TRANSCRIPT

Mary: Welcome to today's episode of Vandenack Weaver Truhlsen, Legal Visionaries, a weekly podcast discussing updated legal news, as well as evolving methods of providing legal service. My name is Mary Vandenack, founder and CEO at Vandenack Weaver Truhlsen. I will be your host as we talk to experts from around the country about tax issues, trusts and estates, business succession, exit planning, legal technology, law firm leadership, and wellbeing.

Mary: On today's episode my guest is Sharon Klein. Sharon is executive vice president and head of the National Divorce Advisory Practice for Wilmington Trust. Sharon is a nationally recognized speaker and author and has an endless list of credentials and honors. I have had the distinct pleasure of speaking at the same conference upon occasion and am an avid fan of Sharon's work. I asked Sharon to join us today to talk about the "Then and Now" in relation to how divorce issues impact estate planning. Welcome, Sharon.

Sharon: Thanks very much Mary for that kind introduction and for inviting me to be your guest. I am delighted to be here, and I love the theme of "Then and Now" and how things have evolved.

Mary: We have both been doing this for long enough that trusts and the law regarding the same has evolved. Early in my practice it was not uncommon for me or another lawyer to say to a client something like, "if you set up a trust for your daughter, it is going to be a third-party trust. So, if she goes through a divorce, the divorcing spouse will not be able to get the assets in the trust." That has changed. Can you explain the "Then and Now" on that issue?

Sharon: Sure. I see now, actually with increasing frequency, that family lawyers are trying to attack trust interests in divorce so that those interests factor into the marital balance sheet, and while much of it depends on state law, in terms of whether a beneficiary's interest can be considered in a divorce proceeding, the starting point is always going to be to determine the nature of the trust's interest.

Mary: So, what are the key things that would be considered in determining whether a beneficiary's interest in a trust is a marital interest?

Sharon: Well Mary, I am first reminded of the old adage, “when all else fails, read the instructions”, because the first thing you need to do is to look at the terms of the trust agreement. Really, the bottom line is that the less chance a trust beneficiary’s spouse will receive their trust distribution and the less control of the trust assets that the trust’s beneficiary has, the less likely that their trust interest is going to be reachable in divorce. A good place to start the analysis is to look at who created the trust and who are the beneficiaries. So, who created the trust is important because courts are less likely to consider a trust created by a third-party as part of the marital estate. So that means a trust created, for example, by a parent or a grandparent because that is more likely to have been done as legitimate estate planning as opposed to a spouse creating a trust, which may be seen as trying to shelter assets in anticipation of divorce. Because let’s face it: it’s just more suspicious if the spouse transfers assets to a trust and then says those assets are no longer part of the marital estate. So that’s number one. Number two, the beneficiaries are important because if a trust includes a class of beneficiaries, particularly a class that has multiple people or there’s several generations, and especially if it’s something called an open class of beneficiaries, which means the class includes beneficiaries who are not yet born, such as future issue. So, the total number of potential beneficiaries is undeterminable. If that is the case, with a very broad class, it is going to be less likely that the beneficiary’s spouse will receive trust distributions as opposed to, for example, the beneficiary’s spouse being the sole beneficiary. So, guess what; with a very broad class, it is less likely that the trust interest will be reachable in divorce.

Mary: So, you also speak regularly about how the standards for distributions are a factor and standards of distributions have become a significant area that is considered in a lot of different case types. Can you explain briefly what a distribution standard is and how it can result in an issue in divorce and result in the treatment of a beneficiary's interest as a marital asset?

Sharon: Sure. A distribution standard is basically the basis on which trustees can make distributions. If a trustee is given broad authority to make distributions within its sole discretion, then the timing and the amount of distributions is uncertain. It is less likely that a court will find that type of discretionary interest reachable in divorce than, for example, if a trustee is required to pay income or required to pay a portion of the principle to a beneficiary. Because, for example, if a trustee is required to pay out income or required to pay out principle pursuant to a standard, an ascertainable standard like HEMS, Health Education Maintenance and Support, then the beneficiary likely will have a right to compel trust distributions in accordance with the trust terms and the assets to which a beneficiary are entitled, may be factored into the divorce balance sheet. So, for example, a dynasty trust, which typically has broad discretionary standards and a broad class of beneficiaries. That's the type of trust that will usually be most protective in divorce.

