Lowenstein Sandler's Trusts & Estates Podcast: Splitting Heirs

Episode 16
The Sad Case of Lovey and Hubby (Part 2)
By Warren K. Racusin

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Warren Racusin: Welcome to the Lowenstein Sandler podcast series. Before we begin, please take a moment to subscribe to our podcast series at lowenstein.com/podcasts. Or find us on Amazon Music, Apple Podcasts, Audible, iHeartRadio, Spotify, Soundcloud or YouTube. Now let's take a listen.

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Warren Racusin: From the law firm Lowenstein Sandler, this is Splitting Heirs. I'm Warren Racusin.

I'm sure you all remember season two, episode four, in which we talked about the sad case of Lovey and Hubby, two clients who celebrated their 50th wedding anniversary, and six months later we're in a beat-each-other-to-a-pulp divorce. Lots of, shall we say, extracurricular activity on both sides that had been discovered and things quickly went south.

We covered a lot of ground in that episode; marital versus separate property, equitable distribution, etc., but there was so much to talk about that we couldn't squeeze it all in. Seriously, even if you don't remember all of that episode, I am certain you remember our special guest, Sharon Klein. Sharon is the President of Family Wealth for the Eastern US Region of Wilmington Trust Company. She is a fellow of the American College of Trust and Estate Counsel. She was formerly a trust and estates lawyer at a major law firm. And this is the one that always gets me; in 2021, she was inducted into the Estate Planning Hall of Fame. So next time you go to Cooperstown, look for her plaque. Okay.

Sharon Klein: It's sitting right here in my office, so yeah.

Warren Racusin: Well, welcome back to Splitting Heirs.

Sharon Klein: Thank you for having me.

Warren Racusin: Yes. And I'm sure even though you've got better things to do with your time, for some unknown reason, she's come back to continue our chat today, so it's great-

Sharon Klein: I can't think of anything I'd rather do, Warren, than be here with you.

Warren Racusin: God bless you. Let's pick up where we left off.

Sharon Klein: Okay.

Warren Racusin: Years before the divorce, Hubby had created trusts for the benefit of his children and transferred property that had been acquired during the marriage into the trust. And that's key; that property that funded the trust had been acquired during the marriage of Lovey and Hubby. That's usually a great estate tax savings play.

You remember from our episode on estate planning, when someone dies, the estate can be hit by a 40% estate tax, and making gifts during lifetime to try to avoid that bumps up against a 40% gift tax. Each of us has an exemption from that estate and gift tax. It's a $13.6 million get-out-of-jail-free card, at least it is now. In 2026, it's going to be cut in half that exemption is. And depending upon who gets elected president, it might be cut even further and even sooner. But in any event, you can make gifts up to that amount. And when the property grows after the gift, all of that appreciation escapes estate tax. Great planning, except if there's a divorce after the gift. Because what happens to that property now? Is it marital property because it was acquired during the marriage? But neither a Hubby nor Lovey own it anymore. How does that all check out in the divorce?

Sharon, can you clear all that up for us?

Sharon Klein: I'll do my best. I will do my best, Warren.

It's interesting because in the last episode of the podcast, we were talking about trusts created by third parties, so a parent or a grandparent, which are typically more protective in divorce. So now we are talking about a trust that's created by one of the parties to the marriage.

The fact of the matter is that the parties might not realize the consequences of transferring marital assets into an irrevocable trust while they're married, until they're going through a divorce. And then the question becomes, if you have a marital asset, and it's transferred into an irrevocable trust, does it lose its character as marital property? In other words, is it off the marital balance sheet? And there are many cases that have held that where married couple sets up an irrevocable trust for the benefit of third parties, and neither spouse is a trustee, neither spouse is a beneficiary, neither spouse has any control over the trust assets, then a court cannot dispose of it in a divorce, even if one or both of the spouses created or funded it.

On the other hand, where there's been nefarious conduct, the result might be different. There was a case coming out of New York, the Yerushalmi case, that I think is the perfect example of that. That was a case in which a married couple transferred a resident to a trust. The particular trust technique they used was called a QPRT, a qualified personal residence trust. It's a very common planning technique, where a home is transferred to a trust and the trust creator reserves the right to live there for a term, and at the end of the term it goes to other beneficiaries. Very common. I'm sure Warren does them all the time.

