

**I DO, ACT II:  
PLANNING IT RIGHT THE SECOND TIME AROUND**

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**I. Introduction.**

The purpose of this outline is to address estate planning in the context of second marriages. Such planning has become increasingly more common and necessary in light of the evolving world in which we practice.<sup>1</sup> Estate planning techniques that are effective for spouses in a first marriage may be unsuited when applied to "blended families" in which one or both spouses have children from prior marriages. This outline points out the pitfalls a practitioner may face when drafting for clients in a second marriage and provides an overview of nuptial agreements, elective share planning, and marital trusts.

**II. Nuptial Agreements.**

The need for a nuptial agreement is particularly pronounced in the case of a second marriage, which may take place later in life, after each party has had the opportunity to accumulate substantial separate assets.

One or both parties will have had experience with divorce and the attendant division of marital property. Ideally, such a client will thus be aware of the turmoil a nuptial agreement can avoid, and he or she will need little persuasion to enter into one. In many cases, a nuptial agreement may be mandatory upon the client's remarriage, in accordance with the terms of a separation or nuptial agreement in connection with the client's prior marriage.

If there are children from previous relationships, each client will want to make certain that their children are provided for regardless of which spouse dies first, and that the subsequent remarriage of a surviving spouse won't allow any diversion of family wealth. The well publicized existence of a nuptial agreement may also lessen any perception on the part of adult children that a new spouse has entered into the marriage solely to usurp their inheritance.

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<sup>1</sup> As of 2004, approximately 15% of men and 16% of women had been married at least twice. U.S. Census Bureau, *Detailed Tables - Number, Timing and Duration of Marriages and Divorces: 2004*, Table 3 (2007), available at [http://www.census.gov/population/www/socdemo/marr-div/2004detailed\\_tables.html](http://www.census.gov/population/www/socdemo/marr-div/2004detailed_tables.html). According to the National Center for Health Statistics, 43% of first marriages end in separation or divorce within 15 years. The study is based on the National Survey of Family Growth, a representative sample of women in the United States ages 15 to 44 in 1995. "First Marriage Dissolution, Divorce, and Remarriage: United States," *Advance Data From Vital and Health Statistics*, No. 323. Hyattsville MD: National Center for Health Statistics: 2001, available at <http://www.cdc.gov/nchs/data/ad/ad323.pdf>.

A. Types of Nuptial Agreements.

1. Prenuptial Agreements. Prenuptial agreements (also known as premarital agreements or antenuptial agreements) are agreements entered into by parties contemplating marriage. These agreements set forth the rights and obligations of each party in the event of death or divorce, as well as during the marriage.
2. Postnuptial Agreements. Postnuptial agreements (also known as postmarital agreements) are agreements entered into by the parties after marriage, which likewise set forth the rights and obligations of each party in the event of death or divorce, as well as during the marriage.

Postnuptial agreements can be used when no divorce is contemplated or when divorce is not imminent. When divorce is imminent, postnuptial agreements are referred to as separation agreements.

- B. Nuptial Agreement Requirements. The Uniform Premarital Agreement Act (the "UPAA"), which has been adopted by twenty-six states and the District of Columbia, sets forth the typical requirements for a valid premarital agreement.<sup>2</sup> Each adopting state may have additional statutes or case law that expand upon these requirements. In addition, different requirements may exist in regard to postnuptial agreements. However, the UPAA requirements provide a useful overview of the considerations that must be taken into account when drafting a nuptial agreement that will hold up to judicial scrutiny.

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<sup>2</sup> The Uniform Premarital Agreement Act, as adopted by the National Conference of Commissioners on Uniform States Laws (1983). The UPAA has been adopted in whole or in part by the District of Columbia and the following states: Arizona, Arkansas, California, Connecticut, Delaware, Florida, Hawaii, Idaho, Illinois, Indiana, Iowa, Kansas, Maine, Montana, Nebraska, Nevada, New Jersey, New Mexico, North Carolina, North Dakota, Oregon, Rhode Island, South Dakota, Texas, Utah, and Virginia. A bill adopting the UPAA was introduced to the West Virginia legislature in 2011.

1. Complete Financial Disclosure. Under § 6(a) of the UPAA, a prenuptial agreement is not enforceable in an action or proceeding if the party against whom enforcement is sought proves that the agreement was unconscionable when it was executed and that, before execution of the agreement, he or she (i) was not provided a fair and reasonable disclosure of the property or financial obligations of the other party, (ii) did not voluntarily and expressly waive, in writing, any right to financial disclosure of the other party beyond the disclosure provided, and (iii) did not have, or reasonably could not have had, an adequate knowledge of the property or financial obligations of the other party.<sup>3</sup>

In some states, individuals who contemplate marriage are considered to be in a confidential relationship with each other. This relationship may give rise to a common-law duty to make a full and fair disclosure of the nature, extent and value of the assets that each party holds so the other party may make an informed decision as to what will be relinquished as a result of entering into the nuptial agreement.<sup>4</sup>

Note that a state's disclosure requirements may make a distinction between prenuptial and postnuptial agreements. For instance, Florida Statutes §732.702(2) provides that where an agreement waives certain spousal rights (such as a right to an elective share), a fair disclosure of each party's assets is required only if the agreement is executed after marriage.

Full disclosure would include details of an individual's net worth (including all assets and liabilities), as well as income. The nuptial agreement should indicate what the value reflects (fair market value, book value, cash value, etc.). Information regarding these values, such as appraisals, brokerage statements and income tax returns for the previous three years, should be provided to the other party and his or her attorney for review.

Complete disclosure is recommended even if the other party already has adequate knowledge of the client's property or financial obligations. This

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<sup>3</sup> UPAA § 6(a)(2).

<sup>4</sup> See, e.g., *Doig v. Doig*, 787 So. 2d 100 (Fla. 2d DCA 2001). Note that some states do not recognize a confidential relationship between individuals contemplating marriage. In such jurisdictions, each spouse has “a duty to make some inquiry to ascertain the full nature and extent of the financial resources of the other.” *Mallen v. Mallen*, 622 S.E.2d 812, 816 (Ga. 2005) (reasoning that the lack of a confidential relationship gives rise to both a duty to disclose and a duty to “exercise ordinary diligence in making independent verification of contractual terms and representations”); see also *Beesley v. Harris*, 883 P.2d 1343 (Utah 1994) (holding that disclosure is an affirmative duty, the failure to do so is nondisclosure, and the burden is not on the other party to inquire); *DeLorean v. DeLorean*, 511 A.2d 1257, 1261 (N.J. Super. Ct. Ch. Div. 1986) (finding that the burden is “not on either party to inquire, but on each to inform” as to the nature and extent of his or her finances).

avoids any possibility that a court will conclude that the other party's knowledge was not as complete as you believed.

2. Disclosure of Lifetime Taxable Gifts. On December 17, 2010, President Obama signed into law the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (the "2010 Act"). Among the significant changes set forth in the 2010 Act is the concept of "portability" of the "deceased spousal unused exclusion amount" (the "DSUEA").

Under § 2010(c)(5)(a) of the Code, as amended by § 303(a) of the 2010 Act, the executor of a deceased spouse may make an election on a timely filed estate tax return to make a deceased spouse's unused gift tax and estate tax exemption amounts (collectively, the DSUEA) available to the surviving spouse. Thus, if the election is made and the deceased spouse made no lifetime taxable gifts, the deceased spouse's unused \$5 million exclusion amount can be passed on to the surviving spouse, who will then effectively have a \$10 million exclusion amount available for her use (assuming that the exclusion amount is \$5 million in the years of their deaths). The surviving spouse can use that \$10 million exclusion amount to either shelter lifetime taxable gifts or to shield assets from federal estate taxation at his or her death.

In light of the enactment of portability, it may be advisable for the parties to execute a prenuptial agreement to (a) disclose any lifetime taxable gifts they may have made and (b) to allow the other party's attorney the opportunity to review their gift tax returns, to make sure any taxable gifts were properly reported.

This disclosure will be of particular importance if one of the parties is a widow or widower. Under § 2010(c)(4)(B)(i) of the Code (as amended by the 2010 Act), a surviving spouse who remarries may only use the DSUEA of his or her *most recently* deceased spouse. So, a surviving spouse's remarriage comes at the risk of losing the DSUEA of his or her deceased first spouse, if the second spouse likewise predeceases him or her. For this reason, it will be of extreme importance to a wealthy widow or widower contemplating marriage to determine how much of the other party's exclusion amount has already been exhausted by lifetime taxable gifts.

3. Consideration. Pursuant to § 2 of the UPAA, a prenuptial agreement is enforceable without consideration. However, the agreement must reflect a degree of mutuality of benefits to support its enforceability, and a ceremonial marriage is a prerequisite to the effectiveness of the prenuptial agreement.<sup>5</sup> Pursuant to § 5 of the UPAA, a premarital agreement that is

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<sup>5</sup> UPAA § 2, cmt.

amended after marriage (or the mutually agreed revocation of the agreement) is also enforceable without consideration.

In some states, a nuptial agreement must recite the consideration that each party has received. In others, the marriage itself is sufficient consideration for a prenuptial agreement. In the case of a postnuptial agreement, mutual promises encompassing various rights of the parties, in addition to disposing of property owned by them, may be considered sufficient consideration.

4. Formalities of Execution. Pursuant to § 2 of the UPAA, a prenuptial agreement must be in writing and signed by both parties.

If a nuptial agreement contains testamentary provisions, state law may require that it be executed in conformity with the more stringent requirements for a Last Will and Testament (for example, execution in the presence of two witnesses). In New York, which has not adopted the UPAA, any agreement made by the parties before or during marriage must be in writing, subscribed by the parties, and acknowledged or proven in the manner required to entitle a deed to be recorded (i.e., acknowledged in the presence of a notary public).<sup>6</sup>

5. Separate Counsel. While not required under the UPAA, case law in some states suggests that each party should obtain separate representation with regard to the nuptial agreement or that an unrepresented party should expressly acknowledge his or her decision to enter into the agreement without the advice of counsel. Even under the UPAA, the presence of independent counsel for each party can be a factor in determining whether the agreement was executed voluntarily and whether the agreement is unconscionable.<sup>7</sup> In any case, separate representation is highly recommended.

In the case of a prenuptial agreement, any meetings with attorneys (as well as the negotiation and execution of the agreement) should occur well in advance of the wedding, making it more difficult for a challenging spouse to assert duress or undue influence.

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<sup>6</sup> N.Y. Dom Rel. § 236(B)(3).

<sup>7</sup> UPAA § 6, cmt.

C. Waivers of Specific Property Rights.

1. Waiver of Alimony and Spousal Support. Pursuant to § 3(a)(4) of the UPAA, the parties to a prenuptial agreement may contract with respect to the modification or elimination of spousal support.

However, under § 6(b) of the UPAA, if a waiver of support leaves a spouse financially unable to support himself or herself, a court may trump the agreement and require support in order to avoid the state having to provide public assistance.

If an agreement is intended to waive alimony, the waiver provision should include all types of alimony, such as rehabilitative, permanent, periodic, bridge-the-gap and lump sum alimony. Note, however, that in some UPAA states (such as Florida) temporary alimony (i.e., alimony paid during the divorce proceeding) cannot be waived.<sup>8</sup>

2. No Waiver of Child Support, Custody and Visitation. Pursuant to § 3(b) of the UPAA, rights regarding child support cannot be waived in a nuptial agreement and, therefore, should not be included in such agreement.

Generally, any attempt to waive child support, custody or visitation in any nuptial agreement will violate public policy, even in non-UPAA states.

3. Waiver of Equitable Distribution of Property. Pursuant to § 3(a)(1) of the UPAA, parties have the power to contract with respect to their rights and obligations in any property they own, either separately or jointly. This includes the right to contract with respect to the disposition of property upon separation or death.<sup>9</sup> However, if the parties wish their nuptial agreement to entirely supplant a state's equitable distribution rules, they should expressly state this intent.

Likewise, if the parties intend to keep certain property as separate property, such as income earned during the marriage, such intent should be clearly stated in the nuptial agreement. Otherwise, income and earnings, and the assets acquired with such income and earnings, may be considered marital property subject to equitable distribution.

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<sup>8</sup> *Belcher v. Belcher*, 271 So. 2d 7 (Fla. 1972).

<sup>9</sup> UPAA § 3(a)(3).