Mary: So, now what if a trust has a sole discretion standard, but for 10 years there has been a distribution to a beneficiary of 5,000 per month, and then the beneficiary gets divorced. Is there any chance that that distribution is going to be treated as a marital interest, even though it was pursuant to a sole discretion standard?

Sharon: Well, you're jumping ahead. You're always one step ahead, Mary. You are talking about "What actually happened?" So, we are right now talking about what are the considerations when you're reviewing the trust agreement. We will continue that, but when you have finished reviewing the trust agreement, that's really only half the story, right? So, then you must look at what actually happened and if there's been a pattern of distributions, the court can consider that, especially if those distributions we use to fund a marital lifestyle. On the other hand, if distributions have been irregular and uneven, it is less likely that that interest is going to be reachable in divorce.

Mary: So, a spendthrift clause is another factor in consideration on this issue. There is a bit of "Then and Now" in the realm of the spendthrift clause. Can you explain what has happened in that arena and how that has impacted trust interest being treated as part of a marital estate?

Sharon: Sure. Well, the spendthrift clause is commonly inserted in trust documents as a form of creditor protection. Essentially what it does is that it prohibits a beneficiary from transferring their interest in the trust, and it provides that a beneficiary's interest is not going to be subject to that person's debt or liabilities. And the bottom line is that a creditor usually has to wait until a distribution is made to a beneficiary in order to assert a claim against those assets. So, if you are representing a spouse, who is a beneficiary of a trust, it's very helpful to find a spendthrift clause in the trust agreement. But the “Then and Now” aspect of it is that a spendthrift clause is not necessarily foolproof. Depending on the state, we are seeing cases now where alimony and child support may be treated differently from equitable distribution, and also where trust funds may be factored into the analysis, despite the presence of a spendthrift clause. That happened, for example, in a case coming out of Massachusetts, the Levitan v. Rosen case, where although the trust interest itself wasn't reachable because there was a spendthrift provision, the court equalized with assets outside the trust.

Mary: So, what other factors should be considered?

Sharon: Well, there's a couple of other very important factors that should be considered. The first is beneficiary control powers. The second is who is acting in the role of trustee. In terms of the beneficiary control powers, the cases show us that the greater the powers of a beneficiary to exert control over a trust, the greater the likelihood that the court is going to consider the beneficiary’s interest in a divorce proceeding. Mary, this one is particularly interesting to me because I don't think that planners are necessarily focused on how control features may make a trust more vulnerable in divorce. Planners are generally focused on how to maximize and safeguard the transfer of wealth. That usually means not making gifts outright. That usually means making gifts and trust while giving the beneficiary the maximum amount of control without triggering adverse tax consequences. But beware, family lawyers are going to take those supposedly innocuous control features and try to turn them into arguments about why they make the trust assets reachable in divorce.

Sharon: So, who knew? What are the control features that I'm referring to? Well control features can include the beneficiaries acting as trustee, including the beneficiaries being able to make distributions to themselves, pursuant to a standard like hems, which shouldn't have as adverse estate tax consequences, but can cause vulnerability in the divorce context. They could also include the power to remove and replace trustees or having a power of appointment, which allows a beneficiary to direct the disposition of trust assets. Particularly if it's a presently exercisable power of appointment, which allows a beneficiary, a substantial current control over the trust assets, as opposed to a testamentary power, which is only exercisable on death. So, beware these provisions in the hands of a family lawyer. The other consideration that I mentioned, who is the trustee, is also very important because if you have an independent, neutral trustee acting, particularly a corporate trustee, that usually removes even the appearance of impropriety and can circumvent the suspicion that a friend or family member acting as a trustee is manipulating trust distributions for the benefit of the beneficiary. Then as I mentioned before, once you've finished reviewing the trust document terms, you have to look at what actually happened because a court can consider the history of distributions.

Mary: So, I like that thought process of sometimes as planners, we get very focused on the estate tax consequences of utilizing a trust, but we want to be really liberal with the access to the beneficiary. That's a conversation we need to have with clients to say, “well, we can give the beneficiaries fairly liberal access, but the more liberal that access is, and if the trustee is themselves or their best friend, those type of things. If they're the only beneficiary, we have a hem standard, those are going to make it more and more likely that their spouse, if they get divorced, is going to have access to it.” I always have to point that out because a lot of times they really don't want everything to go to the spouse. They want to make sure it goes to the next generation. So that is a great point. Another change in the realm of estate planning has related to the definition of spouse and that I find really interesting to follow.

