the class among which the Independent Trustee may distribute outright. If the Independent Trustee creates a new trust, the Independent Trustee may, subject to the provisions of Paragraphs [insert reference to provisions limiting who may serve as trustee, such as prohibitions against naming the settlor as trustee], select as the trustee or trustees of that trust any person or persons (including a trustee of the trust from which the property is distributed); the Independent Trustee may create new powers of appointment in the trustee or trustees or in any member of the class for whose benefit the trust may be created, provided that the exercise of such powers, if granted to a trustee or trustees, will benefit only a member or members of such class, and such powers, if granted to a distributee, may benefit any person specified in the grant thereof; the Independent Trustee may impose lawful spendthrift provisions; the Independent Trustee may create life interests or other limited interests in a distributee with future interests, vested or contingent, in favor of other distributees whether or not in being when the power is exercised; and, generally, in the case of each power, the Independent Trustee may distribute in any manner the Independent Trustee shall determine for the benefit of any person or persons within the class for whose benefit the Independent Trustee is authorized by this instrument to distribute property. It is Grantor's desire, but not direction, that in exercising any power, such person be mindful of any contribution to the invaded trust qualified for the annual exclusion under IRC § 2503(b), the marital deduction under IRC § 2056(a) or § 2523(a),

> or the charitable deduction under IRC § 170(a), § 642(c), § 2055(a) or § 2522(a), as a direct skip whether or not a nontaxable gift under IRC § 2642(c), or qualified for any other specific tax benefit that would be lost by the existence of the authorized Trustee's authority under this paragraph for income, gift, estate, or generation-skipping tax purposes under the Code.

The authority to decant should make clear the extent of any permissible changes, such as which beneficiaries can be affected by decanting and whether powers of appointment can be granted or withdrawn. It should also describe prohibited changes, such as any change that would cause loss of the marital deduction or affect the exempt status of a generation-skipping tax (GST) trust. Procedures for exercising the power to decant, along with who actually has the power to decant, should also be established. For example, do only independent fiduciaries have the power to decant?

It is important to keep in mind the GST consequences of decanting. A trust created before September 26, 1985 is "grandfathered" at the time of its execution, and is thus exempt from GST tax. This generally remains true even if a beneficiary holds and exercises a special power of appointment or a power to decant, so long as the applicable perpetuities period was not extended and the original trust contained the power to decant.[15]

Other ways to modify trust distributions

A trustee must invest assets pursuant to the so-called prudent person rule.[16] Under that rule, a trustee is required to invest for "total return." That is, a trustee must invest in a way that benefits both income and principal beneficiaries. However, when beneficial interests clash, as they typically do in a divorce scenario, the source of return becomes critical, and the tension between investing for income and investing for growth can become more pronounced. More specifically, how does a trustee invest without considering whether return is produced from income or from capital appreciation when the income beneficiary (perhaps a second spouse) is pressuring the trustee for more income and the remainder persons (perhaps children from a prior marriage) are pressuring the trustee to withhold income from the spouse? Fortunately, there are two regimes that provide trustees with the means to implement the mandate of total return investing: (i) the power to adjust; and (ii) unitrust regimes.

Under a power to adjust regime, the trustee is permitted to adjust between income and principal to be fair and reasonable to all beneficiaries.[17] In other words, even if a principal distribution is not permitted under a trust document or is permissible pursuant only to a limited standard (like health or education), the trustee can redefine a portion of the principal as income and pay that to the income beneficiary.

Under the unitrust regime, the trustee can convert an income beneficiary's interest into a unitrust payout of a fixed percentage of the trust's principal. Most states allow a trustee to determine the appropriate unitrust payout within a band of three to five percent. In New York, the unitrust payment is fixed at four percent. Washington's statute provides for a similar payout.[18]

These two distribution methods are intended to ease the tension between competing income and remainder beneficiaries and align interests, so that all beneficiaries benefit from the trust's growth, whether from principal or income.