4. Waiver of Interest in Homestead Property. Some states may have statutes limiting a spouse's ability to waive his or her rights in homestead property. For instance, in Florida, a provision waiving a party's constitutional right to homestead property is valid only if the waiver is made knowingly and intelligently.<sup>10</sup> Accordingly, if each party intends to waive his or her rights in homestead property, the nuptial agreement should explain the nature of the right being waived by setting forth (1) the definition of homestead property, (2) the homestead rights that each spouse would enjoy in the absence of the nuptial agreement, and (3) that each party knowingly and intelligently waives such homestead rights.

If an individual changes domicile to a state with a homestead statute only after he or she has entered into a nuptial agreement, it is recommended that the nuptial agreement be amended to make reference to his or her rights under the homestead laws of the new domicile, and to affirm that these rights are being waived.

5. Waiver of Interests in Retirement Plans. The most significant assets of many clients are their retirement plans. Accordingly, nuptial agreement should be drafted such that any waiver of retirement benefits complies with federal law. The following are federal laws of which the preparer should be aware in connection with the waiver of rights under retirement plans:

- a. The Employee Retirement Income Security Act of 1974 ("ERISA") and The Retirement Equity Act of 1984 ("REA"). ERISA, which overrides state law, was enacted to protect employee retirement benefits. REA then amended ERISA to provide protection to the spouses and descendants of employees. Under REA, a surviving spouse must receive certain benefits from a qualified plan of a spouse who was a plan participant, even if the participant dies prior to retirement age. It is important to note that Individual Retirement Account ("IRA") benefits are *not* subject to REA.
- b. Internal Revenue Code of 1986, as Amended (the "Code"). Section 401(a)(11)(A) of the Code requires that a surviving spouse receive a qualified pre-retirement survivor annuity benefit (if the participant spouse died before the annuity starting date) or a qualified joint and survivor annuity benefit (if the participant died after the annuity starting date).

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<sup>10</sup> *Chames v. DeMayo*, 972 So. 2d 850 (Fla. 2007); *Hartwell v. Blasingame*, 564 So. 2d 543 (Fla. 2d DCA 1990), approved 584 So. 2d 6 (Fla. 1991); *Rutherford v. Gascon*, 679 So. 2d 329 (Fla. 2d DCA 1996).

Section 417(a)(2) of the Code provides that a spouse may waive a right to a qualified plan benefit if the waiver meets the following requirements:

- i. The waiver is in writing;
- ii. The election must designate a beneficiary that may not be changed without spousal consent (or the consent of the spouse expressly permits designations by the participant without any requirement of further consent by the spouse);
- iii. The spouse's consent must acknowledge the election's effect; and
- iv. The spouse's signature must be witnessed by a plan representative or a notary public.

In the case of second marriages, clients often desire to waive their rights to each other's retirement benefits, so that these benefits can pass directly to their respective children. However, the Treasury Regulations to the Code provide that an agreement entered into prior to marriage does not satisfy the applicable consent requirements of § 401(a)(11) and § 417 of the Code.<sup>11</sup>

Accordingly, the nuptial agreement should provide that the parties agree to sign the applicable qualified benefit plan waivers after the parties are married. Of course, the participant spouse (and the estate planner) must be sure to obtain the applicable waivers from his or her spouse after marriage.

The nuptial agreement should also provide that the nonparticipant spouse releases all claims to the retirement plan benefits. To the extent that the participant spouse fails to obtain the required waivers from the nonparticipant spouse, and the nonparticipant spouse fails to release his or her claims to the retirement plan benefits, the heirs of the participant spouse may then have a cause of action against the nonparticipant spouse.

With regard to a plan not required to provide the qualified joint and survivor annuity to a married participant, a participant can withdraw his or her interest in the plan and roll it over to an IRA. By doing so, the participant could defeat the requirement that the nonparticipant spouse waive his or her right to the death benefits of the retirement plan.

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<sup>11</sup> Treas. Reg. § 1.401(a)-20 Q-28 and A-28.

Notwithstanding the foregoing, although federal law does not require that a nonparticipant spouse waive his or her rights in an IRA, some financial institutions impose this requirement.

6. Waiver of Rights Upon Death. If intended, the nuptial agreement should provide that each party waives the following rights upon the death of the other party:
  - a. Rights to elect against the Will or any other testamentary instrument of the other party (i.e., elective share rights);
  - b. Rights as intestate successor;
  - c. Rights as a pretermitted spouse;
  - d. Exempt property rights;
  - e. Family allowance rights;
  - f. Homestead rights (discussed above);
  - g. Right to qualify and serve as personal representative of the other party's estate or trustee of any trust created by the other party.

D. Tax Considerations.

1. Income Tax Issues.

- a. Income Tax Effect of Payments of Alimony. Cash payments of alimony are generally taxable to the recipient spouse and deductible by the payor spouse. Specifically, § 71(b) of the Code provides that a stream of cash payments to or on behalf of a spouse or former spouse pursuant to a divorce or separation instrument, whether for support or as part of a property payout, is taxable to the payee and deductible to the payor if the liability for payment ceases upon death of the payee, is not fixed as child support, and so long as the divorce or separation instrument does not designate such payment as a payment which is not includible in the gross income under § 71 of the Code and not allowable as a deduction under § 215 of the Code.

Both parties must be aware of the recapture rules applicable to excess spousal support payments, and care must be taken to avoid the imposition of such rules in the nuptial agreement. Section 71(f) of the Code provides that if during the first three post-separation years there is impermissible front loading of a cash payment determined under the Code to be alimony, phantom taxable income could be attributable to the payor—and a deduction

could be created for the payee—in the third post-separation year. This rule is intended to prevent spouses from characterizing non-deductible property settlement payments as deductible alimony payments.

- b. Federal Income Tax Returns. The nuptial agreement may mandate that the parties file joint or separate federal income tax returns. Alternatively, the nuptial agreement may mandate that the parties file joint or separate income tax returns if either party makes such a request of the other party. The latter option is generally preferred, as it provides for maximum flexibility each year. The parties should be aware that the filing of a joint tax return imposes joint and several liability on both spouses.<sup>12</sup>

## 2. Gift Tax Issues.

- a. Transfers Incident to a Divorce. Transfers incident to a divorce may be considered gifts for purposes of the federal gift tax. Section 2512(b) of the Code provides that any transfer for less than “full and adequate consideration in money or money’s worth” is a gift. The following are exceptions to the treatment of a transfer incident to a divorce as a gift:
  - i. Section 2516 Payments. Section 2516 of the Code provides that the transferor spouse will be deemed to have received full and adequate consideration if the payment is made from one spouse to the other pursuant to a written agreement and the agreement is effective within two years before or one year after the date of divorce. The agreement must be signed within the prescribed period of time, but the transfer may occur at any time.
  - ii. “Harris Rule” Payments. Under the Harris rule, payments made pursuant to an agreement incorporated into a court decree or under a court order for divorce or support do not have to be made for full and adequate consideration.<sup>13</sup>
  - iii. Payments Made in Satisfaction of Legal Obligation to Support. Payments made in satisfaction of a legal obligation to support a spouse and minor children are not

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<sup>12</sup> I.R.C. § 6013(d)(3).

<sup>13</sup> *Harris v. Comm’r*, 340 U.S. 106 (1950).

gifts because the release of such legal obligation is deemed to be adequate consideration.<sup>14</sup>

- iv. Annual Exclusion Payments and Qualified Transfers. Annual exclusion payments made pursuant to § 2503(b) of the Code and qualified transfers made for certain educational and medical expenses under § 2503(e) of the Code are not treated as gifts.
- v. Waivers of Pension Rights. Waivers of pension rights under § 2503(f) of the Code are not treated as gifts.

b. Gift Splitting. If the practitioner represents the wealthier spouse, he or she may suggest that the wealthier spouse include language in the nuptial agreement that provides that the other spouse must consent to split gifts under § 2513 of the Code upon the request of the wealthier spouse. By requiring such a consent, the wealthier spouse could double the amount of annual exclusion gifts he or she makes during the year. The gift tax annual exclusion amount is the amount an individual can gift per year per donee without using a portion of his or her federal gift tax exemption or incurring gift tax.<sup>15</sup> Such amount is currently \$13,000 annually per donee, or \$26,000 annually per married couple per donee. Including such a provision in the nuptial agreement would also enable the wealthier spouse to gift up to \$2 million during the marriage, which is two times the lifetime gift tax exemption amount (currently \$1 million per person).<sup>16</sup>

- 3. Estate Tax Issues. As discussed above, the 2010 Act introduced the concept of "portability," whereby a surviving spouse is allowed to take advantage of the deceased spouse's unused exclusion amount (a/k/a the "DSUEA"). However, a deceased spouse's DSUEA is only available to a surviving spouse if his or her executors make an affirmative election on a timely filed estate tax return.

Absent a requirement in a nuptial agreement, the executors of a deceased spouse may have no obligation to (a) file an estate tax return (which is not required if the value of the decedent's assets is under the estate tax exemption amount), (b) make a DSUEA election in favor of the surviving spouse or (c) refrain from using the decedent's entire DSUEA to shelter assets passing to the decedent's children from his or her first marriage.

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<sup>14</sup> Rev. Rul. 68-379, 1968-2 C.B. 414.

<sup>15</sup> I.R.C. § 2503(b).

<sup>16</sup> I.R.C. § 2505.

This state of affairs will likely be unacceptable to a wealthy client contemplating marriage, who will want to ensure that he or she can obtain the benefit of the DSUEA of the poorer spouse in the event that the poorer spouse dies first. Indeed, the allure of a \$5 million DSUEA may be a part of what attracted the client to his or her fiancée or fiancé in the first place!

As discussed above, utilization of the other spouse's DSUEA will be of particular importance to clients who have a predeceased spouse from a prior marriage. Since a surviving spouse may only use the DSUEA of his or her *most recently* deceased spouse, he or she runs the risk that the DSUEA of his or her first spouse will be lost forever, if the surviving spouse's second spouse likewise predeceases him or her.

As discussed later in this outline, it will likely be advantageous to use an inter vivos trust to utilize a poorer spouse's estate tax exemption amount, rather than relying on portability. However, as a backup until the couple can pursue more advanced estate planning, the parties may wish to mandate in their prenuptial agreement that one or both of them will, by Will, direct their executors to make a DSUEA election in favor of the surviving spouse. In order to ensure that there will be DSUEA remaining for a surviving spouse, the prenuptial agreement may also require (a) that any future use by one spouse of his or her lifetime gift tax exclusion amount requires the consent of the other and (b) that the executors of the first spouse must set aside a prescribed minimum amount of unused exclusion amount for the surviving spouse.

When drafting such provisions, the estate planner should keep in mind that the 2010 Act "sunsets" at the end of 2012, and thus there is no guarantee that portability (or a \$5 million estate tax exclusion amount) will survive into 2013. As such, the prenuptial agreement should be broad enough to encompass fluctuations in the exclusion amount, as well as legislative adjustment to how the portability election is to be made (for instance, many estate planners speculate that the IRS will release a "simple" version of form 706 for estates that are not subject to federal estate tax).

### **III. Estate Planning.**

This section of the outline addresses common challenges that arise in connection with estate planning for the second marriage, then presents an overview of estate planning techniques that practitioners should consider using to address these challenges.

- A. Challenges. Each client's familial and financial situation is unique, and there is no "one size fits all" estate plan that is always best for clients in second marriages. An effective, individualized plan depends on the estate planner's ability to identify the warning signs of where family conflict may arise. This is only possible where the estate planner obtains a comprehensive understanding of the client's marital,

financial, and familial history, as well as an appreciation of the personalities involved.

1. Obligations to a First Spouse.

- a. Obtain and Review Any and All Marital Agreements. It is crucial to ascertain whether the client is under any obligation to make testamentary dispositions to a former spouse or to the children of a prior marriage. Such an obligation may be by verbal agreement with a former spouse, but is more often contained in one of the following:
- i. Prenuptial or postnuptial agreement
  - ii. Settlement agreement
  - iii. Divorce decree
  - iv. Other court order

An estate planner should always inquire whether any of the above documents exists and should have a copy in hand before formulating an estate plan. Clients may not be eager to dredge up memories of such a difficult time in their life, may feel uncomfortable discussing their divorce in front of their current spouse or fiancée, or may simply be unaware of their long-term obligations. For these reasons, it is not advisable to rely upon a client's mere recollections of the terms of his or her divorce.