Mary: I have to admit just kind of an amusement about the different definitions of spouse that I read. But early in my practice, there was just an assumption that when we were dealing with a husband and wife, that they were going to remain married, and we were planning for them to remain married. I'm not sure that that was really a proper assumption even early on in my career, thinking about the number of my clients that have been divorced since that point, but the standard definition of spouse would be, “hey, the person you are married to at a given time”. You would rarely see these provisions that remove a spouse upon divorce. How does that kind of change the “Then and Now” of that?

Sharon: Well, it is so important, Mary, because oftentimes sort of the core of estate planning is for spouses to create trusts. That is the foundation of our planning, right? And if one spouse creates a trust for the benefit of the other, and suddenly those spouses are getting divorced, the first thing that you need to do is to look at the definition of spouse to see if they continue as a beneficiary. You say you're amused at some of the definitions of spouse, well, some documents make it clear that a divorced spouse is out in the event of divorce by using a term of endearment for trust and estate lawyers known as the “flirting spouse”. Right? Which means that the beneficiary’s spouse is the spouse to whom the set law is married from time to time, which is a very flexible definition and can adjust and readjust with every marriage, divorce, remarriage, divorce, and so on and so forth.

Sharon: But some trust and estates attorneys tell me that doesn't engender the warmest of feelings. If you have the happy couple sitting opposite you and the wife, for example, knows that not only is she out in the event of divorce, but she'll be replaced as beneficiary by her husband's next wife. So, other attorneys use the strategy of defining the spouse as the current spouse provided that spouse is married to or living with the grantor on the date of a distribution, and that also works. But if you haven't defined spouse in the absence of guidance in the document, a court has to search for the creator's intent and that can result in protractive litigation, enormous legal fees, and we've seen that in some of the cases. I predict that this is going to be especially problematic with the types of planning that we are doing now to use the enhanced federal exemption amount.

Sharon: I mean, consider the avalanche of SLATs, those Spousal Lifetime Access Trusts, which are really the darling of estate planning techniques right now, where spouses create trusts for each other. They have to be different enough not to be a reciprocal, but essentially each spouse retains backdoor access to the assets they've transferred to the trust through distributions that are made to their spouse, which of course works very well as long as they're happily married, but access is typically cut off if the spouses get divorced. I think it's really important to be cognizant of that in the drafting phase and for attorneys to focus on what will happen if the couple gets divorced? How do you extricate them? If you don't plan on how to extricate them, it's first of all, a practical problem: who's the beneficiary? And then there's a tax problem that I'm hoping that you'll ask me about later.

Mary: It is always interesting. I had one of those conversations this week with a client where let's just talk about if you pass away and then he remarries, does that change the way you view this? And the answer is almost always yes to that. It's one of those really tough conversations, but I've learned you just have to ask it. Early in my career, premarital agreements were not all that common, and some states were slow to permit such agreements. Today, premarital agreements are fairly common in a wide variety of situations. What should be considered with respect to a premarital agreement?

Sharon: Well, Mary, I would say from my perspective working with a lot of wealthy families, first of all, that premarital planning is becoming a much more routine part of the premarital process without the perception that, “oh my God, you're doing a prenup. You must have some doubts about the success of the marriage.” In fact, nowadays, I think it's quite the opposite. I think many more people understand that prenups really allow couples to start a marriage with open communication, with a shared understanding of their financial future. In fact, I do a monthly tip for a magazine, family law magazine, and the monthly tip I did for February, which of course is Valentine’s Day month was titled “Candy Flowers and Prenups”, because what is more romantic than starting a marriage with that type of shared understanding. So, in terms of the “Then and Now”, I believe that prenups don't typically now evoke the negative connotations that they did in the past.

Sharon: I think that's a very positive development. In terms of what should be considered for a prenup: being prepared before the marriage with a prenuptial agreement can certainly help shield trust assets in the event of a divorce. The requirements for a valid prenup can vary with state law, but they should be signed as far in advance of the marriage as possible, and generally require that the agreement is fair and equitable when signed and depending on the state, potentially also at the time of enforcement, they generally have to have full and adequate disclosure with each party represented by competent counsel. What I think is interesting is that some people say to me, “well, we've got a trust set up for the kids. The kids are all set because we've done this trust planning.” Which of course is fantastic, but I don't think that obviates the need for the prenuptial agreement.

