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Planning Considerations For Children of a First Marriage

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In our practice, we are frequently asked to represent parties in a second marriage who have children from a prior marriage. These situations present obvious conflicts which must be described and discussed with our clients. The use of the Qualified Terminal Interest Trust (QTIP) has been custom designed for this purpose. The QTIP Trust will provide benefits for the surviving spouse during his or her lifetime and will pass the residuary assets to the applicable children or other desired beneficiaries or charities. As described in more detail below, the benefit of a properly drafted QTIP Trust is that it will qualify for the marital deduction. Much has been written and discussed about the various benefits and complexities surrounding the QTIP election. This article will first summarize the QTIP election and then describe alternate considerations where the client elects not to use a QTIP form of Trust.

THE QTIP TRUST

The purpose for the QTIP Trust, is to preserve the marital deduction at the first spouses estate. The Internal Revenue Code (IRC) provides for an unlimited marital deduction.¹ This deduction is easily achieved where a decedent leaves property directly to his or her surviving spouse. However, the planning techniques become more complicated when the spouse does not desire the property to pass outright to the surviving spouse, but desires instead to have the property placed in a trust with the surviving spouse as a lifetime beneficiary and the children as remainder beneficiaries. The QTIP statutory rules and regulations provide the structural framework of this trust in order that it may qualify for the marital deduction.²

Although the requirements of the QTIP trust appear simple and straightforward, there continue to be numerous instances where careless drafting errors result in the loss of or challenge to the claimed marital deduction³. In order to qualify for the marital deduction, the trust must qualify under the rules and the executor must properly elect QTIP status. The will or trust instrument must require that property which passes from the decedent be placed in a trust in which the surviving spouse has a "qualifying income

¹ IRC Section 2056 (a)

² IRC Section 2056 (b) (7)

³ Estate of Whiting v. Commissioner, T.C. Memo. 2004-68

interest” for life. In order to constitute a qualifying income interest, he or she must be entitled to all the income from the property payable at least annually. In addition, no person may have the right to appoint any part of the corpus of the property to any person other than the surviving spouse during his or her lifetime.

The income requirement is designed to give the surviving spouse the equivalent of the beneficial enjoyment of the trust similar to that enjoyed under other trust law provisions. The surviving spouse must therefore also have the right to require the trustees to convert any non-productive interests to income-producing investments.⁴

In Whiting⁵, the draftsman of the trust properly and carefully drafted the marital trust in order to meet the above requirements. However, the will also included disability provisions wherein the trustee had the power to withhold distributions during the disability of a beneficiary. The Internal Revenue Service denied the marital deduction stating that the ability to withhold income was in direct contradiction to the statutory requirements. The treasury regulations prohibit any accumulation of income or any provision allowing for withholding or accumulating income.⁶ The terms of the disability section of the will were in direct conflict with the Treasury Regulations and with the terms of the marital deduction trust, (which was properly drafted). The Tax Court was forced to interpret Arkansas law in construing the intent of the creator of the trust. Ultimately, the taxpayer prevailed because the court determined that the decedent intended the trust to qualify for the marital deduction.

Other cases have not had such taxpayer friendly results. When trusts are improperly drafted, a common problem is the inclusion of children within the distribution power of the trustee. Other trusts have failed where the spouses interest ceased on the occurrence of a condition such as upon remarriage. The regulations expressly prohibit income for a term of years or contingent interests.⁷ In the Estate of Aronson v. Commissioner⁸, the taxpayer was not so fortunate and the court determined that the decedent did not intend that the surviving spouse was entitled to all income from the trust.

ALTERNATIVE METHODS

Due to certain clients’ discomfort of having their assets controlled within a trust, the estate practitioner is sometimes requested to provide guidance as to alternative methods to achieve the client’s goals. When the client elects not to use a QTIP trust, the estate planner is forced to consider other alternatives. The failure to properly plan and document the desires of the client could result in future litigation. For example, in the case of Oursler v. Armstrong⁹, the New York State Court of Appeals was presented with

⁴ Treasury Regulation 20.2056(b)-7(h) example 2.

⁵ Estate of Whiting v. Commissioner, T.C. Memo. 2004-68

⁶ Treasury Regulation 20.2056(b)-5(f)(7).

⁷ Treasury Regulation 20.2056(b)-7(d)(3)

⁸ Estate of Aronson v. Commissioner, T.C. Memo. 2003-189

⁹ Oursler v. Armstrong, 10 N.Y.2d 385 (1961)

a situation where the husband and wife executed their Wills at the same time. The wills provided that upon the death of the first to die, the surviving spouse would receive the entire estate of the deceased spouse. Upon the last to die, the children of both of the spouses would share equally in the remaining assets. After the husband's death, the wife changed her will to disinherit his two children and her new will benefited only her children from the prior marriage.

The New York State Court of Appeals was confronted with the issue of whether the contemporaneous mutual wills created a binding contract which would be enforceable after the husband's death. The court found that although the surviving spouse may have had a moral obligation to include his children, that was not sufficient to allow the court to restrict her right to dispose of her property as she saw fit. The court stated that such a restriction of a person's right to determine the beneficiaries of his or her estate is not a casual matter and that to impose such a restriction, the law requires clear evidence of the existence of a promise. The court was unable to find an enforceable promise or contract made by the surviving spouse for the benefit of her deceased spouse's children.

When representing clients confronted with these issues, it is important to document their intent in a clear and unambiguous fashion. A court will look for the existence of an express or implied promise. However, the mere existence of a confidential relationship between a husband and wife is simply not sufficient. An Antenuptial or Postnuptial contract will be sufficient for this purpose. Such a contract should be entered into contemporaneously with the execution of their wills and should include the clear statement that the parties intend that this agreement shall be enforced as a binding contract for good and valuable consideration including the contemporaneous finalization of their wills. The agreement should also describe the property included in the restrictions imposed. For example, after acquired property or separate inheritances might be excluded from the binding obligations.

In the event a contract is found to exist, a constructive trust will be enforced for the testamentary disposition of assets improperly received from the prior estate.¹⁰ The constructive trust is based upon the equitable principal that a person should not be entitled to unjust enrichment at the expense of another. A court will evaluate the circumstances and actions of the parties in order to determine whether in good conscience, money or other property should be permitted to be retained. A moral obligation alone is not sufficient to invoke the doctrine without an actual promise.¹¹

CONCLUSION

In order to avoid conflict and to assist your clients in the orderly disposition of their estates a QTIP Trust will often be the prescribed measure or first resort. It is important to remember that in New York State a QTIP Trust may be subject to a surviving spouse's right of election and a waiver may be needed in such instance. In cases where your clients do not wish to utilize the formalities of the QTIP Trust election,

¹⁰ Miller v. Schloss, 218 N.Y. 400, 407 (1916)

¹¹ Oursler v. Armstrong, Supra at 391.

consideration should be given to utilizing a clearly documented contractual agreement in order to provide increased certainty that their desires will be respected. If the survivor then seeks to change his or her will, the court may well impose a constructive trust for the protection of their respective beneficiaries.

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