Special considerations for SLATs

One popular planning tool for an environment where a steep reduction in the lifetime gift tax exemption amount is expected is the creation and funding of SLATs. Some practitioners may even prepare and fund two such trusts, one with each spouse as a beneficiary, and have such SLATs essentially be used as division of interests in property if there is a divorce. Practitioners involved in such planning should take care to: (i) prepare a marital agreement in conjunction with this planning to clearly delineate how the interests in the SLATs should be taken into consideration if there is a divorce; (ii) fund each SLAT only with interests that are reasonably in a

SLAT with an adverse party (e.g., interests in an LLC that one spouse actively operates should not be an asset of her ex-husband's trust); and (iii) fully address the fact that the grantor of a grantor trust SLAT must pay that SLAT's income tax even if the parties are divorced, and perhaps set forth work-arounds in the event of a divorce.[19]

PLANNING FOR DIVORCING HEIRS

Parents and other relatives may want to modify their estate planning documents and create flexibility in light of a pending divorce, following a dissolution, or simply to protect the family's assets from a divorcing spouse in general.

In planning for a descendant's divorce, it is best to maintain flexibility. For example, a client who finds her son at fault for divorcing a beloved daughter-in-law raising the client's grandchildren likely would not want that divorced spouse treated as "deceased" for all purposes under the instrument. It is also best to include clear provisions regarding the settlor's intent regarding distributions to a married beneficiary and/or his or her spouse. One of the hallmarks of the common law of trusts and the Uniform Trust Code is that the settlor's intent is paramount. If a settlor intends that a spouse receive no direct or indirect benefit from the trust, then the settlor should clearly specify as such. Trial courts can then understand trustee actions that are taken in relation to a divorce as a trustee acting at the direction of the settlor rather than at the direction of the beneficiary spouse. In courts of equity, such clear language can make an enormous difference in how trustee actions are understood.

Often, the senior generation planning for divorcing heirs will ask the estate planner to draft a prenuptial or postnuptial agreement for the heir. Estate planners should keep certain ethics rules in mind and should act and advise accordingly. The attorney should consider: (i) whether there would be any conflict of interest in representing the heir and the seniors (ABA Model Rule 1.7); (ii) whether either party will request that you keep information confidential from the other party (ABA Model Rule 1.6); and (iii) whether the attorney will be able to freely communicate with each party enough to ensure he or she can make informed decisions (ABA Model Rule 1.4). An engagement agreement with an heir should clearly specify what the heir should expect as to client confidences, and under what conditions the attorney would have to terminate representation. For instance, if an attorney represents the parents of a son who is about to get married, and the attorney has been asked to draft a premarital agreement for the son, the son may disclose that once the prenuptial agreement is signed and the parties are married, he and his spouse plan to "rip up" the prenuptial agreement. On the other hand, the parents may tell the attorney not to reveal to the son their estate planning or the magnitude of their wealth. The attorney must be vigilant in ensuring that he or she meets ethical duties to all clients and is able to communicate with all clients sufficiently to ensure all clients are able to act with informed consent. The following are a few concepts to consider.

Limit control

Generally, it is a good planning strategy to make sure that the descendant has the flexibility not to be the sole trustee of the trust during the time of divorce. Having a corporate or other independent trustee (or at least as co-trustee) can bolster the descendant/beneficiary's arguments during divorce that he or she cannot merely use the trust assets. There also may be other beneficiaries, such as more remote descendants, whose interests need to be taken into account before distributions can be made.

Parents should consider how much control a non-family spouse may have over family assets. For example, organizational documents for a family business should contemplate the possibility of divorce and provide a mechanism to allow other family members or the business to buy out a non-family member spouse. The terms should be reasonable and include the ability to spread out payments to minimize the impact on the business's cash flow. Parents may also consider giving interests in a family business in trust rather than outright.

Add beneficiaries

Additional discretionary beneficiaries, such as descendants, could also be added to the trust. If a trust has discretionary beneficiaries other than the ex-spouse, the trustee would be able to make distributions to those beneficiaries to the exclusion of the ex-spouse. The trust would continue to be taxed as a grantor trust, even if no distributions are made to the ex-spouse.

Spendthrift trusts

A spendthrift trust is a trust in which the beneficiary has no right to demand distributions or the ability to assign or transfer his or her interest in the trust. Instead, one or more trustees are given broad discretionary powers to make or withhold distributions. Many different types of trusts can be drafted to include spendthrift provisions. The broad discretion given to the trustee(s) causes a beneficiary to have no vested rights to be claimed by a spouse or other creditor. As a result, spouses and other creditors of a beneficiary are unable to demand payment of income or principal to satisfy the obligations of the beneficiary.

