ESTATE PLANNING FOR THE NON-TRADITIONAL FAMILY

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I. BACKGROUND.

A. **Historically, most estate plans revolved around the nuclear family structure of husband and wife who were married for the first time and children that were born of that marriage.**

B. **Over the course of the last 20 plus years, divorce rates have increased, more opposite-sex couples are opting to live together without getting married, and there is a greater awareness of same sex couples who are committed to each other. In these situations the traditional approach of estate planning is not always appropriate.**

C. **For purposes of this presentation, the "non-traditional family" consists of either a same sex couple, whether or not recognized as "married" for state law purposes, as well as the opposite sex couple who are committed to each other, but for one reason or another have decided not to get married.**

[1] Although opposite sex couples who have previously been married and have children by a prior marriage are also considered a "non-traditional family" and have unique issues, this relationship will not be addressed in this presentation.

II. FEDERAL AND STATE LAW CONSIDERATIONS.

A. **Opposite sex couples who have not engaged in a marriage ceremony, either civil or religious, are in virtually all States treated as unmarried for state law purposes, unless the State of domicile recognizes "common-law marriage."** Common law marriage typically involves a combination of co-habitating for a certain minimum period of time, together with the couple holding themselves out as being married.

1. **Colorado, for example, requires no period of cohabitation.**

2. **Registration of the "marriage" with local official with normally establish prima facia evidence of marriage.**

B. **State law varies with respect to treatment of same sex couples.**

1. **Five states allow same sex marriage:**
   - Massachusetts
   - New Hampshire
   - Vermont
   - Iowa
   - Connecticut

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2. Four other states allow for either civil unions or domestic partnerships.

a. Pending legislation in Illinois, House Bill 2234, would create the the Illinois Religious Freedom Protection and Civil Union Act providing for same sex civil unions and the bill may be voted on by the General Assembly before the end of this year.

b. California's Proposition 8 which prohibits same sex marriage was recently ruled unconstitutional by a Federal judge in Perry v. Schwarzenegger (CV09 2292/U.S. District Ct., Northern Dist. of CA). CA law offers same sex couples the option of civil unions. The court ruled that Proposition 8 violated the 14th Amendment of the U.S. Constitution; however, the judgment has been stayed pending an appeal to the Ninth Circuit Court of Appeals.

3. Most states have either constitutional amendments or statutes which prohibit same sex marriages.

4. State law governs with respect to property rights of individuals and matters which are purely local in nature.

a. Right to administer a deceased spouse's estate.

b. Statutory share/or spouse's elective share in an estate.

c. Surviving spouse's award.

d. Rights to division of property, alimony or separate maintenance on divorce.

e. Right to make medical decisions in case of incapacity of the other partner.

f. Right to make funeral and burial decisions.

g. Right to file joint income tax return (state and local).

h. Hospital visitation rights.

i. Property rights; (e.g. tenancy by the entirety, homestead rights, etc...).

C. **For Federal purposes, the 800 - pound gorilla in the room is the Defense of Marriage Act ("DOMA") which was signed into law in 1996.**

1. **DOMA defines "marriage" as the legal union, between one man and one woman, as husband and wife.**

2. **DOMA prohibits the federal government from recognizing a same sex- marriage performed by any state or foreign government.**

3. **DOMA also affirmatively allows States to discriminate against same-sex couples who were legally married in States which recognize same sex marriages.**

   a. This provision has questionable constitutionality under the full faith and credit provision of the U.S. Constitution.

   b. Can Illinois fail to recognize a same-sex marriage performed in Iowa?[2]

4. **A number of pending cases are challenging the constitutionality of DOMA.**

   a. Two cases were recently decided in Federal Court in Massachusetts that ruled DOMA was unconstitutional. (Gill v. Office of Personnel Management, 1:09-cv-10309; & Massachusetts v. U.S. Department of Health and Human Services, 1:09-cv-11156 (U.S. District Ct., Dist. of MA)). Both cases challenged constitutionality of Section 3 of DOMA which defines a "marriage." Judge Tauro decided both cases and ruled in one decision that DOMA was unconstitutional as infringing upon a State's rights under the 10th Amendment of the U.S. Constitution and in the other case ruled DOMA violated the Fifth Amendment's equal protection principles. The Department of Justice has appealed both decisions to the First Circuit Court of Appeals and the decisions have been stayed pending the appeal.

[2] If enacted in its current form, the Illinois Religious Freedom Protection and Civil Union Act would cause the State of Illinois to recognize same sex civil unions legally entered into in another jurisdiction.