If the client has a verbal agreement with a prior spouse as to a testamentary plan, it may be in the client's best interests to have that understanding formalized into a written agreement now, rather than suffer a Will contest later. Even if such a contest is unlikely (or appears frivolous), the familial disharmony it can provoke may make the executor or trustee's job that much harder.

Agreements like those listed above may mandate testamentary terms or distribution requirements that narrow the scope of planning options. For instance, a divorce agreement may require that a client set aside a specific fraction of his or her probate estate, create and fund an inter vivos or testamentary trust (such as an alimony trust), maintain a life insurance policy, dispose of real property, or make other provisions for the benefit of a prior spouse or the children of a prior marriage.

If the client enters into an estate plan that does not meet the requirements of such an agreement, not only will the estate be subject to a claim by the spouse or children of a prior marriage, but the drafting attorney may be subject to a claim for malpractice brought by the disappointed family members of the client's second marriage.

Finally, if a client has had multiple prior marriages, the estate planner must make the same inquiries as to any agreements that might exist for *each* prior marriage. As shown in the case below, the consequences of overlooking an early first marriage can be severe.

- b. Consequences of Ignoring Prior Marital Agreements: *Leff v. Fulbright & Jaworski, LLP*. In a 2009 New York case, *Leff v. Fulbright & Jaworski, LLP*, a decedent's third wife brought suit against the attorneys who drafted her husband's Will, arguing that she had received less than her intended share of probate assets due to their failure to take into account the decedent's testamentary obligations under his separation agreement with his first wife.<sup>17</sup>

The separation agreement, drafted in 1974, provided that the decedent's Will would set aside no less than half of his probate estate for his son from his first marriage.

The decedent married for the third time in 1998, and in 2001 he presented to his wife (as an anniversary present) a copy of a Will in which he bequeathed to her half of his adjusted gross estate. This 2001 Will made no reference to the obligation decedent owed to his son under the 1974 settlement agreement.

The decedent died in 2002, leaving an estate of approximately \$90 million. Shortly thereafter, the client's son made a claim pursuant to the separation agreement for half of the probate estate. Only upon receipt of the claim did the drafting attorneys become aware of the existence of the separation agreement, even though a copy of the agreement was found in their files, and despite the fact that the firm that drafted the separation agreement had long before merged into the firm that drafted the 2001 Will.

The Estate settled with the son and ultimately paid him approximately \$20 million. The third wife received a total

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<sup>17</sup> 2009 NY Slip Op. 31445(U) (Sup. Ct., New York County June 30, 2009), *affirmed* 911 N.Y.S.2d 320 (N.Y. App. Div. 2010).



inheritance of approximately \$62 million.<sup>18</sup> Nevertheless, she brought suit against the drafting attorneys for an additional \$9 million she claimed she would have received had the attorneys informed the decedent of the terms of the separation agreement, so that he could have employed other estate planning devices (such as inter vivos gifts) to pass additional assets to her despite his obligation to his son.

Luckily for the drafting attorneys, the Court concluded that the third wife did not have standing to pursue a malpractice claim for two reasons: (1) she was not in privity with the drafting attorneys (since the attorneys had only entered into an attorney-client relationship with the decedent, and not with the decedent's wife) and (2) she did not present any evidence that the decedent would have set aside additional money for her "but for" the attorneys' failure to inform the decedent of the separation agreement.

Many states have begun to move away from a strict privity requirement in malpractice suits brought by disappointed beneficiaries against estate planners.<sup>19</sup> It is possible that a case with facts similar to *Leff* might result in liability for a drafting attorney, if brought in another state.

In fact, even New York has begun to loosen the strict privity requirement, opening the door for more malpractice actions against drafting attorneys. A year after *Leff* was decided, the New York Court of Appeals concluded for the first time that personal representative of an estate "stands in the shoes of a decedent" and thus has the privity required in order to bring a negligence claim against a drafting attorney.<sup>20</sup> However, the Court reiterated that strict privity remains a bar against malpractice claims brought by beneficiaries and other third parties.<sup>21</sup>

## 2. Elective Share Issues.

- a. Overview. Under state law, a surviving spouse generally may elect to take a fixed percentage, often in conjunction with a minimum

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<sup>18</sup> The decedent executed a codicil shortly before his death granting his wife a specific bequest of a \$20 million bond account; thus, after settlement, the wife received more than half of the decedent's adjusted gross estate.

<sup>19</sup> For additional information regarding privity of contract as it applies to a beneficiary's right to sue an estate planning attorney, see Adam Streisand, *To Tell The Truth (T&E Lawyer's Edition): Will My Real Client Please Stand Up*, ACTEC Annual Meeting 2009.

<sup>20</sup> *Schneider v. Finmann*, 933 N.E.2d 718, 720 (N.Y. 2010).

<sup>21</sup> *Id.* At 721.

dollar amount, of the predeceasing spouse's estate. In many states, any testamentary bequests to the spouse will be satisfied first by any property passing to the surviving spouse under the decedent's Will.

Sections 2-202 through 2-209 of the Uniform Probate Code (the "UPC")<sup>22</sup> calculate a surviving spouse's elective share as a proportion of the decedent's augmented estate. The augmented estate is calculated by adding (1) the value of the decedent's net probate estate (reduced by funeral and administration expenses, enforceable claims, homestead allowance, family allowances and exempt property), (2) the value of the decedent's nonprobate transfers to others, (3) the value of the decedent's nonprobate transfers to the surviving spouse, and (4) the value of the surviving spouse's net assets plus any property that would have been included in the surviving spouse's nonprobate transfers to others if the surviving spouse had been the decedent.

Once the value of the decedent's augmented estate is determined, it is multiplied by the elective share percentage that corresponds to the length of the parties' marriage. If the parties had been married for less than one year at the time of the decedent's death, the surviving spouse is entitled to only a nominal supplemental elective share amount. For all other surviving spouses, the elective share percentage ranges from three percent to fifty percent. The product of the augmented estate and the applicable elective share percentage minus the value of the surviving spouse's assets and any nonprobate transfers to the surviving spouse is equal to the amount that the surviving spouse receives as his or her elective share. The elective share is satisfied first from property passing to the surviving spouse, and then from property passing to the decedent's other heirs.

- b. Elective Share Concerns Specific to Second Marriages. The elective share is often of little concern in first marriages, since a typical estate plan in such a case passes the majority of the estate to the surviving spouse (either outright or in trust). Since the surviving spouse has an equal parental and emotional bond to any marital children, he or she can usually be trusted to provide for the

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<sup>22</sup> Unif. Prob. Code § 2-202 through 2-209, as adopted by the National Conference of Commissioners on Uniform States Laws (1990). As of 2009, the following states had adopted Unif. Prob. Code § 2-202 through § 2-209, in whole: Alaska, Colorado, Delaware, Florida, Hawaii, Kansas, Minnesota, Montana, Nebraska, New Jersey, North Dakota, South Dakota, Utah, Virginia, West Virginia and Wisconsin. In addition, the following states had adopted Unif. Prob. Code § 2-202 through 2-209, in part: Alabama, Idaho, Indiana, Iowa, Maine, Maryland, Michigan, Mississippi, Missouri, New Hampshire, New York, North Carolina, Ohio, Oklahoma, Oregon, Pennsylvania, South Carolina, Tennessee and Wyoming.

children upon his or her death, and outright bequests to surviving children on the death of the first spouse are rare.

However, a client with children from a prior marriage may wish to pass the majority of his or her assets to those children, rather than to his current spouse. Even if the client has implicit confidence that his or her current spouse will provide for the client's children, granting a surviving spouse control over assets which the client's children feel are rightfully theirs can result in great animosity.

In these cases, a client may seek to pass the majority of the estate outright to his or her children, or may employ a qualified terminable interest property trust ("QTIP trust") or other marital trust in which the children are the remaindermen.

A surviving spouse's exercise of his or her elective share rights may throw such an estate plan into disarray. The drafting attorney should be aware of the ramifications of such an election and attempt to formulate an estate plan that disincentivizes (or, if a waiver can be obtained, precludes) the surviving spouse from making such an election. An overview of strategies relating to elective share planning is provided below in subdivision B.

3. Blended Families. Each spouse may enter into a second marriage with children of his or her own from a prior relationship (think "The Brady Bunch"), and, in many cases, additional children may then be born within the marriage. Creating an estate plan that takes into account the unique financial situation of each child can be a challenging proposition, particularly when the age range of the children is significant.
  - a. Family Dynamics. While it takes delicacy to obtain it, a working understanding of a client's family dynamics can be invaluable. For instance, a client may have very different relationships with (and different testamentary intent in regards to) his or her children from a prior marriage, children from the current marriage, and stepchildren.

It is also crucial to attempt to determine whether any animosity exists (or may arise) among the children, or between the children and the client's new spouse. This information is essential when helping the client appoint trustees or other fiduciaries, such as in connection with subtrusts for the client's children. In general, a client should be cautioned to think carefully before placing a member of one branch of the family in a fiduciary relationship with a member of another. For instance, children from a prior marriage may not relish being beneficiary of a trust of which his or her stepparent is a trustee (or vice-versa). Likewise, trusts

allowing discretionary distributions to children from different marriages, or to children and stepchildren, may be unwise, even where an institutional trustee is appointed.

- b. Ascertain Resources Available to Each Child. It is important to know what other resources will likely be 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? Are there any agreements in place (as discussed above) that obligate a former spouse to make specific provision for children in his or her estate plan? Are there already inter vivos trusts (or § 529 plans) in place for some children, but not others? Has the client made unequal lifetime gifts to his or her children?

Even if a client wishes to treat all of the children in the blended family with some degree of parity, it may take some investigation to factor in all of the potentialities listed above. Use of an equalization clause may be prudent. If the client intends unequal bequests to children under the assumption that some children will receive inheritances from the client's ex-spouse, it may be advisable to make this intent known to the ex-spouse and confirm that such an inheritance will be forthcoming.

- c. Client Disclosure to Family. Even if the Will is a model of fairness, one or more members of a blended family will likely feel aggrieved by their treatment under the client's estate plan. At worst, this reaction leads beneficiaries to conclude that the estate plan is the result of undue influence on the part of other family members or negligence by the drafting attorney.

To avoid these reactions, in some cases it may be best for a client to explain his or her intentions to his family in his or her own words, whether in a family meeting or a side letter. Of course, a family meeting could backfire, so it is important to undertake a cost-benefit analysis with the client before coordinating such a meeting.

4. Wealth Disparity. The most obvious estate planning challenge where one spouse is significantly wealthier than the other is the inability of the poorer spouse to muster sufficient assets to take full advantage of his or her estate tax exemption amount.

This is obviously less of a problem since the advent of portability under the 2010 Act. However, as discussed in greater detail later in this outline, there are numerous advantages to having the predeceasing spouse fully allocate his or her estate tax exemption amount at his or her death, rather

than electing to pass it on as DSUEA for the surviving spouse. For instance, if the exemption amount is instead used to shelter assets placed in trust, the couple can minimize state estate tax (if they are domiciled in a decoupled state with a low state exemption amount). In addition, the appreciation on any assets left outright to a surviving spouse may be subject to estate taxation on the surviving spouse's death, which could have been avoided had the predeceasing spouse instead utilized a credit shelter trust.

Providing a poorer spouse with sufficient assets to use his or her exemption amount can be particularly problematic in second marriages, where the wealthier spouse is more likely to be disinclined to make lifetime gifts in order to "equalize" to the extent of the exemption amount (particularly if the spouses have already heeded the estate planner and negotiated a premarital agreement that preserves each spouse's separate property).

Various methods of taking advantage of a less wealthy spouse's estate tax exemption amount are presented below in subdivision B.

Even if the wealthier spouse is willing to make equalization gifts, these gifts can be misconstrued by his or her children as evidence that the less wealthy spouse entered into the relationship in search of financial gain. In general, the greater the wealth disparity between spouses, the more potential there is for animosity between the poorer spouse and his or her stepchildren.

A wealth disparity between spouses may indicate that a surviving spouse will be dependant on the assets of a wealthy, predeceasing spouse for his or her support, and increases the likelihood that the surviving spouse will exercise his or her elective share right. This should be taken into account when deciding what amounts should be placed in a QTIP or other marital trust, as opposed to passing directly to the predeceasing spouse's children.

