Estate & Succession Planning Corner

By Louis S. Harrison and Katarinna McBride

After ATRA, the Escalating Importance of Classifying Yours, Mine and Ours

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Funding of the Credit Shelter Trust

Percolating out there in estate planning since 1984 has been the concern about retitling assets to allow the funding of the credit shelter trust at the first spouse's passing. With the estate tax exclusion reaching $600,000 in 1984, planning often required a retitling of assets from one spouse to another to ensure that when the first spouse passed away, there would be sufficient assets to fund that spouse's credit shelter trust.

> **Example 1:** Circa 1984, husband had assets consisting of a $600,000 house, an IRA of $1 million and marketable assets of $800,000. Wife had no assets in her name. During the estate planning discussion, the planner recommended that either the house or a portion of the marketable assets be titled in the wife's name to ensure that wife's $600,000 credit shelter trust was funded in the event she was the first spouse to pass away.

The often glossed-over concern was whether the change in title of assets, from husband to wife in the above example, affected the marital/nonmarital nature of the property for divorce purposes. Given the importance of avoiding estate taxes and the justification for doing so pre-portability, that marital concern often took a back seat to the actual need to reallocate assets for estate tax purposes.

Portability

Portability—the concept of allowing the surviving spouse to inherit the deceased spouse's estate tax

exclusion—decreases the necessity of reallocating assets as between spouses to maximize the use of the estate tax exclusion. A determination of whether to rely on portability is itself a sophisticated analysis, but now the marital/nonmarital concerns related to asset transfers between spouses needs to be considered further because no longer is it a necessity to transfer assets to ensure full use of the estate tax exclusion.

Titling

Title is possession. And possession is nine-tenths of the law. But title does not in and of itself determine whether property is marital or nonmarital.[1]

Example 2: During marriage, wife is the sole breadwinner and titles all earnings in her own name. Despite owning all assets, these assets are marital because they were earned in the traditional sense (not from separate assets) during marriage.

The issue that needs to be examined, however, is whether a *change* in titling transmogrifies—in the marital sense, "transmutes"—the nature of the property from one classification to another.[2]

Example 3: If husband brings into the marriage $1 million of separate assets, and during the marriage gifts those assets to his wife, has that gift changed the nature of the property from the husband's separate property to the wife's separate property? Yes, if the husband intends to make this distinction *via* the gift; no, possibly, if the intent is merely to change title for estate planning purposes (discussed below).

Linked Together by Marriage, but My Assets Remain Mine

A majority of the states have adopted a dual approach to classifying property as either "marital property" or "nonmarital property."[3] Property classified as marital property is property that both spouses are entitled to share in the event of divorce. Property that is classified as nonmarital is awarded to the owner-spouse.[4]

With spouses retitling their nonmarital assets between themselves and titling property in joint ownership, the character and identity of nonmarital assets has become far more difficult to classify, and thereby more difficult to preserve. In marital property states,[5] the problem can be illustrated by the transfer of property to a species of trust known as the "joint trust."

Particularly complicated (or seemingly so) is the analysis of whether nonmarital property transferred to a joint trust results in the property losing its character as nonmarital property. In the joint-trust context, consider the argument if one spouse's property is transferred to a joint trust and falls under the control of the other spouse's unilateral withdrawal right.

Example 4: Spouse 1 contributes 90 percent of their individual property and spouse 2 contributes 10 percent of their individual property to a joint trust. Each spouse has the unilateral right to terminate the trust and withdraw an equal share of the property. On termination, all property is returned to the spouses as tenants in common. Because each spouse exercises their equal and unilateral right to terminate, spouse 1 has arguably made a 40-percent gift to spouse 2 (90 percent initially contributed less 50 percent retained if trust is terminated). As to this 40 percent, if the property was spouse 1's individual, nonmarital property prior to transfer, has it now has become the nonmarital property of spouse 2 because of withdrawal right? Or, alternatively, does this property become marital property to be divided equally at the termination of the trust because it was titled jointly and became a gift to the marriage?

> Given the importance of avoiding estate taxes and the justification for doing so pre-portability, that marital concern often took a back seat to the actual need to reallocate for estate tax purposes.

But the mere transfer to a joint trust is ambiguous as to result.

To Achieve Transmutation

In making the determination as between marital or nonmarital property, courts apply a presumption that the title of the property is how the property should be classified; marital property (joint) or nonmarital property (separate). When title has changed from one estate to another, the courts will review whether

the parties ***intended*** to make a gift from the one estate to the other, thereby transmuting from one classification to another.[6]

Therefore, a change in title, whether it is from one spouse to the other spouse, or from one spouse to both spouses, jointly, or the converse, will at minimum garner scrutiny on property division in divorce.

Consider then a separate document, signed by each of the parties, indicating that (i) transfers to a joint trust (or from one spouse to the other) are being done exclusively for estate planning purposes, (ii) are expressly not intended to transmute the property, and (iii) expressly providing that the character (classification as marital or nonmarital) of the property prior to the transfer will remain in-tact.[7] See Appendix A for an example.

