

Pre and Post-Nup Clauses to Address Trust Issues

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Introduction



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Introduction

- Pre-nuptial and post-nuptial agreements (“agreements”) are ubiquitous in matrimonial practice.
- In order to achieve optimum results for clients, it is beneficial for agreements to be drafted using an interdisciplinary approach.
- A key area where it is important to keep cross-disciplinary concerns at the forefront is with respect to trusts and how they may be impacted by marital agreements.

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Introduction

- As modern trust practice has evolved, the array of provisions in agreements that might need to be added or modified to address a variety of trust planning issues has grown.
- This webinar will explore common provisions used in these agreements and suggest how standard language might be modified to protect a client’s rights or interests in trusts he or she formed before the marriage or which family members formed naming him or her in various capacities.

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Fiduciaries and Other Roles



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“Fiduciary” Can Mean More than Just a “Trustee”

- Pre and post-nups may use terms like “trustee” but practitioners must be cautious since modern trusts may incorporate a range of fiduciary and non-fiduciary functions.
- Agreements might define the term “Fiduciary” or “Fiduciaries.” However, a one-size fits all definition should not be utilized, but rather it should be tailored to address the particular circumstances of each case.
- The use of the term “Fiduciary” in an agreement might not assuredly cover the person or role intended or conversely might include a person or position that is not intended.

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Definition

- Caution should be exercised regarding how expansive the definition of the term “Fiduciary” -- If defined too narrowly, it may avoid missing coverage of positions that are intended. On the other hand, if defined too broadly, it may affect positions that might not have been intended.
- A typical definition might define fiduciary to mean a party's heirs, executors, administrators, trustees, custodians, conservators, guardians, attorneys-in-fact and other legal representatives. Consider whether in the context used including trustees of the various trusts is problematic and whether instead trustees or certain fiduciary positions should be expressly excluded.

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Trust Protector

- The term “trust protector” is quite vague and could mean a myriad of different things. The status of a person serving as trust protector as a fiduciary or non-fiduciary will also vary.
- Approximately 20 states have statutes addressing protectors. Depending on state law and the governing instrument, a protector may or may not be a fiduciary.
- For example, a common role of a trust protector is to remove and replace trustees. Clients want to avoid the conundrum of their former spouse being in a position to remove trustees.

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Loan Director

- Another commonly used position in modern trusts is a person, perhaps called a "loan director," who might have authority to loan trust money or even assets to your client. That person is unlikely to be acting in a fiduciary capacity, so the definition of "Fiduciary" under the agreement might not include the loan director. However, that person's ability to loan trust assets back to your client as grantor might be important to address.

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Trust Notice Provisions and Matrimonial Matters



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Notice Requirements

- The Uniform Trust Code Sec. 813 requires keeping qualified beneficiaries reasonably informed and Sec. 105(b)(8) prohibits waiving the duty to inform qualified beneficiaries over 25 years of age.
- What do these requirements mean in the context of the matrimonial matter?
- Some states have enacted laws permitting silent trusts, so if the trusts involved are formed in such a jurisdiction, and the trust instrument includes the required language, there may be no requirement for notice of any type. The possibility of notification is often not addressed in marital agreements.
- Address the issue in pre and post nuptial agreements.

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Notice Requirements – Surprising Requirements

- **Example:** If the divorcing couple has minor children, might your client's soon to be ex-spouse assert rights to receive notice on behalf of those minor children to a family trust of your client?
- Also, bear in mind that the notice is likely to include a copy of the governing trust instrument, any amendments or actions modifying it, and a full financial statement.

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Sample Clause

- *“Neither party shall request any information, including but not limited an informal or formal accounting, whether on behalf of himself, the children, or otherwise, from any Family Trust.”*
- Consider how to expand the above language if the children are minors, so that the first spouse cannot demand information from the second spouse's trusts on behalf of minor children and thereby circumvent a limitation on his or her right to directly obtain that information.