Several states restrict or prohibit spendthrift trusts. Where allowed, the permissible terms vary widely from state to state. While a spendthrift trust may prohibit claims made by a divorcing spouse against trust assets, it is likely that a divorcing spouse may be able to reach trust assets by attachment of present or future distributions made to the beneficiary-spouse.

In most states, keeping property for descendants in lifetime spendthrift trusts can be an effective way to protect those assets from future creditors, including divorcing spouses.[20] The Massachusetts Supreme Court reinforced the validity of such protections by holding that a spendthrift trust is not included as a marital asset in a divorce.[21]

Notwithstanding its apparent limitations, the general rule in many states that have adopted the Restatement (Third) of Trusts is that a spendthrift trust does not provide protection against several types of claims, including child support.[22] Similarly, the Uniform Trust Code provides that a spendthrift clause does not protect against certain exception creditors, including a spouse, children, or a former spouse who has a judgment against the trust beneficiary for support or maintenance.[23] Similarly, a number of states treat spouses as exception creditors who can receive alimony even from spendthrift trusts.

Requiring a premarital agreement

Depending on state law, certain interests in third-party-created trusts can be deemed marital property or otherwise subject to division upon divorce.[24] Accordingly, it can be useful to include provisions that incentivize trust beneficiaries to have a premarital agreement to expressly protect all such trusts and their growth as separate property. The following is a form of trust provisions expressing this requirement:

> Premarital/Postmarital Requirements. Notwithstanding anything to the contrary contained herein, Trustee shall not make any income or principal distribution to a Primary Beneficiary who is legally married or engaged to be married, unless that beneficiary has a valid, binding marital agreement, specifically segregating all inheritances from this Trust as sole and separate property of that beneficiary.
>
> (a) The marital agreement must provide that the Primary Beneficiary's spouse disclaim any interest in any distributions, and that the distributions, appreciation in value, and profits relating thereto shall remain the separate property of the beneficiary.
>
> (b) The Primary Beneficiary's spouse must agree to execute and deliver any additional documents necessary to carry out the intent of this provision.
>
> (c) The Trustee is authorized to obtain an opinion of counsel regarding the legality of the Premarital/Postmarital Agreement. Trustee is relieved of liability for a distribution

in error of this Section if such an opinion of counsel is received.

(d) If a Primary Beneficiary's spouse fails to execute the marital agreement or other additional documents required herein, the Trustee shall retain the income and principal that would have otherwise been distributed to the beneficiary as a separate share or Trust for the beneficiary, and distributions shall be made in accordance with the following until the required documents are executed:

(1) The Trustee shall apply for the benefit of that Primary Beneficiary such amounts of income and principal of this share or Trust as the Trustee shall from time to time deem appropriate for the beneficiary's support, health care, education, and maintenance; and

(2) Any power of appointment or right of withdrawal held by the Primary Beneficiary may not be exercised during the Primary Beneficiary's lifetime.

As an incentive to comply, a trust can provide a cash distribution of a fixed amount (such as $10,000 or $20,000) once the protective premarital agreement is in place. For example:

<u>Distribution Upon Execution of Premarital Agreement</u>. When a beneficiary and the beneficiary's intended spouse execute a premarital agreement that the trustee is advised by legal counsel is valid, then on or after the date of such beneficiary's marriage, such beneficiary may by written instrument, delivered to the trustee, withdraw from the principal of the trust an amount equal to five percent (5%) of the trust's accumulated net income and principal, as it is then constituted. In addition, upon the request of the beneficiary, the trustee shall reimburse the beneficiary for any and all documented expenses and legal fees incurred by either party in securing such agreement.

Even where certain distributions are mandatory, a trust could be drafted so that distributions may be distributed "to or for the benefit of" a beneficiary. This might allow a trustee to make a distribution for the benefit of the beneficiary without making a distribution directly to a beneficiary and thereby avoid the reach of creditors.