5. Age Disparity. While any second marriage may cause consternation among children from prior marriages, familial discord is particularly likely when one spouse is substantially older than the other. Adult children may presume that the younger spouse is entering into the marriage in an attempt to usurp the older spouse's assets, and may be concerned that, as their parent ages, he or she will be susceptible to undue influence by the new spouse.

Significant age disparity in spouses may also render a standard QTIP trust inadvisable, since the adult children of the older spouse will not want to wait until the death of the younger spouse (who may be younger than they are!) in order to receive their inheritance. As pointed out by Paul Hood,

"little does more to reduce the pressure to litigate an estate plan than the immediate vesting of property in children."<sup>23</sup>

Adult children of the older spouse may have come to depend upon the parent's largesse or long since taken over management of their parent's finances. In addition, if the older spouse was a widow or widower, adult children may feel that their surviving parent has a moral obligation to maintain the estate plan in effect at the death of the other parent. A younger spouse, who may wish to have some role in the older spouse's financial planning, or whom the older spouse may wish to add as a trustee of existing trusts, can represent an unwelcome shake-up of the established order.

Examples of post-death litigation arising from May-December marriages are numerous, the most famous of which being the litigation arising from the marriage of 89-year-old billionaire J. Howard Marshall to 26-year-old model and actress Vickie Lynn Marshall (a.k.a. Anna Nicole Smith), which ultimately went to the Supreme Court.<sup>24</sup>

However, these types of marriages can also result in litigation during the lifetime of the older spouse, as was the case when 80-year-old widower Charles "Chuck" Yeager married 44-year-old Victoria D'Angelo in 2003.<sup>25</sup>

Prior to his relationship with D'Angelo, Yeager's finances had been managed by his daughter, Susan, and most of his assets were held in a revocable trust (of which Susan was co-trustee with Yeager) and in a family corporation of which Yeager and his children were shareholders ("Yeager, Inc."). Yeager, who had made significant lifetime gifts to his children over the years, was happy to stay ignorant of his financial affairs, only requesting to be consulted as to approval of the "big picture."

After commencing his relationship with D'Angelo (who moved in with the famous pilot a month after meeting him on a hiking trail), Yeager informed his children that he wanted to regain control of his finances, dissolve Yeager, Inc., remove Susan as trustee, revoke his power of attorney for financial matters, and leave his money to D'Angelo. Yeager then fired his accountant, estate planning attorney, and personal secretary,

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<sup>23</sup> Paul Hood, *A Second Marriage is a Triumph of Hope Over Experience!*, LISI Estate Planning Newsletter #1470 (May 28, 2009), <http://www.leimbergservices.com>.

<sup>24</sup> *Marshall v. Marshall*, 547 U.S. 293 (2006).

<sup>25</sup> The Yeager case is also used as a cautionary example in the context of estate planning for second marriages in Richard E. Barnes, *Till Death Do Us Part (Again): Estate Planning for Second Marriages*, 21 Prob. & Prop. 34 (2007). This article also provides a useful overview of the different factors to be considered when planning for clients in second marriages.

and became embroiled in lawsuits with his four adult children over the management of his finances.<sup>26</sup>

By that point Yeager's relationship with his children, in his own words, had gone "to hell."<sup>27</sup> The resulting lawsuits between Yeager, his children, and D'Angelo included claims for slander, intentional infliction of emotional abuse, elder financial abuse, conversion, recovery of Trust property, and Yeager's allegation that Susan had breached her fiduciary duty as co-trustee of his revocable trust.

The California Court of Appeals noted that Yeager's children disliked and distrusted D'Angelo, and that these feelings arose from "genuine concern for their father . . . some fear of loss of historic financial generosity" and because "the children also believed Yeager ought to honor their perception of [their deceased mother's] estate plan."<sup>28</sup>

Ultimately, the Court ordered Susan to repay the Trust approximately \$360,000 (representing her profit on real property she had sold to the trust without Yeager's knowledge or consent), and Yeager (presumably) has followed through with his intent to enter into an estate plan that passes the entirety of his estate to D'Angelo.<sup>29</sup>

6. Different Domiciles. If a client's fiancée is domiciled in a different state, the estate planner should take into account the laws of both states when drafting a premarital agreement, particularly if there is any uncertainty as to which state will be the ultimate marital domicile. For instance, even if only one state follows a community property regime, the agreement should make reference to the disposition or waiver of community property (to the extent allowed by state law). As discussed above, if either state has a homestead statute (such as Florida), any waiver of homestead rights may also require specific reference to state law.

Naturally, if a client has ongoing obligations (testamentary or otherwise) under a prior separation agreement, divorce decree, or marital agreement, the estate planner should keep in mind that the law of the state where the decree was issued (or the agreement executed) may substantially differ from that of the client's current domicile.

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<sup>26</sup> See, e.g., *Yeager v. D'Angelo*, 2008 WL 3889943 (Cal.App. 3 Dist. 2008). Note that this case is unpublished and is therefore not citable under California Rules of Court 8.1105, 8.1110 and 8.1115.

<sup>27</sup> *Id.* at \*2.

<sup>28</sup> *Id.* at \*5.

<sup>29</sup> *Id.*

B. Planning. This section addresses some of the initial steps an estate planner should take when a client is in a second marriage, how an estate plan can minimize the disruption of a surviving spouse's exercise of his or her elective share rights, and various methods of taking full advantage of each spouse's estate tax exemption amount.

1. Initial Steps. Before planning for the disposition of the bulk of the client's estate, there are several initial issues that may merit more than ordinary attention, due to the complexity of the client's familial circumstances.

a. Joint Representation vs. Representation of One Spouse. Under the Model Rules of Professional Conduct (the "MRPC"), 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.<sup>30</sup>

Aside from nuptial agreements (in which the parties' adverse interests constitute a non-waivable conflict such that joint representation is impermissible), there is no bright-line rule as to when spousal interests are so adverse that joint representation is either impermissible or fraught with sufficient risk that informed consent must be obtained.

The ACTEC commentaries to MRPC Rule 1.7 indicate that joint representation of spouses in the estate planning context can be beneficial, since it can result in "more economical and better coordinated estate plans prepared by counsel who has a better overall understanding of all of the relevant family and property considerations."<sup>31</sup>

However, joint representation of spouses should not be entered into if each spouse has significantly different goals or if their interests directly conflict to a substantial degree (note that the ACTEC Commentaries state that joint representation is still acceptable where the spouses merely have "somewhat differing goals").<sup>32</sup>

State ethics opinions differ as to whether a desire by each spouse in a second marriage to make separate arrangements for their children from a prior marriage indicates that informed consent and a written conflict waiver must be obtained in a joint representation.

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<sup>30</sup> Model Rules of Prof'l Conduct R. 1.7 (2006).

<sup>31</sup> ACTEC Commentaries on the Model Rules of Professional Conduct, R. 1.7 (4<sup>th</sup> ed. 2006), *available at* <http://www.actec.org/public/CommentariesPublic.asp>.

<sup>32</sup> *Id.*



For instance, a 1996 Montana ethics opinion, after mentioning second marriages, concluded that "different choices made by each spouse with respect to his or her own assets typically do not rise to a material potential for conflict" that would necessitate a written conflict waiver.<sup>33</sup> On the other hand, a 1997 Florida ethics opinion concluded that a conflict of interest was "typically inherent" where either or both spouses have children from a prior marriage for whom they wish to make different beneficial provisions, and thus the attorney should "review with the married couple the relevant conflict of interest considerations and obtain the spouses' informed consent to the joint representation."<sup>34</sup>

In general, then, an estate planner must use his or her own discretion to determine whether joint representation of spouses is advisable.

Even if joint representation is permissible, an estate planner may prefer to represent only one spouse where there are sufficient warning signs that the road may become rocky. The more lopsided the positions of the spouses (such as due to disparities of age, wealth, or comprehension, or where only one client has children from a prior marriage), the more likely representation of only one spouse is a good idea.

- b. Engagement Letter. The client engagement letter should specify which parties are entering into an attorney-client relationship. Failure to clarify that the attorney represents only one of the spouses can result in a surviving spouse's claim of joint representation. Joint representation, in turn, may place a drafting attorney in privity with a surviving spouse (see *Leff v. Fulbright & Jaworski, LLP*, discussed above), which may provide standing for a surviving spouse to bring a claim for malpractice relating to the drafting of the decedent's estate plan.

If the estate planner has decided to represent both spouses jointly, the engagement letter should include a statement as to potential conflicts of interests (and the necessity of the estate planner to withdraw from representation if the conflicts become severe) as well as a conflict waiver.

- c. Obtain Documents Relating to Prior Marriage. As discussed above, prior to formulating any estate plan, the estate planner should ask the client to provide him or her with any marital

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<sup>33</sup> Mont. Eth. Op. 960731 (2006).

<sup>34</sup> Fla. Eth. Op. 95-4 (1997).

agreements, settlement agreements or divorce decrees related to the client's prior marriage. If any of these documents obligates the client to make certain testamentary provisions, the provisions in the subsequent estate planning documents that provide for these obligations should make specific reference to the prior agreement or decree.

- d. Beneficiary Designations and Titling of Assets. Beneficiary designations for any pension, insurance, IRA, annuity, or other non-probate asset should be carefully examined to determine whether the new spouse's waiver is required in order for the client to list his or her children as primary beneficiaries.

If the client is obligated by prior agreement to maintain a former spouse as the beneficiary of an insurance or pension plan, the new spouse's waiver may nonetheless still be required.

If the client executed a prenuptial agreement that includes the waiver of any benefits under a retirement plan, the estate planner should make certain that any waiver is re-executed after the marriage, in accordance with § 401(a)(11) and § 417 of the Code.

The estate planner should also confirm how any real property owned by the client or his or her spouse is titled, and that the client understands that any property held as tenants by the entirety or as joint tenants with rights of survivorship will pass to his or her spouse at the client's death. If the client is concerned with providing a lifetime residence to the surviving spouse, it might be advisable to place the residence in a trust for the spouse or to provide the spouse with a life estate, rather than titling the residence as a joint asset. Of course, prior to advising the client to make such a transfer, the attorney must analyze whether there are any restraints on alienation of the property (which would be the case in Florida, which restrains alienation on homestead property such that the homestead property could not be placed in a trust for the spouse unless the spouse has waived his or her homestead rights).

- e. Tangible Personal Property. Couples in first marriages typically leave the entirety of their tangible personal property to each other, trusting that their spouse will know their wishes as to the ultimate disposition of various family keepsakes or heirlooms.

This approach may be inadvisable in a second marriage, since a client's descendants, rather than the new spouse, may have (a) a better sense of the emotional and sentimental value of certain objects, (b) different recollection of what items their parent

brought into the marriage and (c) a strong belief that certain items had always been promised to them. Familial tension over the disposition of tangible items can increase ten-fold if both spouses die in a common accident, leaving their children from prior marriages (or an executor or trustee) with the unenviable task of apportioning heirlooms between several members of two distinct family lines.

For these reasons, it may be advisable to have the clients make detailed bequests of tangible property in their Will or revocable trust, so that there is no argument about what was intended to go to whom. If there are treasured items that the client wishes to leave to a surviving spouse (rather than to his or her children), this intent should likewise be made clear, to prevent accusations that the decedent simply forgot a longstanding promise to pass the asset to one child or another.

If squabbling over tangible items seems particularly likely, it may be best to have the client inform the children of his or her intentions in advance, or, alternatively, to have the client transfer certain items as lifetime gifts.

2. Elective Share. A waiver is, in many states, the only certain method of ensuring that a surviving spouse will not exercise his or her elective share rights. Even if a waiver is unobtainable or unenforceable, there are still methods by which a client can minimize the assets subject to the elective share and provide disincentives to its exercise.
  - a. Nuptial Agreement. As discussed above, the individual could enter into a prenuptial or postnuptial agreement whereby his or her spouse agrees to waive any right to the elective share of the individual's estate.
  - b. Include Provision in Testamentary Document Regarding Satisfaction of Elective Share. If an individual plans to leave certain assets to his or her spouse, but fears that the spouse may elect against his or her estate, the individual could (if allowed by state law) include a provision in his or her Will or Revocable Trust that provides for the distribution of less desirable assets to the spouse if the spouse makes such election.