Sharon: I think trust planning and prenuptial agreements together present a very powerful combination. Why? Because prenuptial agreements can protect the trust assets and the appreciation on trust assets. Because as we were discussing at the outset, when we were considering whether a trust interest is reachable in divorce, the fundamental question about whether a trust asset is reachable in divorce, generally turns on whether a trust interest is a property interest at all. That could be addressed in a prenup, because if a trust interest is a property interest, even if it's separate property, there still may be claim to appreciation on the trust assets, or there may be a support claim. But if the trust interest is not a property interest, there may not be a basis for any claim. So, some matrimonial attorneys tell me that they create a category in their prenups called Trust Interests, and they disclose the trust interests. Remember there should be full and adequate disclosure, and they specifically define those interests as not being property interests, which I think is an interesting way to protect a client.

Mary: One of the things that I am doing is there's a lot of states that will treat businesses, and my home state is one of them, that if you're active in the business, even if the business was gifted to you, they will treat that as marital property to the extent there was growth. So, I am actually also covering that, and we sometimes have business interests inside of trusts. So, we are kind of double layering that in our current premarital agreements.

Sharon: That's exactly right. That is a common claim for appreciation if one spouse has been active in the business. So just because an interest is in trust doesn't necessarily mean it's protected in full. So that is why I think the combination of the trust and the prenup is a very powerful combination.

Mary: So, you had suggested that I ask you on the tax questions and I think another one of the “Then and Now” issues is some changes in that department. Can you explain the significant changes in the tax area?

Sharon: Yes, Mary, and there have been some very significant changes: two in particular that I want to highlight. The first is that the taxation of trust income has dramatically changed. The 2017 Tax Act repealed the section of the Internal Revenue Code, Section 682, which deals with the taxation of trust income following divorce. So just as background, we all know the benefits of creating grantor trusts. There are proposals, they've always been proposals to curtail how attractive grantor trust planning is. But right now, it's still an extraordinarily attractive technique where you could give assets away in a trust. You get the assets out of your estate, you get the appreciation on the assets out of your estate, but the grantor assumes the tax liability for the trust, which means that the trust can in essence grow tax free because the beneficiaries are not saddled with the tax liability.

Sharon: So practitioners often purposely include in their trust agreements provisions that are going to trigger grantor trust status. In addition to that, there's a provision of the Internal Revenue Code, Section 677 A1, where a grantor is treated as the owner of any portion of the trust, if the income can be distributed to the grantor's spouse. Under Section 672 E1 of the code, the so-called Spousal Unity Rule, a grantor is treated as holding any interest held by an individual who was the grantor spouse at the time the interest was created. So that's the operative time: the date of creation. So that means that if the trust is a grantor trust, because it was created by spouses, and the grantor spouse could receive income, it remains a grantor trust even after the couple gets divorced because the operative time is the time of creation of the trust, not the time of distribution.

Sharon: So that means if after a divorce trust income was payable to a grantor spouse, in the absence of relief, the grantor would continue to be taxed on the income and the ex-spouse would receive the income tax free. A pretty surprising result, I'm sure if you ask that grantor. So, Section 682 used to prevent that result by providing that income in that scenario that was distributed to an ex-spouse after divorce was taxable to the recipient and not the grantor. The problem is that the 2017 Tax Act repealed Section 682 regarding divorces, beginning in 2019. The repeal of Section 682 is keyed to the date of the divorce, not the date of the trust agreement. That means that a grantor spouse might be liable to pay the income tax on tax income from grantor trust potentially created years before a divorce.

Sharon: This is a big deal. Why is it a big deal? Because of the estate planning that we are doing nowadays, as I mentioned before, the SLATs, the Spousal Lifetime Access Trusts, the Qualified Personal Residents Trusts, the Lifetime Marital Trusts. All of these by their nature are grantor trusts. In the drafting phase, again, we have to be really cognizant of the definition of spouse. Spouses can extricate, if you find yourself in this situation, the trust is already drafted. People are getting divorced, and it hasn't been covered. It's really important to collaborate with estate planning attorneys, matrimonial attorneys, and investment advisors to investigate possible solutions. There are possible solutions with the caveat that if it's a trust for which you've previously garnered the marital deduction, you want to be really careful about not having any potential adverse tax consequences. But with that caveat, some of the suggestions are removing the spouse as a beneficiary by virtue of an amendment power in the trust agreement or decanting either under the provisions of the trust agreement or state law, and perhaps equalizing with other assets, dissolving the trust and making an outright distribution of property to one spouse and equalizing the other spouse.