While well-meaning, a requirement that a child or grandchild enter into a premarital agreement may impact an adult-child relationship with their significant other. Premarital agreements deal with what happens at divorce and death. These issues are ice water on romance for a couple in love. The generous parent or grandparent may choose to leave this issue alone and let the child deal with these issues on their own. If they want to have influence, perhaps be specific in what assets should be kept separate. Note that inherited and gifted property is separate or non-marital property in many states, even without a premarital agreement. And in some, the rent, issues, and profits are separate property.

On the other hand, the heir could be grateful that the parents are dictating the premarital agreement because it takes this difficult decision out of their hands. They can always say, "my father made me do it."

Powers of appointment

A power of appointment (POA) is a powerful tool to provide flexibility, especially where a trust is expected to continue for multiple generations. A limited POA could also be drafted so that a beneficiary may direct distributions toward a spouse or away from a spouse and for the benefit of other trust beneficiaries in the event of divorce.

Some parents may want to entirely exclude the ability to exercise a POA in favor of a spouse. Another option to protect descendants is to limit a descendant's special POA so that lifetime exercises can be made only to descendants and charities, but that testamentary gifts can include a surviving spouse (i.e., one who was married to the descendant and did not have a divorce action currently pending at the time of the descendant's death).[25]

It should be noted that certain POAs may be deemed a property interest under dissolution of marriage laws in some states.[26]

Trust protectors

A trust protector can add flexibility to a trust. A trust protector is an individual who is granted powers under the trust agreement to see that the grantor's wishes and intent are carried out. Trust protector powers can be quite broad. In general, some common powers include the power to terminate the trustee, appoint successor protectors, direct or veto trust distributions, and add or remove beneficiaries. A trust protector can protect assets that might otherwise be subject to the claims of a divorcing spouse.

No-contest/in terrorum provision

In jurisdictions where permitted, a no-contest or in terrorum provision can be a useful deterrent to an heir seeking to change the terms of an irrevocable trust or will. Except in the case of a marital trust, a spendthrift provision may provide that the attempted assignment by a beneficiary of his or her trust benefits would automatically terminate those benefits.

ANTICIPATE THE CONSEQUENCES TO THE BENEFICIARIES

An adult irrevocable trust beneficiary going through a divorce may have to address the issues presented by the trust's income. This income will show up on the parties' income tax returns. It may be that the distributions were used to improve their marital standard of living. These distributions will likely increase their obligation to pay child and spousal support. A court has the discretion to include recurring gifts as income for child support.[27] One-time gifts or inheritances are not income for support purposes but income that they can generate is.[28]

Gifts from a supported spouse's parents are also factors in setting spousal support. On the other hand, a subsidy the supported spouse receives from a parent does not relieve paying a spouse's spousal support obligation.[29] The income definition for child support purposes is very broad. Even debt cancellation can be considered as income available for support.[30] Receipt of an inheritance is not necessarily required; the imminent receipt of an inheritance may be considered in setting child support.[31]

A case involving a man born to wealth and social prominence who was living without any visible means of support is illustrative. His family home was a 16,000 square foot luxurious mansion built by his grandfather in 1918, surrounded by 47 acres of land with hiking trails, streams, wildlife, and gardens. It contained valuable art, jewelry, furnishings, and other items collected by his parents and grandparents. He and his wife met in the early eighties, with the husband not working since 1972, relying instead on income from securities and family trusts. The appellate court held that the trial court did not abuse its discretion in setting child and spousal support that exceeded the husband's monthly income where his extensive property holdings and exceptional circumstances allowed deviation from guidelines.[32]

In *In re Schwartzkopf*, the court noted that California law is well-settled that "a trust created for the purpose of defrauding creditors or other persons is illegal and may be disregarded."[33] This rule was extended to apply to the creation of trusts where the grantor's intention was to prevent his wife from reaching the property.[34]

In *In re Marriage of Dick*, a large alimony order was affirmed despite the husband having no assets or income.[35] The parties lived a very lavish lifestyle that included residences in the US and abroad, servants, continuous first-class travel, the use of expensive automobiles and unlimited funds for clothing and entertainment, and other luxuries. One of the wife's experts testified from a reconstruction of expenses that the couple spent $74,521 per month during the last 17 months of their marriage. In this case, the court held that "[t]he rule regarding fraudulent corporations is equally well settled: 'When a corporation is used by an individual or individuals, or by another corporation, to perpetrate a fraud, circumvent a statute, or accomplish some other wrongful or inequitable purpose, a court may disregard the corporate entity and treat the acts as if they were done by the individuals themselves.'"[36]

Generous parents no doubt mean well, and their gifts can significantly impact child support and alimony. In some states, well-meaning gifts can cause the division of property to be skewed. A court will determine whether income will be imputed to a party based on the past history of giving or on the party's standard of living with greater wealth.

