

Premarital Agreements & Trusts

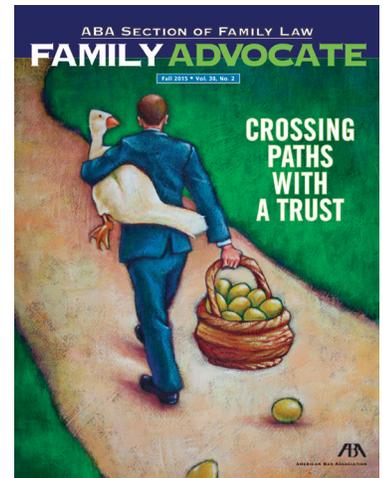
BY ANNE W. COVENTRY & LINDA J. RAVDIN

Adequate financial disclosure is essential to a valid and enforceable premarital agreement. When one party is the beneficiary of a third-party trust or the settlor of his or her own trust, the existence, key terms, and value of trust assets will necessarily figure into that disclosure. Even if a trust does not already exist, the parties may wish to incorporate one or more trusts into their premarital agreement terms.

Disclosure of existing trusts

The proponent of a premarital agreement will achieve maximum protection of property rights if financial disclosure is substantial, accurate, and meaningful—in other words, if it exceeds the minimum standards courts generally have been willing to accept. A lawyer for the beneficiary or settlor of a trust must ensure that these interests are disclosed. In general, the party will need to disclose vested rights, such as an interest as a beneficiary in an irrevocable trust or a revocable trust of which the party is the settlor. The kinds of information the party as beneficiary or settlor should disclose (and the other party should request) include:

- The name of the trust;
- The identity of the settlor;
- The value of trust assets;
- The nature of trust assets;
- The number and identity of trust beneficiaries (e.g., is the party to the premarital agreement the sole beneficiary or only one of four?);
- The identity of the trustee;
- The current rights of the party, if any, to income and principal;
- Whether the trustee can distribute income or principal to the party, the standard for the exercise of this power, and whether the trustee has discretion to withhold distributions from the party;
- The history of income and principal distributions, if any, to the party;
- What future rights the party has and when these rights come into being, such as upon a parent's death or upon reaching a certain age;
- Whether the party has a power of appointment and whether it permits the party to exercise it in favor of a spouse;
- Whether the trust is revocable or irrevocable;
- Whether trust assets will be includible in the gross estate of the party (or anyone else) for federal estate tax purposes.



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Trusts in prenup negotiations

A trust can provide a benefit to one person (the beneficiary) under the supervision of another (the trustee) upon terms dictated by a third (the settlor). Trusts can be flexible and useful tools in premarital agreement negotiations as a means of fulfilling one spouse's obligation to provide a benefit to the other without giving up complete control of an asset. Trusts also can pose traps for the unwary.

A trust can:

- balance competing interests,
- provide for minor children,
- fund an alimony or property settlement obligation at divorce,
- provide for a spendthrift spouse,
- sweeten the pot, and
- minimize taxes.

Consider the following uses of a trust in a premarital context.

Example 1: Bob worries about having enough to live on if Andrea predeceases him, but Andrea wants her wealth to pass to the children of her first marriage. If the premarital agreement requires Andrea to leave assets outright to Bob at her death, there is no guarantee that Bob will create an estate plan that honors Andrea's wishes. In this blended family, the premarital agreement can require that, upon Andrea's death, her assets will pass to a trust with lifetime income to Bob and, at his death, to Andrea's children.

Example 2: Arthur and Betty are miles apart on negotiating the terms of their premarital agreement. Betty wants \$5 million at Arthur's death (or upon divorce), but Arthur is unwilling to put anything close to that into Betty's hands. If the dollars go in trust for Betty—rather than outright to her—Arthur is amenable.

Example 3: Barry remembers the headache of enforcing an alimony award against his first spouse and wants to avoid a similar battle in his subsequent marriage. In lieu of alimony payments to Barry, the premarital agreement can require Anthony to establish a trust at divorce that will distribute a fixed monthly amount to Barry for a fixed duration. The premarital agreement can direct that a neutral third party serve as trustee.

Important types of trusts

• **Qualified terminable interest property (QTIP) trust.** If property for a spouse is left in a trust that meets the requirements of the federal estate and gift tax QTIP rules, it will qualify for the unlimited marital deduction. For a trust to qualify, it must provide:

- no distributions to anyone other than the spouse during the spouse's lifetime;
- the spouse must be entitled to receive all net trust income, at least annually; and
- the spouse must have the power to direct the trustee to invest the trust's property in income-producing assets.