For instance, the client could create an entity, such as a family limited partnership or a limited liability company, and provide for the distribution of interests in such entity to his or her spouse in the event that the elective share right is exercised. Such entity interests would be of little utility because of restrictions on transferability, participation and liquidation.

Creating such an entity, however, comes with the risk that the spouse's interest will be subject to minority or lack of marketability discounts. The greater the discount applied to the value of the spouse's interest, the larger the interest will have to be in order to satisfy the elective share amount.

A Florida Court of Appeals case involving entity interests passing to a stepchild (rather than a spouse) illustrates how valuation discounts can significantly decrease the value of entity interests passing at death.

At issue in *Zoldan v. Zohlman* was the decedent's obligation under a post-nuptial agreement to name his stepdaughter as an "equal heir" with his three sons from a prior marriage.<sup>35</sup>

The decedent's estate consisted primarily of a trust, which had been funded with a 99% interest in a limited partnership to which the decedent had transferred \$40 million in securities. Contrary to the terms of the post-nuptial agreement, only the decedent's three sons were named as trust beneficiaries.

After the stepdaughter brought suit to enforce the post-nuptial agreement, the Estate offered her an interest in the limited partnership equal to that set aside for each of the three sons. The stepdaughter rejected the offer and instead obtained a judgment for monetary damages in an amount equal to the value of sharing in the estate equally with the three sons.

In determining how to calculate the value of these monetary damages, the court had to determine whether to value a 25% interest in the limited partnership according to its "fair value" (computed without application of discounts) or its "fair market value" (computed using discounts). The stepdaughter and the Estate both agreed that the "fair value" of the interest was \$6,450,937, while the "fair market value" was only \$2,247,573.

The Court's starting point was the partnership agreement itself. By its terms, the General Partner (one of the three sons) was given exclusive power to make or direct property distributions, which were to be based on "the property's fair market value as of the time of the distribution."<sup>36</sup> The Court concluded, that, under Florida case law, fair market value was what a willing buyer would pay a willing seller for the interest. The Court also noted that a provision

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<sup>35</sup> 11 So. 3d 982 (Fla. 3rd DCA 2009).

<sup>36</sup> *Id.* at 985.

in the agreement permitting certain sales of limited partnership interests required the selling partner to establish the market value of their shares by obtaining a "bona fide offer from a willing buyer in the marketplace."<sup>37</sup>

Accordingly, the Court affirmed that the stepdaughter's shares were to be valued at a fair market value of \$2,247,573, a price which reflected various discounts for lack of marketability and minority interests.

- c. Make Gifts. To the extent possible, the individual should make gifts to an irrevocable trust to remove assets from his or her elective estate. Lifetime gifts made to an irrevocable trust in which an individual has not retained the right to or enjoyed the possession or use of the income or principal of the assets may be excluded from the elective estate. Generally, state law will include in the elective state gifts made within a certain number of years of the individual's date of death. For instance, both New York and Florida include in the elective estate gifts made within one year of death.<sup>38</sup> However, gifts to individuals in amounts no greater than the gift tax annual exclusion amount, as indexed for inflation in accordance with the gift tax annual exclusion under § 2503(b) of the Code, or to educational institutions and medical providers under § 2503(e) of the Code, are exempted from "look back" statutes for inter vivos gifts.

If a client wishes to make as many non-taxable gifts as possible, a "Cristofani" irrevocable trust may be advisable.<sup>39</sup> Such a trust grants rights of withdrawal not just to primary beneficiaries (such as the settlor's spouse and children), but also to contingent beneficiaries (such as grandchildren, nieces and nephews, siblings, etc.). This allows the settlor to take advantage of his or her gift tax annual exclusion amount for a wider variety of individuals. To be effective, anyone granted withdrawal rights must have an actual interest in the trust, even if contingent.

- d. Insurance. Depending on applicable state law, the augmented estate subject to the elective share may or may not contain the proceeds of insurance policies held on the decedent's life. If such proceeds are not included in the augmented estate, a client may consider purchasing a term life insurance policy to satisfy some or

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<sup>37</sup> *Id.*

<sup>38</sup> N.Y. EPTL § 5-1.1-A(b)(1)(B); FLA. STAT. § 732.2035(8)(b).

<sup>39</sup> See *Estate of Cristofani v. Comm'r*, 97 T.C. 74 (1991).

all of the elective share. For example, the elective estate under Florida law only includes insurance proceeds to the extent of the decedent's beneficial interest in the net cash surrender value immediately before his or her before death (unless the insurance policy was maintained pursuant to a court order).<sup>40</sup>

- e. Transfers to Trusts. State law varies as to whether bequests and non-testamentary transfers to a surviving spouse are applied first to satisfy his or her elective share. State law also varies as to how to calculate the present value of the electing spouse's beneficial interest in property that qualifies for the marital deduction, such as a QTIP trust or a life estate with a power of appointment in the surviving spouse.

Thus, depending on applicable state law, a client may have additional incentive to place assets in a QTIP or other trust eligible for the marital deduction, since the client is able to satisfy (or at least reduce) the surviving spouse's elective share amount while retaining the ability to designate the ultimate beneficiaries of the trust property.

Even if the client is located in a state that does not allow trust assets to count towards satisfaction of the elective share, he or she may, by funding a QTIP with assets with a value greater than the elective share amount, create an incentive for the surviving spouse not to exercise his or her right of election.

State law varies wildly as to whether a QTIP or other trust eligible for the marital deduction can be used to satisfy the elective share, and in what amount.<sup>41</sup> Below are examples of the different approaches states have taken, ordered by increasing permissiveness in using trusts to satisfy the elective share.

- i. New York (No Satisfaction by Trust). Prior to September 1, 1994, if a spouse's elective share amounted to at least \$10,000, New York law allowed a testator to satisfy all or a portion of the elective share by creating a trust, life estate, or annuity where income was payable to the surviving spouse for life.<sup>42</sup> The only qualification was that the

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<sup>40</sup> FLA. STAT. §732.2045(d); §732.2035(6).

<sup>41</sup> For an overview of state law as to the valuation of marital trusts for elective share purposes, see Donna Litman, *The Interrelationship Between the Elective Share and the Marital Deduction*, 40 Real Prop. Prob. & Tr. J. 539 (Fall 2005).

<sup>42</sup> N.Y. EPTL § 5-1.1(c).

surviving spouse had the right to take \$10,000 outright from the underlying property in which he or she was given an interest. This arrangement could be used to significantly diminish the elective share, since, under case law, the beneficial interest set aside for the surviving spouse only had to comprise of a fair cross-section of the decedent's assets, even if those assets produced little income.<sup>43</sup>

In response to this potential for abuse, the legislature enacted N.Y. EPTL § 5-1.1-A, which provides that an elective share can only be reduced by assets which pass "absolutely" from the decedent to the surviving spouse, which expressly excludes interests in trusts or trust equivalents.<sup>44</sup>

Thus, in New York, there is no way to use a trust to minimize risk of exercise of the elective share. However, a marital trust can still provide a disincentive to taking the elective share, if funded with assets greater than one-third of the net estate (which is the elective share amount under New York law).<sup>45</sup> The spouse will be forced to choose between one-third of the estate outright, or a lifetime interest in an even greater amount.

- ii. Tennessee (Trust Satisfies at Present Value of Income Interest). Tennessee permits life estates or trusts for the benefit of the surviving spouse to count against the elective share, but only to the extent of the present value of the surviving spouse's income interest, as determined actuarially.<sup>46</sup>
- iii. Florida (Trust Satisfies at Value of Fraction of Trust Assets). Florida law is unique in its comprehensive treatment of "elective share trusts," and in its delineation of a tiered set of conditions under which an increasing

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<sup>43</sup> See, e.g., *In re Shupack*, 136 N.E.2d 513 (N.Y. 1956); *In re Clark*, 7 N.Y.S.2d 176 (Sur. Ct., Kings County (1938)). See also C. Raymond Radigan, *Advisory Committee: Recommendations on Right of Election Statute*, 229 N.Y.L.J. 3, col. 1 (Jan. 29, 2003).

<sup>44</sup> N.Y. EPTL § 5-1.1-A(a)(4)(B).

<sup>45</sup> N.Y. EPTL § 5-1.1-A(a)(2).

<sup>46</sup> TENN. CODE ANN. § 31-4-101(c).

percentage of trust assets will satisfy the elective share amount.<sup>47</sup>

In Florida, irrevocable transfers made to an elective share trust to satisfy the elective share are included in the elective estate.<sup>48</sup> An elective share trust is any trust under which (a) the surviving spouse is entitled for life to the use of the property or, at least annually, to all of the income; (b) the surviving spouse has the right under the terms of the trust or state law to require the trustee to either make the property productive or convert it to productive property within a reasonable time; and (c) during the spouse's lifetime, no person other than the spouse has the right to distribute income or principal to anyone other than the spouse.<sup>49</sup> The requirements to qualify as an elective share trust are essentially the same as the requirements to qualify as a QTIP trust under § 2056(b)(7) of the Code, except that no QTIP election must be made to an elective share trust on a federal estate tax return.

If the spouse has only a mandatory income interest in the elective share trust, 50% of the value of the property in such trust is counted toward satisfaction of the elective share.<sup>50</sup> If the elective share trust allows the spouse or trustee to invade the principal of the trust for the health, support and maintenance of the spouse (a "qualifying invasion power"),<sup>51</sup> 80% of the property in such trust is counted toward satisfaction of the elective share.<sup>52</sup> It is permissible for the trust to require the trustee to consider the spouse's other resources prior to making any distributions of principal to the spouse.

If the elective share includes a qualifying invasion power and a qualifying power of appointment (which is a general

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<sup>47</sup> Note that in other jurisdictions, an "elective share trust" most commonly refers to a trust created for the benefit of an incapacitated surviving spouse. The trust is funded with the elective share amount, thereby preserving the incapacitated spouse's eligibility for government assistance.

<sup>48</sup> FLA. STAT. §§ 732.2025(10) and 732.2035(9).

<sup>49</sup> FLA. STAT. § 732.2025(2).

<sup>50</sup> FLA. STAT. § 732.2095(2)(b)(3).

<sup>51</sup> FLA. STAT. § 732.2095(1)(c).

<sup>52</sup> FLA. STAT. § 732.2095(2)(b)(2).



power of appointment that only the spouse may exercise), 100% of the value of the trust is counted toward satisfaction of the elective share.<sup>53</sup> Inclusion of 100% of the trust is rare, however, as the settlor usually does not want his or her spouse to have ultimate control over the disposition of trust assets.

- iv. South Carolina (All Trust Assets Satisfy). In South Carolina, all property (including beneficial interests) which pass to the surviving spouse are applied first to satisfy the elective share. The value of the surviving spouse's beneficial interest in any property that qualifies for the marital deduction is computed at its full value (not just the present value of the surviving spouse's income interest), even if the spouse is only given an income interest in the property.<sup>54</sup> The determination of whether an interest qualifies for the marital deduction is to be made without regard to whether an election has been made to treat the property as qualified terminable interest property.
3. Gift Splitting. Annual gifts from one spouse to his or her descendants should be split with the other spouse in order to take advantage of the couple's combined gift exclusion amount under § 2513 of the Code. The couple should make certain to signify their consent to split these gifts by timely filing separate gift tax returns for the year in which the gifts were made, in accordance with Treas. Reg. § 25.2513-2.
4. Utilizing a Spouse's Full Estate Tax Exemption Amount. As discussed above, spousal "portability" of the estate tax exemption lessens the risk that a predeceasing spouse's estate tax exemption amount will be wasted, which would have been the case prior to the 2010 Act if he or she (a) died with an estate worth less than the exemption amount or (b) passed the entirety of his or her estate outright to the surviving spouse.

However, portability is not a panacea, as it lacks many of the advantages of traditional trust planning. This is particularly true in the case of second marriages, where spouses are unlikely to want to leave their assets outright to each other and give up their control over the identity of the ultimate beneficiaries of those assets (not to mention the creditor protection that such a trust provides).

For instance, if assets equal to the estate tax exemption amount are instead left in a credit shelter trust, the predeceasing spouse can make full use of

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<sup>53</sup> FLA. STAT. § 732.2095(1)(b).

