ESTATE PLANNING CONSIDERATIONS IN MARITAL DISSOLUTIONS

By Erik S. Schimmelbusch*

In the marital dissolution process, the areas of estate planning and family law often collide. If a family law attorney or estate planning attorney is not careful in advising clients and preparing documentation, unintended consequences can result in either or both practice areas. This article is intended to provide family law attorneys with some perspectives of an estate planner, with the hope we can each render legal advice to our clients with greater awareness and coordination of relevant issues.

Estates, Wills and Trusts

Provisions in divorce documents relating to death of either or both of the divorcing spouses often impose obligations on the estate of a party, or require that a party create a will that includes certain provisions for the benefit of a former spouse or children. Such provisions can have the unintended effect of preventing a party from creating a revocable trust, or requiring a party to include provisions in a will that would be addressed more efficiently in a revocable trust. If flexibility can be maintained to permit death-related obligations to be fulfilled by either a will or a trust, both spouses will often be better served. For example, through a revocable trust, the probate process (discussed below), with its associated delays, can be avoided.

Taking Realities of Estate Administration into Account

I have seen provisions in divorce settlement documents that require a party's personal representative or trustee to pay to a former spouse or to children a particular dollar amount, or to distribute particular assets, within a certain number of days after that person's death. It may be impractical or impossible to comply with such a provision within the time allotted, given statutory requirements and practicalities involved in probating estates.

A person nominated as personal representative under a decedent's will does not receive authority to deal with estate assets until he or she petitions the court and is appointed as personal representative. Often, such appointment takes place weeks after the decedent's death. In addition, Oregon law generally does not permit distributions to be made to estate beneficiaries until the probate process is concluded and the court grants approval for final distribution of estate assets.

It often takes a year or more to conduct an estate administration, particularly if assets must be sold prior to distribution or if a federal estate tax return or Oregon inheritance tax return needs to be filed. Although the court may permit interim distributions prior to conclusion of the estate administration, such distributions may not be permitted prior to expiration of the four-

month creditor claim period and without a showing that sufficient assets will remain to pay taxes and administration expenses.

If assets are held in a revocable trust at death, the probate process can be avoided entirely and assets may be distributed at any time without court approval. However, a trustee is limited by provisions of the trust agreement and by fiduciary obligations, which may require that trust administration expenses and taxes be paid (or at least ascertained and sufficient assets be held in reserve) before any distributions can be made.

Protecting Children

In the turmoil of the marital dissolution process, sometimes death-related provisions are made without full consideration of how the disposition of the estate might affect children or other descendants. For example, an obligation might be imposed on one or both spouses to transfer particular assets or a dollar amount to children, either during lifetime or at death. It is important to consider whether it is appropriate for a child to receive assets directly, or whether the assets should instead be held in trust until he or she attains an appropriate age. If a trust is desired, then the parties should agree on the terms of the trust, including who can be appointed as trustee, and what standard will apply to any discretionary distributions prior to the full distribution of the assets? In addition, provision should be made for a child predeceasing the party with the obligation to transfer assets at death. Does the obligation transfer to the child's descendants (or siblings or other individuals) or does it terminate?

Modifying Planning Documents

Sometimes the marital dissolution process results in estate planning documents being modified or terminated. With revocable documents, such as wills and revocable trusts, modification or termination is easily accomplished. Some other documents, such as irrevocable trusts, can be modified only with consent of all affected parties and sometimes only with court approval, in accordance with statutory provisions that apply to trusts. Also, modification of irrevocable trusts can have estate and income tax consequences. In some cases (including modification of generation-skipping trusts and charitable remainder trust), requirements in the IRC and federal Treasury Regulations must be carefully followed, to avoid adverse tax consequences.

Even if the parties do not agree on any modifications to estate planning documents, Oregon law provides for automatic revocation of certain will provisions. Under ORS 112.315, unless a will evidences a different intent, divorce or annulment of marriage after the execution of the will revokes all provisions in the will in favor of the testator's former spouse, and any provision therein naming the former spouse as personal representative, and the effect of the will

is the same as though the former predeceased the testator. Regardless of the method by which estate planning documents are altered by divorce proceedings, clients should be advised to seek the advice of an estate planning lawyer following divorce to review and update estate planning documents.

Life Insurance

One provision that is sometimes included in divorce settlements is the requirement that a party obtain and maintain a life insurance policy and name the other party and/or children as a beneficiary. Such a requirement can generate federal estate tax liability (as well as Oregon inheritance tax liability). Under Section 2042(2) of the Internal Revenue Code ("IRC"), the death proceeds of any life insurance policy in which the decedent possessed any "incidents of ownership" are included in the gross estate for federal estate tax purposes.

Estate tax inclusion of life insurance proceeds not only places a burden on the estate of the insured; it also can result in less than the full amount of the life insurance proceeds being available to pay to a former spouse or children, since estate tax liability is typically apportioned pro rata among the assets of the estate that generate the tax liability. Such pro rata apportionment is the default approach under Oregon law and in many estate planning documents. However, a will or trust can provide for a different apportionment.

Life insurance proceeds often can be excluded from an individual's taxable estate by placing a life insurance policy in an irrevocable life insurance trust. It is important that such a trust be structured carefully to ensure that the proceeds are excluded. If the insured party (1) retains any "incidents of ownership in the life insurance policy (such as the right to change the beneficiary), (2) is a beneficiary or trustee of the life insurance trust, or (3) retains certain other rights or powers under the trust agreement, the insurance proceeds may be included in the party's taxable estate. In addition, the transfer of the life insurance policy to the trust and subsequent transfers to the trust to provide funds to pay life insurance premiums can also create gift tax liability without proper structuring.

If a divorce settlement agreement requires that an existing life insurance policy be transferred from one spouse to the other, the transfer of the policy may create estate or gift tax liability. For estate and gift tax purposes, qualifying transfers to a U.S. citizen spouse do not generate gift or estate tax liability due to the estate and gift tax marital deductions available under IRC Sections 2056 and 2523. However, if the transfer occurs after the marriage is dissolved, these deductions are not available.

Family Business Assets

In many families, wealth is concentrated in business assets, and the estate plan incorporates provisions for such assets. Often legal entities are involved, with layers of documentation, including shareholder agreements, partnership agreements and limited liability company (LLC) operating agreements, which include buy-sell and other transfer provisions. Such provisions typically address transfers at death, and may also address transfers incident to divorce. Sometimes family business structures are unwound or re-negotiated in the marital dissolution process. If estate planning considerations can be taken into account as part of that process, all parties often will be well served.

Conclusion

Family law and estate planning attorneys will be well served to consider the impact of the work we do for clients in our respective areas of focus. By increasing general awareness of relevant issues and working more closely together, we can avoid pitfalls and provide the best results for our clients.

The discussion above is intended to provide a general overview of some common issues that have arisen in my estate planning practice. With respect to those issues, there are many nuances that could not be discussed, and application of the concepts discussed is very fact-specific. In addition, different issues may arise in the context of marital dissolution proceedings that affect estate planning, which have not been discussed in this article.

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