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III. ISSUES PRESENTED.

A. Ownership of Assets. At the outset on any estate planning it is first essential to determine how the assets are owned/titled. For instance, if assets are held in joint tenancy, then regardless of what a person's will or revocable trust provides, at the death of a joint tenant, the surviving joint tenant(s) becomes entitled to the property because joint tenancy assets do not pass through probate.

B. State Laws

1. Statutory Share/Elective Share.

a. Spouse entitled to specified share of decedent's estate if there is no will.

b. Spouse entitled to a minimum share of estate even if there is a Will which makes no provision for the spouse or less than a specified amount.

2. Right to name Administrator. If decedent did not have a Will, spouse has priority in naming administrator.

3. Surviving Spouse's Award.

a. Most states provide that a surviving spouse can petition the court for a certain distribution during the administration of the estate.

b. Purpose is to cover living expenses during period of administration.

4. Surrogacy Act. These laws provide that, absent a direction in a health care power of attorney, a health care provider can take direction from the nearest "relative" with regard to health care decisions if the individual is incapacitated.

5. Tenancy By the Entirety.

a. Tenancy by the entirety is a form of joint tenancy, between a husband and wife, which precludes the creditors of either owner from attaching that person's interest in the property. Therefore, a creditor cannot force partition of the property until one spouse dies or parties divorce.

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b. Tenancy by the entirety is not available to same sex couples in States that do not recognize same sex marriages.

C. Qualified Employee Benefit Plans.

1. Federal Law governs the administration of employee benefit plans.

2. ERISA and subsequent laws provide that a spouse has certain rights with respect to other spouse's qualified plan that cannot be terminated without spouse's consent.

a. "Qualified Plans" include 401(k), Pension and Profit Sharing Plans, but not IRAs.

3. Right to be named as beneficiary of the account balance of profit sharing, money purchase pension or 401(k) plan.

4. Right to 50% survivor annuity if benefits from any Plan payable in the form of an annuity.

5. Spouse has right to elect to roll over participant spouse's benefit into his/her own IRA.

D. Estate and Gift Tax Issues.

1. The primary issue presented for couples who are not considered married under DOMA is the loss of the unlimited marital deduction for gift and estate tax purposes.

2. The purpose of the unlimited Marital Deduction, which was first recognized under the Tax Reform Act of 1986, was to treat a married couple as a unit for transfer tax purposes and to defer the imposition of any transfer tax until the death of the second spouse to die.

3. In order to qualify for the Marital Deduction the transfer must be either:

a. directly from one spouse to the other, or

b. in a trust where the other spouse has the right to all income for life and no person has the right to direct the property to any other person ("Qualified Terminable Interest Property Trust"); or the surviving spouse has a

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general power of appointment (“General Power of Appointment Trust”).

4. **Since same sex couples are not recognized as being married for federal tax law purposes, any transfers between them are subject to federal gift or estate tax laws, and are not eligible for the Marital Deduction.** The value of the transferred property must be applied against the transferor’s gift or estate tax Exemption (to the extent it exceeds any available annual exclusion). Therefore, to the extent that the couple’s ultimate beneficiaries are the same, this can result in a double tax or at least the unnecessary utilization of the estate or gift tax Exemption.

   Example No. 1: Partner A gifts assets having a value of $1,000,000 to Partner B. Partner B then bequeaths the property to their children. The value of the property is subject to a gift tax, after utilization of Partner A’s Exemption, and then at Partner B’s death is subject to the estate tax. This “double taxation” would not be the case if the Partners were “married.”

   Example No. 2: If instead of an outright gift, Partner A creates a trust at death, with Partner B receiving income for life, remainder at death to children, there would be a taxable event at the time of the transfer, since it would not be eligible for the Marital Deduction. However, Partner B would not have an increased estate tax liability from the trust principal because the gifted property is held in trust and not includable in Partner B’s estate.

5. **Gifts from either partner to a third party are not subject to the election to split gifts which is available to spouses.**

E. Joint Tenancy Property.

1. **The creation of joint tenancy property between non-spouses is treated as gift to the extent that the contribution from one spouse exceeds his or her pro rata share of the ownership.**

   Example: If a couple that is not married purchases a house costing $500,000 and Partner A contributes $350,000 and Partner B contributes $150,000, Partner A has made a gift of $100,000. Since they are not recognized as being married no marital deduction is available.