<sup>54</sup> S.C. CODE ANN. § 62-2-207(a).

his or her GST exemption amount (which is not portable) and, in addition, any appreciation on those assets will not be subject to estate taxation at the death of the surviving spouse. Even if the couple's combined estates (with appreciation) are likely to have an aggregate value less than their combined federal estate tax exemption amounts, if the couple lives in a "decoupled" state that uses an exemption amount lower than the federal equivalent, state estate taxes may still be imposed. These taxes can be partially avoided by use of a credit shelter trust.

Reliance on portability is particularly inadvisable given its uncertain future. Section 304 of the 2010 Act provides that portability only applies in 2011 and 2012, and there is no guarantee that Congress will continue it in 2013 and beyond. Likewise, no one knows what the estate tax exemption amount will be after 2012, making it impossible to determine now which estates are small enough to avoid federal estate taxation.

Unpredictable events in the lives of the spouses can also derail an estate plan that relies on portability to preserve a predeceasing spouse's exemption amount. Unless required by a prenuptial agreement (or unless the surviving spouse is appointed as executor), there is no guarantee that the predeceasing spouse's executors will, in fact, make the election to pass the DSUEA to the surviving spouse. Even if the election is timely made, the predeceasing spouse's exemption amount will be lost entirely if the surviving spouse remarries and survives his or her next spouse (since a spouse is only permitted to take advantage of the DSUEA of his or her *most recently* deceased spouse).

For these reasons, it is advisable that the predeceasing spouse fully utilize his or her estate tax exemption amount at his or her death. In the case of a *first* marriage, if one of the spouses lacks sufficient assets to accomplish this, the wealthier spouse often makes a lifetime gift to the poorer spouse in the necessary amount. However, equalization by outright gift may be undesirable in the context of a second marriage, since these assets thereby pass entirely from the control of the wealthier spouse, leaving no guarantee that the poorer spouse, at death, will dispose of these assets for the benefit of the wealthier spouse's descendants.

As an alternative to outright equalization, an inter vivos trust may be employed to utilize the poorer spouse's exemption amount, while preserving one or more of the wealthier spouse's rights (1) to control the investment of trust assets, (2) to receive income from trust assets, (3) to recover trust assets in the case of divorce or (4) to designate ultimate beneficiaries. None of the three varieties of trusts discussed below preserve all of these rights (and two of them grant a general power of appointment to the poorer spouse, leaving them subject to the same type of abuse possible in outright equalization), but all afford some additional benefit or security to the wealthier spouse.

- a. Joint Revocable Trust. A joint revocable trust consists of assets contributed equally by both spouses and can be used to fund a credit shelter trust with the estate tax exemption amount of whichever spouse dies first. Use of a joint revocable trust to utilize a poorer spouse's exemption amount appears increasingly disfavored, since (1) funding the trust requires an initial equalization of assets, (2) the predeceasing spouse is granted a general power of appointment and (3) recent case law (as discussed below) draws into question the technique by which the credit shelter trust is deemed to have been funded by the predeceasing spouse. For these reasons, an inter vivos QTIP trust is likely a better option.

Unlike an inter vivos QTIP, a joint revocable trust is typically revocable by either party during their joint lifetimes. For instance, if the client revokes the trust due to divorce, each party will receive back the assets he or she contributed to the trust (i.e., 50%).

- i. Use in Community Property States. Joint revocable trusts are most common in community property states, where they are used to preserve the designation of trust assets as community property. This allows a surviving spouse to obtain a step-up in basis over the entire trust property at the death of the first spouse under § 1014(b)(6) of the Code (rather than only over those assets deemed to be the separate property of the deceased spouse) and avoids later inquiry as to whether community property was transmuted into separate property upon transfer into a trust settled by only one of the spouses.<sup>55</sup>

In accordance with Rev. Rul. 66-283, in order to preserve the community property status of trust assets, these trusts generally (1) grant each spouse a unilateral power to revoke the trust, (2) require the consent of both settlors for any amendment, (3) explicitly provide that community property transferred to the trust remains community property and (4) make provisions for certain management rights in regards to trust withdrawals when state law permits other than joint management.<sup>56</sup>

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<sup>55</sup> See, e.g. *Katz v. United States*, 382 F.2d 723 (9<sup>th</sup> Cir. 1967) (The court applied California law to determine the character of community property placed into a trust created only by the husband).

<sup>56</sup> Kenneth W. Kingma, *Property Division at Divorce or Death for Married Couples Migrating Between Common Law and Community Property States*, 35 ACTEC J. 74, 76-77 (Summer, 2009).

- ii. Use to Preserve a Spouse's Exemption Amount. In common-law states, a joint revocable trust provides no equivalent step-up in basis for the entirety of trust assets. This is because § 1014(e) of the Code disallows a step-up for transfers made within one year of death, and in the case of a joint revocable trust, each settlor retains dominion and control over trust property in the year preceding the death of the first spouse to die, since each spouse has the power to revoke the trust at any time.<sup>57</sup>

However, a joint revocable trust does have utility in a common law state as a mechanism for utilizing the estate tax exemption amount of whichever spouse dies first.<sup>58</sup> In accordance with two private letter rulings,<sup>59</sup> such a trust is typically structured as follows:

- (1) Each spouse contributes 50% of the total assets of the trust. If the spouses need to equalize separately owned assets in order to equally fund the trust, this should be accomplished by first separating assets into two equal bank or brokerage accounts (one in the name of each spouse). These accounts then fund the trust. Record of these transactions should be retained, so that a surviving spouse can prove the origin of trust assets when seeking a step-up in basis for assets contributed by the first spouse to die.
- (2) Each spouse retains a unilateral right to revoke the trust while both of them are alive. This retained power to revoke ensures that the initial trust contributions are not taxable gifts,<sup>60</sup> and ensures that the 50% of trust assets contributed by the first spouse to die is included in their gross estate at death under § 2038 of the Code.
- (3) The trustees (who are usually also the settlors) may make discretionary distributions of income or principal to either spouse while both are alive, or by

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<sup>57</sup> I.R.S. Tech. Adv. Mem. 9308002 (February 26, 1993).

<sup>58</sup> See Beth A. Turner, *Joint Revocable Trusts: New Flexibility in an Old Form*, 19 Prob. & Prop. 49 (July/Aug. 2005) (Providing an in-depth discussion of the use of joint revocable trust for purposes of preserving each spouse's exemption amount).

<sup>59</sup> I.R.S. Priv. Ltr. Rul. 200101021 (Jan. 5, 2001); I.R.S. Priv. Ltr. Rul. 200210051 (March 8, 2002).

<sup>60</sup> Treas. Reg. § 25.2511-2(c).

the mutual demand of the settlors. Any such distribution qualifies for the gift tax marital deduction.

- (4) The first spouse to die is granted a general power of appointment over all of the trust assets (which may be either a testamentary or a lifetime power). If the power is not exercised, an amount sufficient to utilize the predeceasing spouse's estate tax exemption amount is set aside in a credit shelter trust, and any remaining assets pass to the surviving spouse, either outright or in further trust. This general power of appointment ensures that the 50% of trust assets contributed by the *surviving* spouse are included in the gross estate of the predeceasing spouse under § 2041 of the Code.
- (5) The trust becomes irrevocable on the death of the predeceasing spouse. At that point, the surviving spouse is deemed to have made a gift (which qualifies for a marital gift tax deduction) of his or her share of the trust to the predeceasing spouse. This is necessary in order to assert that the predeceasing spouse was the transferor of all trust assets at his or her death (ensuring that these assets will not be part of the surviving spouse's gross estate).

iii. *Estate of Lee v. Commissioner. Estate of Lee v. Commissioner* involved a husband who died 46 days after his wife.<sup>61</sup> The husband's Will provided that if he died within six months of his wife, the wife should be deemed to have survived the husband. Quixotically, the executor of the husband's estate determined that this clause permitted him to establish a credit shelter trust in the wife's name and to fund it with the husband's residuary estate, as if the wife had survived the husband.

Unsurprisingly, the Tax Court was not convinced. The Court concluded that "surviving spouse" should be construed in terms with its ordinary meaning, which "requires that a spouse actually survive his or her spouse."<sup>62</sup>

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<sup>61</sup> T.C. Memo. 2007-371 (2007).

<sup>62</sup> *Id.* at \*4.

This common-sense conclusion may imperil step (5) of the overview of joint revocable trusts provided above, which relies upon the legal fiction that the surviving spouse made a gift of trust assets to the predeceasing spouse at the instant of his or her death.<sup>63</sup> This uncertainty (along with the fact that the use of a joint revocable trust to fund a credit shelter trust has only been approved by private letter ruling, not by regulation) has lessened the appeal of joint revocable trusts.

- b. Spousal Power of Appointment Trust. In two private letter rulings, the IRS has approved the use of a trust created solely by the wealthier spouse (a "spousal power of appointment trust") to take advantage of the poorer spouse's estate tax exclusion amount.<sup>64</sup>

In such a trust, income is paid to the settlor during the settlor's life (either as the settlor requests or as the trustees deem necessary). In the event that the poorer spouse predeceases the settlor, the poorer spouse is granted a testamentary general power of appointment in the amount necessary to utilize whatever estate tax exemption amount is in effect at the predeceasing spouse's death (taking into account any other assets that are in the poorer spouse's gross estate).

Under § 2041(a)(2), the assets over which the poorer spouse has a general power of appointment are included in his or her gross estate.

Unlike in an inter vivos QTIP trust (discussed below), the wealthier spouse is able to retain the right to receive income from the trust property, and the trust is revocable by the settlor (a feature which is handy in the event of divorce). However, this right comes at the expense of a testamentary general power of appointment in the poorer spouse, which may be exercised in favor of whomever the poorer spouse chooses. As with use of joint revocable trusts to preserve the poorer spouse's exemption amount, a spousal power of appointment trust has only been approved by private letter ruling, not by regulation, so there is also the risk that the IRS will take a different stance on these trusts in the future.

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<sup>63</sup> See, e.g., Jeffrey N. Pennell, Steven C. Davis, & Len B. Cason, *Fully Utilizing Credits of Both Spouses – Creative Thinking*, LISI Estate Planning Newsletter #1292 (May 7, 2008), <http://www.leimbergservices.com> (hereafter "LISI Newsletter #1292").

<sup>64</sup> I.R.S. Priv. Ltr. Rul. 200403094 (Jan. 16, 2004); I.R.S. Priv. Ltr. Rul. 200604028 (Jan. 27, 2006).

There is also concern that the use of a spousal power of appointment trust is, as with a joint revocable trust, undermined by the holding in *Estate of Lee v. Commissioner* (discussed above),<sup>65</sup> since the IRS may conclude that the gift of trust property to the predeceased spouse really took place after the predeceased spouse's death, and that thus the settlor's gift is not eligible for the marital deduction.

Jeffrey N. Pennell, Steven C. Davis, and Len B. Cason have proposed avoiding the uncertain impact of *Estate of Lee* by instead granting the poorer spouse a lifetime general power of appointment, exercisable upon written notice by the poorer spouse, delivered to the trustees.<sup>66</sup> The poorer spouse can then either (1) immediately exercise the power by written notice, effective immediately upon the poorer spouse's death (and then, only if the settlor is still alive) or (2) immediately release the power of appointment in accordance with § 2041(a)(2) of the Code. Either method, in theory, ensures that trust assets are included in the gross estate of the poorer spouse if he or she predeceases the settlor, without requiring any of the at-death complications called into question by *Estate of Lee*.

- c. Inter Vivos QTIP Trust. The obvious downside of joint revocable trusts and spousal power of appointment trusts are that they, by definition, grant the poorer spouse the power to appoint assets to whomever they wish. If the richer spouse is nervous about granting such an unfettered power (which could, for instance, be exercised by the surviving spouse in favor of whomever he or she remarries after the richer spouse's death), a better solution is an inter vivos QTIP trust.

An inter vivos QTIP trust can be funded with sufficient assets to utilize the poorer spouse's estate tax exemption amount, but does not require the settlor to give up the power to determine the ultimate beneficiaries of trust principal.

An inter vivos QTIP trust also allows the settlor to take advantage of the poorer spouse's unused generation-skipping transfer tax ("GST tax") exemption. If the settlor designates his or her grandchildren or more remote descendants as the remaindermen of the QTIP trust, any funds passing from the trust to the remaindermen at the poorer spouse's death will be deemed to have

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<sup>65</sup> LISI Newsletter #1292.