WHAT ESTATE PLANNERS AND MATRIMONIAL LAWYERS CAN LEARN FROM EACH OTHER

It is not uncommon for a matrimonial lawyer to draft provisions in premarital agreement addressing what will occur at the death of their client without consulting an estate planning lawyer:

- Drafting provisions that apply at death of a party in premarital, postmarital, and cohabitation agreements without making sure that there is a will or trust in place;
- Not taking into account taxes on death;
- Not clarifying whether the payment at death is before or after taxes;
- Agreeing to pay a percentage of the estate without taking into account the nature of the assets, their liquidity, and the cost of valuation;
- Agreeing to pay a lump sum without taking into account liquidity;
- Entering into an agreement that may take time and expense to implement;
- Not addressing portability issues;
- Entering into a contract to make a will without knowing the consequences;
- Creating a binding estate plan that does not take into account changes in fortune and wishes;
- Not considering using life insurance as an alternative to a percentage of the estate or a lump sum;
- Providing for the use of life insurance without being clear as to who the policy owner is, when it will expire, or the increasing costs of carrying a policy;
- Not considering the parties' children from a prior marriage, thereby opening the door to future litigation;
- Not considering court-imposed obligations to secure previous child and spousal support;
- Assuming that the client will review the agreement from time to time; and
- Assuming the client will keep the agreement in a safe place so that it can be enforced.

Of course, estate planners can also miss issues that family law lawyers would not. These issues include:

- Seeing a premarital agreement primarily as an estate planning tool and not a divorce planning tool;
- Representing both parties in a transmutation of assets as part of an estate plan, which a family lawyer may view as problematic in some, but not all, jurisdictions. In those jurisdictions where separate counsel is advisable, a lawyer may represent both parties without a conflict or confidentiality waiver;
- Advising parties to change separate property to community property to obtain a step-up in the basis of the property, without warning the parties that if they divorce, the transferor may be giving up their interest in that property;
- Not telling the transferee that the transferor may not have waived their right of reimbursement;
- Not recognizing nuances in drafting limitations on alimony/maintenance or realizing how these limitations have become a primary reason a premarital agreement is drafted;
- Not being aware of the difference between premarital and postmarital agreements;
- Drafting documents providing for transfers at death that are not conditioned on marital status;

- Violating Automatic Temporary Restraining Orders in place in the dissolution matter;
- Transferring property to a family trust without language in the trust stating that property maintains its character and
- Transferring separate property to community property without considering that the parties may divorce.

CONCLUSION

Estate and matrimonial counsel can work together to recognize the many implications and opportunities in light of a divorce. It is important that estate planning practitioners understand the potential consequences of their planning in the event of a divorce. Similarly, matrimonial counsel would serve their clients well by involving a skilled trust and estate attorney to analyze any trust benefiting parties to a divorce and assist in structuring their planning, separately or together, to facilitate the conclusion of the divorce. Estate planning counsel can also coordinate planning going forward, including planning with marital agreements. This article provides a high-level survey of complex issues, all of which can vary considerably depending on state law. Awareness of the issues will encourage better planning.

Notes

1 Cal. Fam. Code § 2040(a)(3)-(4).

2 Cal. Fam. Code § 2040(b).

3 UPC §2-804(h)(2).

4 I.R.C. § 121.

5 Id. § 677(a)(1).

6 Id. § 672(E)(1)(A).

7 For additional drafting suggestions see George Karibanjian, Richard Franklin & Lester Law, Alimony, Prenuptial Agreements, and Trusts Under the 2017 Tax Act, Bloomberg Estates, Gifts and Trusts J., Number 3 (May 10, 2018); Justin Miller, Reform Could Make Divorce a Lot More Taxing, ABA Family Law Quarterly (Summer 2018).