2. **In the case of a joint bank account or U.S. Savings Bonds there is no gift at the time of creation, but only when one party withdraws more than his or her contribution.**

   Example: In the above example if the parties had created a joint bank account there would be no taxable gift until Partner B withdraws more than $150,000.

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3. For federal estate tax purposes, joint tenancy property held solely by a married couple is treated as being owned one-half by each party.

a. As a consequence of the above at the death of either spouse, one-half of the basis of the joint property is stepped up to the date of death values.

b. Since same sex couples are not treated as being married, 100% of joint tenancy property is includable in the estate of the first spouse to die, except to the extent of the value resulting from the contribution of other partner. The burden of proof is on the surviving joint tenant so prove contribution.

Example: If two partners own a piece of real estate in joint tenancy worth $500,000 at the date of Partner A's death, the entire value is includable in Partner A's estate, unless Partner B can establish that he or she contributed to the purchase of the property. If Partner B can establish that he or she contributed one-half of the cost of the property, then only one-half (1/2) of the value is includable in Partner A's estate.

V. POTENTIAL PLANNING TECHNIQUES AND OPPORTUNITIES.

A. Basic Estate Planning Techniques

1. Estate Planning Documents.

a. Wills and Revocable Trusts

i) It is imperative that non-married couples execute Wills and, in many cases, Living Trusts, specifically setting forth their intentions with respect to the distribution of their estates, including contingent beneficiaries, if both partners are deceased. Without a specific testamentary scheme, the intestate laws of the state of residency will control.

ii) In most states, if a married couple gets divorced after estate planning documents are executed, any provisions for the former spouse are automatically revoked. This is not true if the partners are not married. Therefore, it is advisable to state that if the partners are no longer residing together, any provisions for the other spouse are terminated.

iii) Since testamentary dispositions to a same sex partner are frequently subject to attack by the descendant's "natural" family members, care should be taken to establish the validity of the documents and to prevent any potential contest. One possibility is to have a court reporter present to record the proceedings and to ask the testator questions establishing his or her competency and relationship with the other partner. Other possibilities are videotaping and physician affidavits (to establish the testator's mental capacity to execute legal documents.)

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b. Powers of Attorney for Health Care.

i) Gives partner power to make critical health care decisions;

ii) Allows partner to get access to medical records under HIPPA.

c. Beneficiary Designations for Retirement Accounts and IRAs

i) It is important to utilize appropriate forms provided by employer or IRA custodian.

d. Durable Power of Attorney

i) Power of Attorney allows other partner to make financial decisions, but does not cover assets in the living trust.

ii) Allows decisions to be made even after one partner becomes incapacitated.

iii) Power may include the right to transfer property to revocable trusts, and to make inter vivos (lifetime) gifts.

2. Lifetime Gifts.

a. **The most obvious tax strategy for non-married couples is for the wealthier partner to make lifetime gifts to the other spouse which are subject to the annual exclusion under Section 2503(b).** Pursuant to that Section any person may make annual gifts not to exceed a specified amount (currently $13,000) to any one person without reducing the donor's estate or gift tax exemption.

b. **These gifts can be very powerful because:** (i) there may be an opportunity to reduce the value of the gifted asset through various techniques, such as a gift of minority interest in real estate, gifts of interests in a family partnership or limited liability company or a business; GRATs, GRITs (see following discussion); or Charitable Remainder Trusts ("CRTs"); and (ii) all future appreciation is eliminated from the donor's estate. It also enables couples to increase the poorer partner's estate to make use of his/her estate tax exemption.

c. **If the client is uncomfortable making outright gifts, consideration should be given to making the gift in a trust.** In order for the gifts to a trust to be subject to the annual exclusion, the beneficiary or beneficiaries must be notified that he or she has a limited right to withdraw the amount of the gift from the trust (usually 30 days) after which the funds are subject to the trust provisions. This exception was established in the case of Crummey v. Comm'r (397 F2d 82 (9th Cir., 1968)). The number of individuals having the power to withdraw funds need not be limited to the income beneficiary, but can include remote contingent beneficiaries, Cristofani's Estate v. Comm'r, 97 T.C. 74 (1991).