<sup>66</sup> *Id.*

been made by the poorer spouse, and any GST tax due will be calculated against his or her GST tax exemption amount.

- i. Statutory Requirements. An inter vivos QTIP trust functions essentially the same as a testamentary QTIP trust. If the poorer spouse is a U.S. citizen and is given a qualifying income interest for life in the trust principal in accordance with § 2523(f)(2) of the Code, and if interest is paid to the poorer spouse at least annually, the trust property will be deemed part of the poorer spouse's gross estate under § 2044 of the Code. Any funds contributed to the trust by the wealthier spouse will qualify for the gift tax marital deduction under § 2523(a) of the Code. There is no requirement that the poorer spouse be given a power of appointment over trust property (although it is common to give the poorer spouse a limited testamentary power of appointment in favor of the descendants of the wealthier spouse).

As with a testamentary QTIP trust, the settlor can also grant the trustees the discretion to invade principal for the benefit of the poorer spouse. The settlor may reserve for himself or herself a lifetime interest in the trust in the event the poorer spouse predeceases the settlor, as long as the lifetime interest does not grant the settlor the power to alter, amend, revoke or terminate the trust as provided in § 2038(a) of the Code.<sup>67</sup>

For the property in the trust to qualify as QTIP property, an election must be made in accordance with § 2523(f)(4) of the Code by the gift tax filing deadline for the year in which the transfer was made. Such an election, once made, is irrevocable; thereafter, the property in the trust will be included in the poorer spouse's gross estate.

Note that this filing deadline is set by statute, not by regulation, limiting the IRS's discretion to grant extensions of time in which to make the QTIP election.<sup>68</sup>

Under § 672(e)(1)(A) of the Code, an inter vivos QTIP trust must be a grantor trust, since the settlor is treated as holding any power or interest granted to his or her spouse

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<sup>67</sup> Treas. Reg. § 25.2523(f)-1(d)

<sup>68</sup> See, e.g. I.R.S. Priv. Ltr. Rul. 200314012 (April 4, 2003).



under the trust. In the event of a later divorce or legal separation, § 682(a) of the Code provides that the income of the trust is thereafter includable solely in the estate of the beneficiary spouse, not the settlor.

The settlor may serve as trustee of the inter vivos QTIP trust. Under § 2523(f)(5) of the Code, this should not cause the trust to be includable in the grantor's gross estate. However, there is concern that this result may not hold where the trust allows the grantor, as trustee, to make discretionary distributions of principal to the poorer spouse.<sup>69</sup>

An inter vivos QTIP trust also provides for planning opportunities if funded with assets susceptible to discounts for lack of marketability or control. Cases have held that, at the death of the poorer spouse, his or her individually held assets will be valued separately from the assets held in the QTIP trust for his or her benefit.<sup>70</sup> This means, for instance, that even if the poorer spouse's gross estate contains the entirety of the interests in real property or a partnership, if those interests are held partially in the QTIP trust and partly in the remainder of the estate, both portions are considered to be held independently and are thus eligible for separate valuation discounts.

- ii. Divorce. An individual is allowed to create a new QTIP trust for each spouse he or she marries. So, even if a client already created a QTIP trust to take advantage of his previous spouse's estate tax exemption, nothing precludes creation of a similar trust for his or her second spouse.

An inter vivos QTIP trust is not terminated by divorce, and the former spouse will retain his or her income interest for the remainder of his or her life, even in the event of remarriage. However, only those provisions in the trust required to meet the statutory QTIP requirements must continue after divorce. Since a trustee's discretionary power to invade principal for the benefit of the poorer spouse is not a statutory QTIP requirement, the trust may be drafted to make any discretionary invasion contingent

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<sup>69</sup> Howard M. Zaritsky, *Tax Planning for Family Wealth Transfers: Analysis With Forms*, ¶6.03, n. 31 (WG&L). Retrieved from RIA Checkpoint database.

<sup>70</sup> See, e.g., *Estate of Mellinger v. Comm'r*, 112 T.C. 26 (1999).

upon the ongoing marriage of the settlor and the settlor's spouse.

- iii. Inter Vivos QTIP as Self-Settled Trust. The Settlor of an inter vivos QTIP may be tempted to provide that the trust's assets are to be held in further trust for his or her own benefit in the event the Settlor survives the spouse for whom the QTIP is created. The risk involved with such a provision is that state law may treat the inter vivos QTIP as a self-settled trust, thereby placing its assets within reach of the Settlor's creditors. This, in turn, raises the possibility that the trust will be included in the Settlor's estate by virtue of a constructive power of appointment deemed to be held by the Settlor's creditors.

In Florida, however, this is no longer a concern. As of July 1, 2010, the Florida legislature has amended § 736.0505 of the Florida Trust Code to explicitly state that an inter vivos QTIP will not be considered a self-settled trust, even if it creates a further trust for the Settlor upon the death of his or her spouse.

## 5. Other Transfers that Qualify for the Marital Deduction.

- a. Testamentary QTIP Trust. A testamentary QTIP provides an exception to the general rule that terminable interests do not qualify for the marital deduction under § 2056 of the Code. If the surviving spouse (who must be a U.S. citizen) receives a qualifying income interest for life (paid at least annually), the trustees are not given the power to distribute principal to anyone but the surviving spouse during his or her lifetime, and the executor of the testator's estate elects to treat the trust as a QTIP trust under § 2056(b)(7) of the Code, the trust property will be included in the surviving spouse's gross estate under § 2044 of the Code.

In the context of a second marriage, the remaindermen of a testamentary QTIP are typically the testator's children from a previous marriage. This arrangement has certain disadvantages.

First, the testator's children will be forced to wait for their stepfather or stepmothers to die before they can receive principal from the trust. If the surviving spouse is significantly younger than the predeceasing spouse, this waiting period may stretch into decades. During this period, the stepchildren and the surviving spouse will also have a conflict of interest as to the investment of trust assets, since the spouse will prefer investment in income-

producing assets, while the stepchildren favor assets that are geared for long-term growth.

The surviving spouse's estate is given the power under § 2207A of the Code to recover from the remaindermen any estate tax attributable to inclusion of the QTIP in the surviving spouse's estate. Depending on whether the surviving spouse's gross estate exceeds his or her estate tax exemption amount, the estate tax attributable to the QTIP may be substantial, thereby significantly decreasing the amount of assets that ultimately pass from the predeceasing spouse to his or her children.

In addition, applicable state law (or the trust instrument) may provide that the spouse has the power to compel the trustee to make trust property productive or to convert it into a productive asset within a reasonable time.<sup>71</sup> Under Treas. Reg. § 20.2056(b)-5(f)(4), inclusion of such a power in the trust instrument allows the settlor to give an attendant power to the trustee to hold substantially unproductive property. If the testator's goal is to use the QTIP to preserve a particular asset (such as a family business he or she wishes to ultimately pass to his or her children), the testator should be made aware that the surviving spouse may be able to force a sale of the business by virtue of her power to compel the trustee to render trust assets productive.

If the testator resides in one of the majority of states that has passed some version of the Uniform Principal and Income Act, he or she should also be made aware of the trustee's discretionary power to adjust between principal and income, which can be exercised to increase (but not decrease) the amount of income that the surviving spouse receives.<sup>72</sup> Such a power of adjustment may have unsettling consequences if the QTIP is wholly comprised of illiquid assets. Trustees, however, may be loath to exercise any power to adjust for fear of having to justify their actions to the beneficiaries or prove their impartiality in an accounting.

- b. QTIP Unitrust. A QTIP unitrust has the same requirements and functions as a standard QTIP, with the exception that the qualifying income interest is satisfied by paying the surviving

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<sup>71</sup> If the corpus of the trust consists substantially of property not likely to be income producing during the life of the surviving spouse, such a provision (or a provision allowing the spouse to require the trustee to provide the required beneficial enjoyment in some other way, such as out of other trust assets) is required by Treas. Reg. § 20.2056(b)-5(f)(5) in order to qualify for the marital deduction.

<sup>72</sup> Uniform Principal and Income Act § 104 (2000). This power of adjustment is not considered a power of appointment that would disqualify the trust's QTIP status. Treas. Reg. § 20.2056(b)-7(d)(1).

spouse a fixed percentage of the trust corpus, rather than the actual income earned by the trust.

A unitrust (also known as a "total-return unitrust") is a product of local law, and must be authorized by state statute. Under Treas. Reg. § 20.2056(b)-5(e), a surviving spouse's right to income from a QTIP is satisfied if applicable local law provides for a reasonable apportionment between the income and remainder beneficiaries. The Code definition of "income" for estate tax purposes provides that a unitrust amount of no less than 3% and no more than 5% of the fair market value of trust assets meets this "reasonable apportionment" standard.<sup>73</sup>

Several states (including California, Delaware, Florida and New York) have adopted unitrust statutes, and each state's statute varies as to how to determine the value of trust assets, how to handle illiquid trust assets, how to calculate the unitrust amount, and what language is required for a trust to opt into the unitrust regime.<sup>74</sup> If drafting in a state without an authorizing statute, it is not advisable to rely solely on case law holding that a unitrust meets the QTIP qualifying income interest requirement. Rather, in these states, the trust should be drafted to grant the surviving spouse the right to the greater of the unitrust amount or the total trust income.

The primary disadvantage of a QTIP unitrust is that it is ill-suited for trusts primarily funded with non-liquid assets, such as real property or closely held family businesses. These sort of assets are not only difficult to value for purposes of calculating the unitrust amount each year, but their unmarketable nature can leave a trustee unable to pay the unitrust amount without completely liquidating the entire asset.<sup>75</sup>

However, if funded with sufficient liquid asset to provide for the unitrust amount each year, the QTIP unitrust has numerous advantages, particularly in the context of a second marriage.

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<sup>73</sup> Treas. Reg. § 1.643(b)-1.

<sup>74</sup> An overview of these various state statutes can be found in Richard W. Nenko, *The Power to Adjust and Total-Return Unitrust Statutes: State Developments and Tax Considerations*, 42 Real Prop., Prob. & Tr. J. 657 (2008).

<sup>75</sup> Some states (such as New York) allow a trustee to ignore residential property (if being used by the beneficiary) when calculating the value of trust assets for purposes of calculating the unitrust amount, under the logic that the beneficiary receives the rental value of the property in lieu of the unitrust amount.

i. Advantages.

- (1) Avoids Conflict Between the Surviving Spouse and the Decedent's Children. In a standard QTIP, the surviving spouse and the trust remaindermen are in a constant battle as to how trust assets are invested; the spouse, as income beneficiary, wishes to maximize the income earned by trust assets each year, while the remaindermen are primarily concerned with the long-term growth of trust corpus.

This intrinsic conflict of interests can lead to confrontation, as each attempts to influence the trustee to adjust the trust's investments in his or her favor. This bitterness can be particularly pronounced where the surviving spouse is young, since the stepchildren know it may be decades before the trust pays out their remainder.

A QTIP unitrust alleviates this internecine conflict, since the spouse is assured of payment from the trust regardless of what income the trust produces. This allows the trustee to invest a larger percentage of the trust in equities and other growth-oriented assets.

- (2) Investment Freedom. In states that have adopted the Uniform Prudent Investor Act, a trustee walks a tightrope trying to provide sufficient income to the surviving spouse while still meeting the "total return" standard mandated by statute.

In a unitrust, a trustee is not obligated to obtain a reasonable rate of interest and is thus able to invest a larger percentage of trust assets in equities (including stocks that do not pay dividends), rather than in bonds or fixed-income investments, which historically have a lower rate of return.

This latitude in investment breakdown may make it easier to find an individual willing to act as trustee, since the trustee is freed from the responsibility of continually justifying his or her income/growth breakdown and is thus shielded from the competing

investment demands (and potential legal claims) of the surviving spouse and stepchildren.

- (3) Greater Control and Predictability for the Settlor. To be within Treas. Reg. § 1.643(b)-1, a trust's unitrust rate should be set from between 3% to 5%. In some states, a settlor is allowed to select a unitrust percentage from within this range, affording the settlor a modicum of control over what amounts will pass to his or her spouse than in a standard QTIP.

In addition, a QTIP unitrust offers greater predictability to the surviving spouse, particularly if the unitrust amount is calculated in accordance with a "smoothing" rule that derives the unitrust amount from the average net fair market value of the assets over multiple years. For instance, under New York EPTL § 11-2.4(b)(3), commencing with the third year of the trust, the unitrust amount is calculated based on the average net fair market value of trust assets during the last three valuation dates (i.e., the beginning of the first business day of each valuation year).