Sharon: Although, that of course made defeat the original planning goal of setting up the trust, which is getting the assets out of the estate of both spouses and to the kids, but that is an option. Another option is to keep the spouse as a beneficiary, but in a settlement agreement, provide that the spouse has to reimburse the grantor for the income taxes attributable to the trust income that the spouse receives. But the bottom line here is that the tax impact of every trust created during the marriage really needs to be carefully reviewed when you're negotiating a divorce settlement before the divorce is final, because if a matrimonial attorney says to their clients, “let's finish the divorce, and then you could go to your trust and estate's attorney to update your planning.” It's going to be too late. And I might add, the changes regarding the appeal of Section 682 are permanent.

Sharon: They do not sunset. They're here to stay. The other very significant tax change is in the tax treatment of alimony. Until 2019, alimony payments were characterized as taxable income to the recipient. They were deductible by the payer and with the spouse paying the alimony, likely to be in a higher income tax bracket than the spouse receiving the alimony, the recipient spouse was potentially able to pay taxes on the alimony at a lower rate, and that bracket play often resulted in savings for the parties as a couple. So let me give you a very simple example to put into context how significant this change is, and I'm going to make up tax brackets for ease of math. So, let's say a husband had to pay his wife $90,000 in alimony, and let's say, I'm making up brackets, he's in a 40% bracket and she's in a 25% bracket.

Sharon: Under the old law, he would pay her $120,000, which was taxed to her at the 25% bracket. So that's $30,000 worth of tax she would pay to be left with the $90,000 that she was entitled to. Under the new law, where everything is taxed to the husband, he would have to earn $150,000 and pay $60,000 worth of tax in his 40% bracket to be left with the $90,000 that he owes her. So $30,000 more of tax in this very simple example with these pretty modest numbers between the difference in the years, depending on which law was in effect. I'm sure you could imagine if the numbers were higher, you could really see a significant disparity, because of this change in the treatment of how alimony is taxed. Divorces before 2019 are going to be grandfathered with that old tax law. But I want to point out a trap for the unwary because a prenuptial agreement is likely not going to be included in the definition of divorce or separation agreement that are grandfathered.

Sharon: That means a prenuptial agreement that was signed before 2019 likely will not be grandfathered with the old tax treatment, even if the prenuptial agreement was negotiated on the basis of, and premised on the foundation that the payments would be deductible by the payor, and includable in the income of the payee. So, all prenups signed before 2019 have to be reviewed in light of those changes. And while you could always reopen a prenup and revisit the issue, oftentimes people allow to do that because who knows what can or worms you open when you do that? So, interesting issue and interesting that for state purposes, some states have decoupled from the federal treatment of alimony payments and alimony can be subtracted from the federal gross income in computing the state income. For example, that's the case in California, in New York and in New Jersey.

Mary: That's a really interesting change, both on the issues of the alimony payment and the taxation of the trust income. We're seeing a lot of changes and really having to think about, how do we structure this? I've been through a few of the divorces going on with some of those in place. I say, you really got to do the math and stay logical and try to negotiate a PLA to a good place, if you can- not always possible. I think you referred to can of worms, and that's often what you see in divorce, no matter how you slice it. Well, do you have any last thoughts on the “Then and Now” issue Sharon?

Sharon: Well, I have thoughts in general, which is that whether you're talking about “Then and Now”, or in general, I would just add, Mary, that this is a very complicated, nuanced arena. As we've seen from our discussion today, there's lots of overlap with different professional disciplines. At the end of the day, how a client feels is largely going to be dependent on their team of professional advisors. If they have a trusted team of experts, which generally includes a trust in estates, attorney, a matrimonial attorney, a financial advisor, and an accountant who could all collaborate, they could really position clients for success. So, at the end of the day, whether it's then, whether it's now, whether it's in the future, I think it's really all about the team.

Mary: Yeah. I would just add emphasis to that. I had a client once say to me, “you're really good at certain things, but the best thing you can do for me is to have a great network, so when it's beyond your scope, you have other people to bring in and on to the team.” That's all for now. Thanks for listening to today's episode and stay tuned for our weekly releases.