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3. Life Insurance and Life Insurance Trusts.

a. **Life insurance is an excellent method of (i) providing liquidity for the payment of estate taxes;** (ii) replacing the income that could be lost by the death of an income provider partner; (iii) providing wealth replacement due to the loss of the Marital Deduction.

b. **Life insurance offers the advantages of:**

i) total confidentiality;

ii) minimum potential for contesting the transfer;

iii) income tax- free proceeds; and

iv) estate tax-free proceeds if policy not owned or controlled by the insured.

c. **In general, life insurance proceeds are includable in the insured's gross estate for estate tax purposes if he retains any ownership rights in the policy ("incidents of ownership") or if he transfers those rights within three (3) years of death.**

d. **One method of avoiding estate taxation on life insurance proceeds is to have a third party (normally an Irrevocable Life Insurance Trust ("ILIT")) apply for the policy.**

i) The insured is considered as having made a gift to the extent: (A) he transfers an existing policy that has a market value at the time of transfer; and (B) to the extent of any amounts transferred to the trust to pay premiums.

ii) In order to insure that gifts to the trust are subject to the annual exclusion, it is important that beneficiaries of the trust be given Crummey rights of withdrawal.

e. **Since an ILIT must be irrevocable in order to insure that the proceeds are not taxable in the insured's estate, it is necessary to build in flexibility in the event circumstances change.**

i) The trust should contain a mechanism to prevent the other partner from benefiting if the relationship does not exist at the insured's death. For example, define "partner" as including the person with whom the insured resides at his or her death.

ii) A provision can be included naming someone (typically not a beneficiary) as a "special power holder" or "trust protector". This person can be given the power to amend the trust, but normally only for a specific category of individuals, such as existing beneficiaries or members of the insured's family. The special power holder should not be able to appoint for himself or his estate or it can be considered a general power of appointment.

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B. More Sophisticated Estate Planning Techniques.

1. **Individual clients with large estates that have fully utilized their annual gift tax annual exclusions often seek more complex techniques to limit the possibility of growth in their estates.** Prior to 1990 clients resorted to techniques where all future growth in certain assets could be passed on to their beneficiaries with little or no tax consequences. The ability to utilize these techniques was eliminated or severely restricted by the addition of Chapter 14 of the Internal Revenue Code. However, the impact of Chapter 14 is limited to "family members".

2. **Common Law GRITs.**

   a. Prior to 1990 a frequently utilized estate planning technique was a common law grantor retained income trust ("GRIT"). Under this technique an irrevocable trust was created a period of years (calculated to be shorter than the grantor's life expectancy) for the benefit of children or other future generation beneficiaries, with the grantor retaining the right to the income for the term of the trust.

   b. If the Grantor survived the term of the Trust, the balance of the Trust, including appreciation, passed to the remainder beneficiaries and was not subject to the estate tax. If the Grantor died during the term of the trust the value of the trust was includable in the Grantor's estate under IRC Section 2036.

   c. At the time the trust was created the grantor was treated as having made a gift, which measured by the value of the transferred property less the present value of the retained income interest. The value of the income interest is calculated by utilizing the interest rates published by the IRS monthly known as the Section 7520 rates. The grantor has the option of utilizing the rate for either of the two months preceding the transfer.

   d. Under Section 2702 of the Internal Revenue Code the advantages associated with GRITs were eliminated if the beneficiary of the trust was a "member of the Grantor's family," since the value of the retained interest was treated as 0 and the gift, therefore, would be 100% of the transferred property. Since a partner in a same sex couple or opposite sex couple who are not formally married are not treated as "members of the family", this technique is still a viable strategy.

   e. **Example:** Taxpayer established a 10 year GRIT with $1 million in cash for the benefit of his same sex partner. The value of the gift is discounted by the value of the retained interest based on AFR tables published by the Treasury (currently, about $350,000), leaving a taxable gift of approximately $650,000. If the asset generates little, if any, income then there is little value retained by the grantor and all appreciation passes to the remainder beneficiary.

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3. Estate Tax Freeze.

a. Like IRC Section 2702, Section 2701 basically eliminated business freeze techniques between family members.

b. Historically, the classic estate tax freeze involved the recapitalization of a partnership, limited liability company or corporation, whereby the owner, in exchange for his ownership interest, received: (i) a preferred interest which paid a preferred dividend (usually non-cumulative) and had a fixed value on liquidation (and, consequently did not participate in future growth); and (ii) a non-preferred or junior equity interest, such as common stock, with respect to which all of the future appreciation inured. The initial value of the preferred stock typically equaled nearly the entire value of the business, so that a gift of the junior equity interest had little, if any, value. The owner could then transfer common stock to his or her beneficiary gift-tax free.

c. Since same-sex couples and opposite sex couples who are not formally married are not considered "family members," estate tax freezes are still a viable method of transferring assets between partners on an advantageous tax basis.