- ii. Examples of State Unitrust Statutes. State unitrust statutes have developed without the benefit of a uniform statute, and can vary significantly in their approach. Below is a brief overview of the unitrust statute of three different states.

In general, these statutes allow a trust to set a unitrust amount from between 3% and 5% and provide a default percentage to be used in the event that no specific unitrust amount is indicated in the trust.

Note that some states separate their unitrust statutes into two sections: one for the conversion of preexisting income trusts into unitrusts and one for trusts originally drafted as unitrusts. The overviews below give only a cursory nod to the statutory provisions relating to unitrust conversions. However, it is important to note that, barring an express prohibition in the trust agreement, a trustee generally has the power to convert a trust from a unitrust to an income trust, and vice versa, although such a conversion may require the acquiescence of the beneficiaries.

- (1) New York. Under New York EPTL § 11-2.4, a trust is subject to the provisions of the unitrust statute (a) if the trust agreement provides that the statute applies to the trust, (b) if the trustee, within two years of the trust's funding, and with the consent of all interested persons, elects to have the section apply to the trust or (c) by court discretion, at any time, upon petition by the trustee or any beneficiary.<sup>76</sup>

Unless the terms of the trust provide otherwise, the default unitrust amount is 4% of the net fair market value of the assets in the trust. For the first year of the trust, the net fair market value is determined on the first business day of the current valuation year. For the second year, the amount is calculated on the average fair market value of the trust on the first business day of both the current year and the previous year. For the third year of the trust (and for each year thereafter), the amount is calculated on the average fair market value of the trust on the first business day of the current year and the previous two years.<sup>77</sup>

The fair market value is proportionally reduced for any distributions from, or additions to, the trust during the valuation year. Short years are likewise pro rated on a daily basis.

Fair market value is to be calculated by "any appropriate technique" adopted and consistently applied by the trustee.<sup>78</sup> For valuation of real property or other property not regularly traded on an active market, the trustee's valuation is conclusive, as long as made reasonably in good faith.

Residential and tangible personal property that is occupied by a beneficiary—or over which a beneficiary has a right of possession or control—is not factored into the fair market value of the trust;

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<sup>76</sup> N.Y. EPTL § 11-2.4 (e).

<sup>77</sup> N.Y. EPTL § 11-2.4 (b).

<sup>78</sup> N.Y. EPTL § 11-2.4 (c)(5).

rather, the right to occupancy, possession or control itself constitutes payment of the unitrust amount for said property.<sup>79</sup>

- (2) Delaware. Delaware has separate statutory provisions for express unitrusts<sup>80</sup> and for the conversion of preexisting trusts into unitrusts.<sup>81</sup> These statutes provide a great deal of freedom to the trustee to adjust the unitrust amount, to determine fair market value of trust assets, and to opt out of the unitrust regime entirely.

An express unitrust is a trust that, by its terms, permits the distribution, at least annually, of a unitrust amount between 3% and 5% of the fair market value of trust assets.<sup>82</sup> The trust does not need to specifically reference the unitrust statute. The trust may provide that the unitrust amount is to be determined in reference to the fair market value of trust assets in one year, or for more than one year.<sup>83</sup>

By default, the trustee of an express unitrust has the power to change the unitrust percentage or to convert the trust to an income trust, as long as notice is granted to all interested parties and none of them objects within 30 days of receipt of notice.<sup>84</sup> A trust's terms may expressly deny the trustee these conversion powers or modify the terms under which they may be exercised.

The trust instrument may permit the trustee to value assets for which a fair market cannot be readily ascertained by any "reasonable and appropriate" method.<sup>85</sup> In addition, the trust may provide that

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<sup>79</sup> N.Y. EPTL § 11-2.4 (c)(6)(A).

<sup>80</sup> DEL. CODE ANN. tit. 12, § 61-107.

<sup>81</sup> DEL. CODE ANN. tit. 12, § 61-106.

<sup>82</sup> DEL. CODE ANN. tit. 12, § 61-107(a).

<sup>83</sup> DEL. CODE ANN. tit. 12, § 61-107(b).

<sup>84</sup> DEL. CODE ANN. tit. 12, § 61-107(d) and (e).

<sup>85</sup> DEL. CODE ANN. tit. 12, § 61-107(i)(1).



any residence or tangible personal property being "used" by a trust beneficiary may be excluded from the net fair market value when computing the unitrust amount.<sup>86</sup>

For a trust for which a marital deduction has been taken for Federal tax purposes, if said trust has previously been converted from an income trust to a unitrust, the surviving spouse has the right to compel reconversion of the trust back to an income trust.<sup>87</sup>

- (3) California. In California, a trust may set a unitrust amount between 3% and 5% of the fair market value of trust assets and may provide that the amount is to be calculated on the net fair market value of trust assets of the current year or averaged on a multiple-year basis.<sup>88</sup> California has no other provisions pertaining to trusts expressly formed as unitrusts, but some of the provisions relating to the conversion of trusts into unitrusts are instructive.

An income trust may be converted to a unitrust if the trustee gives notice to all interested parties and no party objects within 45 days of receipt of notice.<sup>89</sup> After conversion, the unitrust amount is 4%, and is based upon the average net fair market value of trust assets over the preceding three years (or over the period the trust has been in existence, if less than three years).<sup>90</sup> If conversion is done with the consent of the beneficiaries, the trustee may adopt any unitrust amount between 3% and 5%.<sup>91</sup>

After a trust is converted into a unitrust, any residential or personal property over which a beneficiary has a right of occupation, possession, or

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<sup>86</sup> DEL. CODE ANN. tit. 12, § 61-107(i)(2).

<sup>87</sup> DEL. CODE ANN. tit. 12, § 61-106(k).

<sup>88</sup> CAL. PROB. CODE § 16328.

<sup>89</sup> CAL. PROB. CODE § 16336.4(b).

<sup>90</sup> CAL. PROB. CODE § 16336.4(e)(2).

<sup>91</sup> CAL. PROB. CODE § 16336.5(a).

control shall be administered as if no conversion had occurred.

For a converted trust, the net fair market value shall be reduced proportionately for any distribution or additions that exceed 10% of the value of the assets. In addition, the trustee has the discretion to adjust the net fair market value to take into account distributions or additions that do not meet this 10% threshold.<sup>92</sup> The trustee is also given the discretion as to how to value nonliquid assets.<sup>93</sup>

- c. Life Estate With Power of Appointment. Under § 2056(b)(5) of the Code, if the surviving spouse is granted a life estate in property passing from the decedent, as well as a general power of appointment, said property will qualify for the marital deduction despite being a terminal interest. To qualify under the exception:
- i. The surviving spouse must be entitled for life to all the income from the entire interest or a portion thereof, payable at least annually.
  - ii. The surviving spouse must be granted a general power of appointment (including in favor of the surviving spouse or his or her estate) over that portion of the interest of which he or she is entitled to receive income. The power cannot be subject to any contingency and must be exercisable solely by the surviving spouse.
  - iii. No other person can be granted a power to appoint the subject property to any other person.

A life estate with a power of appointment trust is subject to the same regulations as a QTIP trust in regards to the definition of "income" and the trustee's power to adjust between income and principal. As such, any apportionment between income and principal must be "reasonable," but the use of a unitrust amount to satisfy the life estate is permitted.<sup>94</sup>

A life estate with a power of appointment is uncommon in second marriages, since (as with a spousal power of appointment trust or a

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<sup>92</sup> CAL. PROB. CODE § 16336.4(e)(5).

<sup>93</sup> CAL. PROB. CODE § 16336.4(f)(5).

<sup>94</sup> Treas. Reg. § 20.2056(b)-5(f)(1).

joint revocable trust) the testator may be unwilling to give his or her second spouse such unfettered control over the ultimate disposition of the property subject to the life estate.

6. Tax Apportionment. Care must be taken when drafting tax apportionment provisions to ensure that one spouse's children are not inadvertently burdened with taxes attributable to property passing to their stepsiblings.

By default, Federal and state law apportions taxation of non-probate assets to the beneficiaries of those assets. For instance, under § 2206 and § 2207 of the Code, an executor may recover, pro rata, from the beneficiaries of any life insurance policies that are included in the decedent's gross estate, or from the beneficiaries of property included in the gross estate by virtue of a decedent's power of appointment.

Likewise, under § 2207A of the Code, any estate taxes attributable to inclusion of a QTIP trust in the gross estate of the surviving spouse is to be recovered (barring a specific waiver in the surviving spouse's Will) from the remaindermen.

These provisions operate under the common-sense assumption that most testators want each beneficiary to bear the cost of his or her own bequest. This is particularly the case of second marriages, since the spouses may have made an effort to keep property separate, so each may pass their property, undiminished, to his or her children from a prior marriage.

Estate planners should think carefully about the implications of thwarting these default rules by apportioning taxes to the residuary of the surviving spouse. For instance, if the predeceasing spouse's children are to take at the surviving spouse's death by a non-probate asset such as an insurance policy, Totten trust, or spousal power of appointment trust, and the surviving spouse's children are to take as residuary beneficiaries, a clause apportioning taxes entirely to the residuary may force the survivor's children to forfeit a substantial portion of their inheritance so that their stepsiblings may take theirs tax-free. This is not the recipe for familial accord.

To avoid similarly unpleasant scenarios, the estate planner should make certain that apportionment is treated identically in each spouse's estate planning documents and that the apportionment provisions of any trusts do not conflict with the equivalent provisions in the couple's Wills.

#### **IV. Estate Planning in an Uncertain Tax Environment**

When the Economic Growth and Tax Relief Reconciliation Act ("EGTRRA") was passed in 2001, most estate planners thought it inconceivable that 2010 would dawn without Congress acting to prevent the repeal of the estate tax. That lesson learned, no one was

surprised when the 2010 Act, passed at the tail-end of the year, was merely a stop-gap legislation with a two-year lifespan. So, estate planners are still in the unenviable position of having to draft estate plans that achieve the client's goals regardless of what law may be in effect at his or her death. Such a plan must achieve its aims regardless of intervening changes in the tax rate, the federal estate tax exemption amount, or the portability rules.

As discussed above, the estate planner should not rely on portability as a safety net, and should instead use family trusts and other techniques that affirmatively use the predeceasing spouse's full remaining tax exemption amount at his or her death.

In addition, the estate planner should be cautious when drafting an estate plan that distributes assets in accordance with a formula tied to some statutorily-derived amount, such as funding a family trust with a decedent's unused estate tax exemption or passing the decedent's unused GST tax exemption amount to grandchildren or more remote descendants.

If the estate tax or GST exemption amounts are significantly larger or smaller at an individual's death than they are today, the logic and operation of these formula clauses may break down, potentially passing assets in a manner that the decedent never intended.

The estate planner should therefore examine how a formula clause will function under a variety of theoretical exemption amounts, keeping in mind that the potential impact of a formula clause can be greater for clients in a blended family than for clients in a first marriage.

In a first marriage, an ill-conceived formula clause most likely unintentionally passes more assets to either the surviving spouse or the couple's children, at the expense of the other. In such a case, the damage may be limited, since a surviving spouse may compensate by passing more assets to the children in his or her Will, and the enriched children may use their assets to support their surviving parent.

The odds that the enriched party will compensate or support the diminished party are far lower where the parties involved are a surviving spouse and his or her stepchildren.

In addition, a client in a blended family is more likely to have used the formula clause in an attempt to segregate assets between groups of beneficiaries (for instance, by passing the tax exemption amount to the children of a prior marriage, while passing the remainder to the surviving spouse), rather than merely as a tax avoidance mechanism.

## **V. Conclusion.**

An estate plan for a client in a second marriage must satisfy the client's obligation to his prior spouse, preserve assets the client wishes to keep as separate property, provide for the possible exercise of a surviving spouse's elective share rights and fulfill the client's dispositive intent. This task is complicated where the client has a blended family, since

its members often have competing goals and loyalties, increasing the risk of future dispute as to the client's dispositive intent. In order to foresee future conflicts, the estate planner must first obtain a working knowledge of the client's financial and familial history, then employ nuptial agreements, elective share planning, marital trusts and other estate planning techniques to ensure that the client's wishes are achieved.