More specifically, consider the following steps:

Step one: Know the state law to understand if there are any quirks in the state law that should be taken into account in drafting the intent agreement.

Step two: The parties, both represented by the same counsel, sign an agreement that all transfers (to the joint trust or otherwise) are being done exclusively for estate planning purposes, are not intended to transmute the property and that the character of property remains as prior to the transfer.

Step three **(optional)**: Have the parties acknowledge in the agreement that the practitioner is representing both parties, and the parties consent to that representation, that the agreement may not be effective under state law to protect against transmutation and that the parties nevertheless intend for this document to prevent transmutation, to every degree possible.

Step four: Effectuate the transfer, but make sure the parties know to monitor the assets and reinvestments thereof. The parties should invoke

Appendix A

Memorandum of Intent

Marital/Non-Marital Property Agreement

We, John Jones and Jane Jones, husband and wife, have consulted with legal counsel to prepare our respective estate plans.

Part of the consultation addressed the estate tax benefits which may arise from severing joint tenancies, changing beneficiary designations and transferring various assets, so that the first of us to die may more strategically use the estate and generation-skipping transfer tax-free amount then available, or maximize basis step-up opportunities.

The consultation also made us aware that absent an agreement between us, some changes which may be beneficial for estate tax purposes may be argued to alter our respective rights in the event of dissolution of our marriage.

This Agreement is executed to document our intent that all changes made now or in the future to maximize potential estate tax savings or to avoid probate, specifically including (but not limited to) title to [our primary residence], shall not alter our respective rights upon dissolution of marriage.

Assets and benefits acquired as marital property during our marriage shall remain as marital property without regard to which of us may be in title, and without regard to transfers between us or to or from trusts or other entities controlled by either of us. Similarly, assets and benefits currently held or acquired in the future as non-marital property shall remain as non-marital property without regard to which of us may be in title, and without regard to similar transfers.

Executed at _____, Illinois, on _____, _____.

_____ _____

John Jones Jane Jones

tracing principles because if a court cannot identify their separate assets and they have lost their character because they cannot be traced or identified, the court may characterize the assets as marital property.

Conclusion

In 2013, asset allocation as between spouses must be done with extreme care and preferably with the following memorandum of intent.

Endnotes

1 The title system to determining property in divorce has been changed by state equitable distribution statutes. *See, e.g.*, Morgan, *When Title Matters: Transmutation and Joint Title Gift Presumptions*, 18 Journal on Matrimonial Lawyers 33 (2003).

2 A transmutation is a transfer of property between spouses whereby the characterization of the property changes as a result of the transfer.

3 The "dual classification" states, which classify property as marital or separate are: Alabama, Alaska, Arkansas, Colorado, Delaware, District of Columbia, Florida, Georgia, Illinois, Iowa, Kansas, Kentucky, Maine, Maryland, Michigan, Minnesota, Mississippi, Missouri, New Jersey, New York, North Carolina, Ohio, Oklahoma, Pennsylvania, South Carolina, Tennessee, Utah, Virginia, West Virginia and Wisconsin. In the remainder of the equitable-distribution states, all property, however and whenever derived, is subject to equitable distribution. The "hotchpot" states, which provide that all property is subject to division are: Connecticut, Hawaii, Indiana, Massachusetts, Montana, Nebraska, New Hampshire, North Dakota, Oregon, Rhode Island, South Dakota, Vermont and Wyoming.

4 The courts reserve no jurisdiction to divide nonmarital property, though they often find 'equitable' methodologies as an end around, such as awarding alimony, requiring reimbursement, and applying various equitable doctrines, such as marital energies doctrine; that the effort of one spouse helped enhance the value of the nonmarital property of the other spouse. Nonmarital assets are generally defined as property acquired before the marriage, by gift or inheritance, or protected under the terms of a valid agreement between the parties.

5 Meaning noncommunity property states.

6 In a majority of states, the law presumes that when individual, nonmarital property is transferred into the joint names of both spouses, the property has been gifted to the marital estate. Extrapolating to a joint trust (not exactly the same as a joint name), one could argue that the transfer of non- marital property to a joint trust may also invoke this presumption. But because it is a presumption, that can be overcome by an intent by the parties to treat it otherwise.

7 The best evidence a spouse could have to rebut the joint title gift presumption is a written instrument signed by both parties with an express provision stating that no gift is intended. *Burnside v. Burnside*, 460 SE2d 264, 273 (W. Va. 1995). *See also Connealy v. Connealy*, 578 NW2d 912 (Neb. Ct. App. 1998) (an unsigned prenuptial agreement was evidence of the husband's lack of donative intent); *Parkinson v. Parkinson*, 744 NYS2d 101 (N.Y. App. Div. 2002) (a document signed by both parties, though not meeting requirements of an enforceable contract, was sufficient to show evidence of intent).