4. Qualified Personal Residence Trust. ("QPRT")

a. A qualified personal residence trust is an irrevocable trust created for a period of years, the sole asset of which is a personal residence of the grantor. The grantor retains the right to live in the residence for the term of the trust, after which the trust property can pass to or be held for the grantor's beneficiary. Like a GRIT, if the grantor outlives the term of the trust, the value of the trust, including any appreciation is not includable in his estate for estate tax purposes, but if he dies during the trust term the value of the trust is includable in his estate under Section 2036.

b. If the grantor outlives the term of the trust, he or she can continue to live in the house, but must then pay rent to the remainder beneficiaries. Although this can be a stumbling block to the implementation of this technique, it may be a method of further reducing the grantor's estate without any gift tax consequences.

c. For gift tax purposes the transfer of the residence to the QPRT is deemed to be a gift, the value of which is determined by reducing the value of the house by the actuarially determined value of the retained interest of the donor. As in the case of a GRIT, the interest of the Grantor is determined by applying the applicable federal interest rate in effect at the date of the transfer.

d. Since the QPRT regulations prohibiting sales between certain family members, do not apply to unmarried individuals, one opportunity that exists is for the grantor to repurchase the residence prior to the termination of the trust, so that the sale proceeds would pass to the grantor's partner.

e. The technique can work extremely well in an economy where real estate values are depressed.

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5. Charitable Remainder Trust. ("CRT")

a. A charitable remainder trust is an irrevocable split-interest trust which provides that the grantor and perhaps his or her partner retain an annuity (equal to at least 5% of the value of the trust) for life (or two lives) or a term of years (not to except 20 years) after which the balance of the trust passes to a qualified charity or charities.

b. The tax advantages to the grantor are: (i) he is entitled to an income tax deduction equal to the value of transferred property less the value of the income interest; (ii) trust is includable in the grantor's estate only to the extent that a non-charitable beneficiary has an income interest after the grantor's death; and (ii) current income of the trust is not taxable to the trust and is only taxable to the grantor to the extent distributed and then based on the nature of the income realized by the trust.

c. A CRT is beneficial to an individual who owns a highly-appreciated capital asset, and wants to diversify, since the CRT can sell the asset income tax-free. Capital gains are only taxable when distributed to the beneficiary.

6. Domestic Partnership/Cohabitation Agreement

a. Purpose of Agreement. Inasmuch as there is a paucity of laws governing the rights and obligations of same-sex and opposite-sex couples who are not recognized as being married, it is important that if the partners have made a commitment to each other by commingling assets, purchasing property, living together or raising children together, that they execute an agreement governing their relationship. The agreement can take the form of either a domestic partnership agreement or cohabitation agreement or a co-ownership agreement.

b. Ethical Considerations. Ethical considerations become more acute when you move away from estate planning and into the area of domestic partnership agreements because the parties are contractually defining their rights to assets vis-a-vis one another. In drafting domestic partnership and cohabitation agreements it is always preferable to have separate counsel as in these circumstances it is difficult; if not impractical, for an attorney to remain objective and look after both parties' interests.

7. Domestic Partnership Agreement ("DPA").

a. A DPA is an agreement between domestic partners defining their relationship and may be either very narrow or broad in scope.

b. A DPA should be in writing and should state the consideration for the agreement, such as business, or investment strategies, home making and providing care for each other and their children. Sexual favors are against public policy and cannot be the basis for such an agreement.

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c. A DPA is similar to a Premarital Agreement and can cover issues such as the following:

i) relative contribution to common expenses, such as travel, entertainment and living expenses;

ii) financial obligations of support;

iii) acquisition of any residence and relative contribution to purchase price and maintenance costs;

iv) definition of "termination of relationship;"

v) division of property upon termination;

vi) payment of support upon termination;

vii) support of children;

viii) provision for the survivor in the event of death of either partner;

ix) life insurance; and

x) alternative dispute resolution.

8. Cohabitation or Co-Ownership Agreement ("CA")

a. CA's probably have same legal requirements as DPA's but are more limited in scope.

b. Typically, CA's involve obligations of the parties relative to specific property, such as personal residence.

c. Major issue in CA is relative contributions toward costs of occupancy including mortgage payments, insurance, maintenance and repairs.

d. Agreement should specifically address termination of relationship, as well as procedure for liquidating assets.

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