8 Each year, attorney Steven J. Oshins revises his Domestic Asset Protection Trust State Rankings Chart, available at http://www.leimbergservices.com. See Leimberg Information Services, Inc., 11th Annual Domestic Asset Protection State Rankings Chart, Asset Protection Newsletter No. 402 (Apr. 13, 2020).

9 William F. Fratcher, 4 Scott on Trusts § 330 (1986).

10 Uniform Voidable Transactions Act, § 4(a)(1).

11 Uniform Fraudulent Transfer Act, § 4(a)(1).

12 72 N.E.3d 541 (Mass. 2017). For a detailed analysis of decanting in the context of divorce and the Ferri cases, see Jonathan Haskell & Marc A. Chorney, Decanting in Connection with Divorce, Colo. Lawyer (Oct. 1, 2019), https://ssrn.com/abstract=3490793.

13 Ferri v. Powell-Ferri, 165 A.3d 1137 (Conn. 2017).

14 See Susan T. Bart, Summaries of State Decanting Statutes (updated Jan. 1, 2020), https://www.actec.org/assets/1/6/Bart-State-Decanting-Statutes.pdf .

15 Treas. Reg. § 26.2601-1(b)(4)(i)(A) provides that a distribution of trust principal from a trust that was irrevocable on September 25, 1985 to a new trust will not cause loss of exempt status if the terms of the governing instrument or applicable state law at the time the trust became irrevocable authorizes the decanting to the new trust without the consent or approval of any beneficiary or court, and the terms of the governing instrument of the new trust will not extend the time for vesting beyond the original perpetuities period.

16 Restatement (Third) of Trusts §227 (Am. L. Inst. 1992).

17 See, e.g., RCW § 11.104A.020.

18 RCW § 11.104A.040

19 26 U.S.C. §§ 672 and 677; see also, Kanyuk, Roots and Wings – Structuring Trusts to Give Beneficiaries a Chance at Success, Despite Inheriting Money – Taxation of Grantor Trusts after Divorce (May 11, 2021), https://www.cftexas.org/cft/files/e8/e8e9d79d-0aa2-4e9a-9a23-a1bdf3cd154b.pdf.

20 See generally George Gleason Bogert & George Taylor Bogert, The Law of Trusts and Trustees, § 222 (2d ed. 1980).

21 Pfannenstiehl v. Pfannenstiehl, 55 N.E.3d 933 (Mass. 2016) (overturning lower court decision that assets in a discretionary spendthrift trust created by a third party were reachable as marital assets).

22 Restatement (Third) of Trusts § 59.

23 Uniform Trust Code § 503(b).

24 See, e.g., Texas, Connecticut, Michigan, or Massachusetts. See also In re Marriage of Bentson, 656 P.2d 395 (Ore. 1983) (Wife gained interest in any distribution from corpus of testamentary trust of which husband was a beneficiary).

25 See Bogert & Bogert, supra n.20, § 264.20.

26 Gerard Deffenbaugh & David Kirch, How Powers of Appointment Affect Irrevocable Trust Remainder Interests in Dissolution of Marriage Proceedings, The Colo. Law. (Dec. 2019).

27 In re Marriage of Alter, 89 Cal. Rptr. 3d 849 (Cal. Dist. Ct. App. 2009).

28 In re Marriage of Scheppers, 103 Cal. Rptr. 2d 529 (Cal. Dist. Ct. App. 2001).

29 In re Marriage of McQuoid, 12 Cal. Rptr. 2d 737 (Cal. Dist. Ct. App. 1991).

30 In re Marriage of Kirk, 266 Cal. Rptr. 76 (Cal. Dist. Ct. App. 1990).

31 Straub v. Straub, 29 Cal. Rptr. 183 (Cal. Dist. Ct. App. 1963).

32 In re Marriage of de Guigne, 119 Cal. Rptr. 2d 430 (Cal. Dist. Ct. App. 2002).

33 In re Schwarzkopf, 626 F.3d 1032, 1037 (9th Cir. 2010) (internal quotation marks and citation omitted).

34 Id.

35 In re Marriage of Dick, 18 Cal. Rptr. 2d 743 (Cal. Dist. Ct. App. 1993).

36 Id. at 752 (citation omitted).