If you would've asked me, is this home included in the marital balance sheet? I would've said, "Of course not. Duh. The parties don't own it. It's owned in the trust. How could it be part of the marital balance sheet?" And the Supreme Court in New York actually said just that, "The marital residence was not a marital asset because it was owned by the trust and not by the parties," but the appellate court reversed. And at the appellate level, the court said that, "Since the marital residence was purchased by the parties during the marriage using marital funds, it was presumed to be marital property," and according to the court, "the fact that title had been transferred to the trust," and I'm quoting from the court when I say "allegedly for estate planning purposes", was insufficient to rebut the presumption that it continued to be marital property.'

Now, when I read that case, that was shocking to me. You can't see Warren's face, but he's also shocked. We're appalled at the fact that a perfectly seemingly legitimate estate planning technique was completely disregarded. That's shocking to me, anyway. But I did speak to one of the attorneys who was involved in the case and, apparently, under the particular facts of the case, it would've been inequitable for the residents to be off the marital balance sheet, so the court really backpedaled to the result that they wanted.

I think that the moral here, and this applies in many other cases, whereas a trust estate attorney, you may be scratching your head at the results where a legitimate technique is just disregarded. The moral is that while legitimate estate planning should be and thankfully is often respected, at the end of the day, the family court is a court of equity, and planning is not going to stop a matrimonial lawyer from at least trying to poke holes in the planning to tell a story and show vulnerability and convince a court of equity why trust assets should be considered.

Warren Racusin: Right. I think it's an important lesson to learn that courts and judges are human beings. And judges get a whiff of a case right at the beginning and that can color a judge's perception of the case right through. And particularly, as Sharon said, in a court of equity, a court that is designed to do what the judge believes is the right thing, that can have all sorts of repercussions in terms of planning that you thought was perfectly legitimate. Planning that might look completely legitimate to us as planners may look not so much to a family court or divorce judge.

And that's something to keep in mind when you're thinking about how you're going to get divorced. Is this worth fighting about? Is it not worth fighting about? You never know what a judge is going to do. And I think that's maybe in some ways the most important lesson to take away from the Yerushalmi case. Let's look at a variation on that theme.

Believe it or not, lots of people like to have their estate tax savings cake and eat it too. What do I mean by that? This may come as a shock to many of you, but trust Sharon and I, it's true. So, for example, Lovey could create a trust but make Hubby a beneficiary. Not just the kids; make her spouse a beneficiary. This is back when everything was hunky-dory between the two of them. Same gift and estate tax result. No gift tax, if within the exemption. The property doesn't get hit by an estate tax, but because Hubby's a beneficiary, if at some point down the road they need those gifted dollars, the trustee can just make a distribution to Hubby.

That sounds like it may be a bit too good to be true, but it is a perfectly legitimate and used all the time technique. We call it a SLAT, S-L-A-T, short for a spousal limited access trust, a SLAT, and we do them all the time. Sharon recommends them and people do them all the time, and they work just great.

But planners often talk to their clients about what happens if there's a divorce down the road. Can you make the Hubbies of the world disappear out of that trust if they split up? And at least in theory, you can. You can create what's called the floating spouse or the disappearing spouse. How does that work? The beneficiary of the trust is defined as Hubby, and here's the punchline, so long as he is married to and living with Lovey. If they split up, he goes away not only out of her life but out of her trust as well.

Sharon, you want to talk about how the floating spouse shakes out to mixed metaphors for a moment? How does that all fall into the overall scheme of what's happening in the divorce?

Sharon Klein: In the context, particularly when you're talking about trust created by parties to a marriage, so one spouse creates a trust for the benefit of the other, the first thing that you should really do is review the definition of spouse. And some documents do make it clear that a divorced spouse is out in the event of divorce by using that floating spouse concept that Warren just mentioned. That means that the spouse is very flexibly defined as the person to whom the trust creator happens to be married from time to time. So that's a very flexible definition, and that can adjust and readjust again for every divorce, and marriage and divorce, and remarriage, and so on and so forth.

But some trust estate attorneys, and maybe Warren, you're among them, tell me that doesn't engender the warmest of feelings if the happy couple is sitting opposite you, and one spouse knows that not only for example, if it's the wife, will she be out in the event of divorce, but the husband's next wife is going to step into her shoes as beneficiary. So, while that does work, other attorneys find it more palatable to name the current spouse, but with the provisor that the current spouse is married to and living with the trust creator on the date a distribution is made.