The settlor can name the trustee, decide whether to allow distributions of principal, and direct where trust assets will pass at the spouse's later death.

• **Irrevocable life insurance trust (ILIT).** An ILIT holds life insurance on the life of the trust's settlor. This keeps the policy proceeds out of the settlor's (and, often, the beneficiary's) taxable estate at death. It must be irrevocable, and almost certainly the settlor will not be the trustee or a beneficiary.

- **Revocable living trust.** Typically used to avoid probate, this trust is revocable and can be amended or terminated at any time during the life of the settlor. For estate and income tax purposes, there is no distinction between a revocable trust and its settlor; each is the other's alter ego. The trust instrument directs how assets titled in the trust pass to the settlor's beneficiaries at his or her death. Depending on state law, a surviving spouse's elective-share rights may or may not include rights to revocable trust assets.

- **Domestic asset protection trust (DAPT).** Intended to insulate trust assets from future creditors of the settlor or beneficiary, including a future spouse, this is an irrevocable trust that includes its settlor as a beneficiary. Because not every state has laws permitting DAPTs, they are often established with a corporate trustee in another state, such as, Delaware, South Dakota, Alaska, or Nevada.

Negotiating trust terms

When the premarital agreement permits or requires the establishment of a trust, pay careful attention to the terms of the trust. (See "Checklist of Terms" below.) A premarital agreement that simply says, "Arthur may satisfy the foregoing obligations to Barbara by establishing a trust for her benefit," leaves Arthur with nearly unlimited freedom to choose the dispositive terms of the trust, its trustee, and its investment policy. Barbara should negotiate for more detail about what such a trust must or may provide.

Drafting considerations for trust beneficiary

Formula provisions based on gross estate. When carving out provisions to benefit a surviving spouse that will depend on a formula, drafters of premarital agreements often use the value of the deceased spouse's gross estate, defined in federal estate tax rules. When a trust is part of the picture, it is important to understand whether the value of an existing trust will be includible in the gross estate for federal estate tax purposes. If a valuable trust is not includible under the federal estate tax rules, a premarital agreement provision granting the surviving spouse X% of the deceased spouse's gross estate may result in a much lower figure than the surviving spouse expects. If the gross estate will be a measuring stick, be sure you understand what is—and what is not—included in the gross estate. Obtain a complete copy of the trust instrument and have an estate planning attorney review it and advise as to the beneficiary spouse's powers and beneficial interests and whether it will be includible in that spouse's gross estate. If the beneficiary spouse holds a general power of appointment, the trust's value will be includible in her gross estate. If she holds only a limited power of appointment, it probably will not be includible.

Using A's trust to B's advantage. The beneficiary spouse may have rights and powers over her trust that could be employed to benefit the other spouse. In crafting premarital agreement provisions, consider the extent of A's power over her trust and whether A can exercise those powers in a way that benefits B during the marriage or at A's death. For example:

- The premarital agreement treats earned income as marital property. Bram must work for a living, but Alyssa has a trust fund. Alyssa could stop working (and thereby stop adding earnings to the marital pot). Alyssa holds a unilateral power to withdraw up to \$X from her trust assets each year. The premarital agreement can require Alyssa to exercise that power and contribute the funds to the marital pot.
- Andrew is the beneficiary of a trust that will continue for his children after his death. Andrew can appoint trustees of the children's trust. The premarital

agreement can require Andrew to name Billie as successor trustee for their mutual children.

- Alice holds a limited power of appointment over her trust assets, which she can exercise in favor of her spouse upon her death. The premarital agreement can require her to do so.

Drafting considerations for trust settlor

If a party to a premarital agreement has created a trust, a similar analysis is in order. Some trusts are includible in the settlor's gross estate whereas others are not. The settlor may have retained rights and powers—even a beneficial interest—that could be employed to benefit the other spouse or the parties' mutual children. The settlor may have retained the authority to remove and replace trustees, direct where trust property passes at the settlor's death, approve or veto trust distributions, add or change beneficiaries, or substitute trust assets.

Irrevocable trusts

An irrevocable trust is not always set in stone. Many of these trusts (even DAPTs) are drafted to be flexible.