Now, this becomes particularly important when people, Warren, are creating those SLATs that you just mentioned, the spousal lifetime access trust, because there's a big push now to use the enhanced exemption amount, that $13.6 million number that Warren mentioned before, it potentially halves in a couple of years. The SLAT is so attractive because it's a trust with an escape hatch. So typically what happens with the SLAT is that one spouse creates a trust for the other, and those assets are out of their estate, but they're not really out of reach because the spouse who created the trust maintains backdoor access through distributions to the spouse. And then the second spouse does the same thing for the first spouse. So they each maintain backdoor access to the assets that they've given away. The trust can't be identical, otherwise the IRS would collapse them, but it's easy enough to make them different enough so that they're not identical.

The issue with the avalanche of SLATs now being created because it's a very effective way to use the exclusion amount, people are skittish about giving away irrevocably a large amount of money in case they're going to need it one day, so this escape hatchet, the SLAT gives them comfort that they will have access to the funds. But what happens in the event of divorce? So my prediction-

Warren Racusin: Right. That's the having your cake and eat it part, but the cake can go bad.

Sharon Klein: Well, with the avalanche of SLATs that are being created now and with all trust estate attorneys not as sophisticated as Warren and not necessarily focusing on what will happen if the happy couple gets divorced, I predict this is going to be a big problem in extricating the couple, if the document doesn't say what happens in the event of divorce for a number of reasons, including tax reasons.

Warren Racusin: That is clearly a problem. Also, as you and I have talked about, there is a lurking income tax problem in all of this as well, right?

Sharon Klein: Exactly.

Warren Racusin: We've been talking about the estate tax issues, but there is a very subtle but potentially very nasty income tax problem lurking in these SLATs if the couple ends up in the same place that Hubby and Lovey ended up.

You want to chat about that for a second?

Sharon Klein: Yes, exactly correct. And I would say it's a trap for the unwary.

The issue really stems from the repeal of a section of the Internal Revenue Code, which is Section 682, which dealt with the taxation of trust income following divorce. To understand the impact of their appeal, you really have to understand the concept of a grantor trust. And the important concept to understand here is that ownership for estate tax purposes and ownership for income tax purposes can be different. So I could transfer assets to a trust. I don't own them anymore. They're out of my estate for estate tax purposes, but I continue to own the assets for income tax purposes, and I'm responsible for paying the taxes generated by the trust assets.

So why would anyone want to do such a thing? Create a grantor trust, give away the assets so you can't access them anymore, but remain on the hook for the income tax liability. Why? Because that's perfect estate planning. Because to the extent the person who created the trust is paying the trust tax liability, the trust beneficiaries, they're relieved of the obligation to pay the taxes, and in essence, that means that the trust can grow tax-free, and that's a very attractive planning technique.

So how do you make a trust a grantor trust? Well, there are a number of provisions that estate planning attorneys can put into their trust agreements to trigger grantor trust status, and oftentimes they purposely put in those provisions because it's so attractive for tax planning reasons to have a grantor trust.

Additionally, there are times when trusts can be grantor trust automatically without putting in any of those triggering provisions. And one of those times is when the trust creator creates a trust and the creator's spouse can get income from the trust, like the SLAT we just talked about. That's an example of that. And very importantly, the time to determine whether or not a trust is a grantor trust is the time the trust is created.

So, what does that mean? It means that if the trust was a grantor trust at the time it was created because the trust was created by someone and their spouse could receive the income, it remains a grantor trust even if the creator and the creator's spouse subsequently divorce, because the operative time to determine the tax status of the trust is the time of creation.

So, if after a divorce, trust income is payable to a creator's spouse, in the absence of relief, the trust creator would continue to be taxed on the income and the ex-spouse would receive the income tax-free.

Warren Racusin: Right. That's called adding insult to injury or injury to insult, or whichever way that works.

Sharon Klein: Or salt to the wound, or whatever you want to call it.

Until recently, that section, Section 682, prevented that result by providing that the income distributed to a spouse after a divorce is taxable to the recipient and not the trust creator. The problem is that that Section 682 has been repealed with regard to divorces beginning in 2019, and the repeal is key to the date of the divorce, not the date of the trust agreement. And so the creator's spouse will be liable to pay the income tax on trust income from grantor trusts potentially created years before a divorce, five years before, 10 years before, 20 years before, it doesn't matter, even though their beloved ex-spouse is going to be receiving all that income. This is a big deal. It's a big deal because it affects the staples of estate planning, like the SLAT, the spousal lifetime access trust that we just talked about.

So, if you're in the drafting stage, very important to focus on the definition of spouse to make sure you could extricate the couple in the event of divorce. If you're dealing with a couple who's getting divorced and an existing trust agreement where spouse is not clearly defined, that's where collaboration between estate planning attorneys, matrimonial attorneys, investment advisors, is really key to investigate possible solutions. And there are solutions that can be investigated.