If different trust terms are desired, have an estate planning attorney determine whether:

- anyone holds a power—either under the trust instrument or pursuant to applicable state law—to “decant” the trust (i.e., distribute its assets into another trust with different terms);
- the trust can be modified under state law by consent of certain parties or upon petition to an appropriate court;
- the trust's situs can be moved to a jurisdiction that permits decanting or modification by consent;
- anyone has the power to add beneficiaries;
- anyone has a power of appointment;
- anyone has the power to remove and replace an uncooperative trustee;
- anyone has the power to substitute trust assets for assets of equivalent value (a “swap” power);
- a trust-owned life insurance policy can be sold from the existing trust to a new life insurance trust with different terms.

If the trust's terms are sufficiently flexible, or can be modified, the trust may become a useful vehicle for carrying out the terms of the premarital agreement.

Trusts are versatile arrangements that help achieve parties' objectives under a premarital agreement, but they can be complicated and pose traps for the unwary. If your client's intended spouse is a trust beneficiary, do not settle for a vague and abbreviated summary of its terms; obtain a complete copy of the trust instrument and review it to determine the extent of her power over it and beneficial interest under it, whether it will constitute part of her gross estate, whether it can be used to benefit your client (or the couple's children) during the marriage or after the spouse's death, and to what extent it can be modified. When seeking advantageous premarital agreement terms for your client, consider whether a trust arrangement can bolster those benefits or help the parties get over negotiating hurdles. **FA**

Sidebar:

Checklist of Terms

For Your Client as Trust Beneficiary...

Following are trust terms to seek when the premarital agreement permits or requires the creation of a trust.

If the trust will be created for the benefit of your client, aim for:

- Terms that will satisfy the QTIP rules;
- The right to serve as trustee, to choose additional and successor trustees, and to remove and replace trustees;
- If your client will not be the trustee, seek some control over the trust's investments and the right to an annual accounting;
- The right to principal distributions, e.g., the unilateral right to withdraw principal (which could be subject to a cap, such as the greater of \$5,000 or 5% of trust assets per year); mandatory distributions at regular intervals; discretionary distributions for any purpose; or discretionary distributions only for certain purposes (e.g., health, education, maintenance, and support);
- The right to direct where trust assets will pass upon your client's later death (i.e., a "power of appointment"). A general power of appointment includes the power to direct assets to herself, to her estate, to her creditors, or to the creditors of her estate. A general power of appointment causes trust assets to be includible in your client's estate for estate tax purposes at her death. A limited or special power of appointment precludes the beneficiary from directing the assets to herself, her estate, her creditors, or creditors of her estate. Beyond that, her appointment powers could be broad (i.e., she can direct assets to anyone else) or narrow (e.g., she can direct assets only among a handful of named individuals or charities). A limited power of appointment does not cause the trust to be includible in your client's estate for estate tax purposes at her death.
- If permissible under applicable state law, a waiver of the trustee's obligation to provide information, notices, or accountings to anybody other than your client during her lifetime.

For Your Client as Trust Settlor...

If your client will create the trust for a spouse, aim for:

- Terms that will satisfy the QTIP rules;
- Your client's right to determine the trustee, successor trustees, and investment advisors;
- Limits on principal distributions, such as only:
 - at the discretion of the trustee (selected by your client);
 - for certain purposes (health, etc.);
 - after the beneficiary spouse's other resources have been exhausted; and/or
 - while the beneficiary spouse remains unmarried.
- Your client's right to select the remainder beneficiaries;
- If the beneficiary spouse will have a power of appointment, limitations on that power;

If the beneficiary spouse will serve as (or will select) the trustee, the right of remainder beneficiaries to receive regular accountings and other trust information.

In all events, be sure that both you and your client understand which assets may or must be used to fund the trust, who will be the trustee, what the distribution provisions may or must be, who has the right to receive trust accountings and other information from the trustee, and whether anybody will have a power of appointment.

— *A.W.C. & L.J.R.*

Anne W. Coventry is a shareholder in Pasternak & Fidis, P.C., Bethesda, Maryland, where she practices exclusively in the area of trusts and estates, including premarital agreements. She is a fellow of the American College of Trust and Estate Counsel (ACTEC). She is licensed in Maryland, Virginia, and the District of Columbia.

Linda J. Ravdin is a shareholder in Pasternak & Fidis, P.C., Bethesda, Maryland, where she practices exclusively in the area of divorce and family law, including premarital agreements. She is the author of *Premarital Agreements: Drafting and Negotiation*, published by the ABA. She is licensed in Maryland, Virginia, and the District of Columbia.