But I think the point is that the tax impact of every trust created during the marriage needs to be carefully considered before the divorce is finalized. After the divorce is finalized, it's going to be very challenging to change the results. So, before the divorce is finalized. And this is one of the changes that has been made to the tax law that is permanent. It does not sunset in a few years with many of the other changes.

Warren Racusin: There are even more tax issues to talk about. But despite the fact that I'm sure that everybody's hanging on every tax word we've been talking about here, I really want to shift the focus for a few minutes and talk about the human side of divorce.

What I mean by that, Sharon, you encounter people all the time, because this is a major part of what you do. You encounter folks all the time who are in the midst of the divorce and may have been very successful in their professional lives and other parts of their lives, but really don't have a clue about the financial part of their life. And I'd love if you could just share your thoughts about that, and how you advise and consult with people like that to get them on the right path.

Sharon Klein: Well, Warren, I'm so glad you asked that because what is most important, in my opinion, when you're working with people, whether they're maneuvering through divorce, or they're going through some other life event, is to balance expertise with empathy and technical expertise and the ability to pass through complexity. That, of course, is foundational. But no matter how accomplished you happen to be, I have found that clients want to know you care before they care how much you know. Divorce is one of the lowest points in someone's life, and I think you have to be highly attuned to that. And against that backdrop, there are really two ways we help people on the financial side.

One is actually before the divorce is final by running analytics to best position attorneys at the negotiating table. And we often use our sophisticated proprietary analytics to show that opposing side settlement proposals, which are often predicated very simplistic Excel spreadsheets, are woefully inadequate because they don't take into account variables, like the possibility of different investment returns, the possibility of different economic environments, the impact of taxes and so forth. And so, with our comprehensive data, attorneys are often able to demonstrate that they need a much larger settlement sum than the other side proposed.

The other way we help financially is, of course, after the divorce with comprehensive investment management. And here's what's key particularly, Warren, if someone is not used to handling the financial side of affairs. We couple investment management with financial education and financial projections to give people peace of mind that they could live the life they aspire to lead. And often one party, as you mentioned to a marriage, has been in charge of finances, and when the other party gets a divorce settlement sum, it sounds stereotypical, but it typically still is the wife, she may have no idea how to invest it, how to budget, how to plan. And often these people can be completely shell-shocked and intimidated about handling their financial lives after divorce.

But it's actually really amazing to see what happens when you equip someone with the tools, and the knowledge, and the confidence to believe in themselves. And it's personally and professionally rewarding to see these formerly intimidated people, to see them emerge as self-assured, self-confident, kick-ass people. That's really great.

Warren Racusin: And it makes a big difference in their lives because they have that confidence that they, with the help people like you, can actually manage this and make it work and make it work well. And that is in some ways the most important thing that as advisors, we can give to people in these terrible but surmountable circumstances.

Sharon Klein: Warren, I've actually worked with several attorneys who found themselves in this situation. And there's one case that we have right now that really underscores what the issue is and how important it is to get in front of it.

There was a very acrimonious divorce, and the husband was putting $10 million into a trust for his wife for her lifetime benefit that was going to be part of the divorce settlement, and on her death, the trust assets would pass to the children of the marriage. But if that trust would've been created as part of the negotiations before the parties were actually divorced, so while the parties were still technically married, even though they were on the verge of divorce, the husband likely would've been stuck with that lingering grantor tax burden, the burden to pay the taxes on the income his wife received for her lifetime. So what they did is that they created the trust after the divorce was final, so they were no longer spouses, and they avoided that whole issue with the help of a couple of very helpful sections of the Internal Revenue Code.

Warren Racusin: Yeah, we've been involved in other situations that involve just the opposite; making gift or transfers before the divorce so that the spouse was still treated as a spouse, so the gift that was made wouldn't be treated as a taxable gift. It comes down to trust, and sometimes the people who were getting divorced trust each other enough to be able to go with that, and sometimes not so much. I'm not sure how Hubby and Lovey would've come out on that one. But you're right; in the right situation with the right people and the right advisors, that can make a big dollar and cents difference.

Thank you to everybody at Lowenstein, and to Good2BSocial for making this possible. Thanks, of course, to all of you listeners, and a special thanks to our friend and now Splitting Heirs veteran Sharon Klein. I hope you never get divorced, but if you do, you know who to call.

We'll see you next time. Until then, as we say in these parts, have a good one.

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