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Excluding Trusts

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Excluding Trusts

- When drafting a marital agreement, practitioners may have the other spouse expressly disclaim any rights or interests to various trusts that might benefit the client.
- With modern trust drafting, it may be impossible to identify every trust the client may be a beneficiary of, or have other rights to.
- **Example:** Modern trust drafting often embodies a range of provisions and mechanisms to provide flexibility. A common technique is powers of appointment that might grant the client or another person the right to designate who might benefit from the trust property. Another family member may have the right to designate if a class of persons, which might include your client, could receive any portion or all of the trust assets at some event or point in time. The language in the marital agreement, if appropriate, should be broad enough to encompass these future trust interests as well.

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Sample Clause

- *"All actual, constructive or beneficial interests Client Name now has or may come to have in any family trust, including any and all actual, constructive or beneficial interests the client now has or may come to have in any trust she or a family member of her has or will create, whether as a current beneficiary, remainder beneficiary, contingent beneficiary, power holder, fiduciary, or in a non-fiduciary position (including by way of example and not limitation serving as a trust protector, loan director, person empowered to add a charitable beneficiary, or otherwise). A trust for her or their benefit, including but not limited to, each trust listed in the following paragraph, shall constitute the client's Family Trusts. The client's Family Trusts include but are not limited to:*
- *Smith Family Irrevocable Life Insurance 2009 Trust 10/3/09; Joan Smith 2010 Irrevocable Trust 9/6/10; Sam Smith Irrevocable Trust 9/6/13; and the Joan Smith 2012 DAPT 2/22/2012.*
- *And all trusts established after the execution of this agreement by [List Family Members] except to the extent that such trust holds marital property."*

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Excluding Trust Distributions from Marital Claims



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Excluding Trust Distributions from Marital Claims

- In agreements, sometimes clients elect to have a more narrow definition of marital property than would otherwise exist under the applicable law. For example, under an agreement, certain types of income may be excluded as marital property and instead constitute a party's separate property.
- These provisions should also address the various types of income as well as distributions, which may not be encompassed in a typical definition of income from trusts.

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Sample Clause - 1

- *"All of [Wife's/Husband's] income, earnings, and compensation, including, but not limited to, rent, wages, base salary, bonuses, commissions, fees, royalties, dividends, revenues, profits, draws, trustee or other fiduciary fees (including but not limited to fees as a trustee, executor, trust protector or paid in any fiduciary or non-fiduciary capacity as a result of serving in a fiduciary or non-fiduciary capacity for any Family Trust), or fees for serving the client or the Family Trust in a fiduciary or non-fiduciary capacity, or other sources of earned income or compensation derived from employment or self-employment, and perquisites, from before, during, or after the parties' marriage.*

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Sample Clause - 2

- *[Wife's/Husband's] income, earnings, and compensation, including, but not limited to, from the Family Trusts, shall remain [Wife's/Husband's] Separate Property regardless of whether any such payment is re-characterized by any tax authority as constituting something other than compensation or any income. Any distributions or benefits from any family trust including but not limited to the trusts listed above ("the Family Trusts"). This shall include by way of example and not limitation: any distribution of income or principal, any direct or indirect benefit from the client's exercise or non-exercise of any power of appointment, or any direct or indirect benefit from any other person, family or not exercising or not exercising a power of appointment under a client Family Trust, proceeds of a loan from any such trust, any tax reimbursement from such trust, the use or benefit of personal use property held in any such trust, or otherwise."*

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Waiving Fiduciary and Other Appointments

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Waiving Fiduciary and Other Appointments

- Traditional trusts often name a trustee. If an institutional or corporate trustee was named, it was often named without provisions to remove and replace them.
- Modern trusts often take a different approach and provide a plethora of mechanisms to remove and replace trustees and other fiduciaries. Thus, it can be important to include a waiver by the client's spouse of any appointments in any fiduciary capacity to avoid any inadvertent appointment or pressure by the other spouse to gain such a position.

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Sample Clause

- *"Each party does hereby agree not to petition, apply for, or seek appointment or designation as conservator, committee, custodian, guardian, personal representative, executor, administrator, trustee, trust protector, loan director, or any other similar position with respect to and Family Trust of the [Wife/Husband], the person, the Property or the estate of the other party in any jurisdiction even if appointed to such a position by the other party after the date hereof."*

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Trusts and Tax Reporting



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Income Tax Considerations

- Tax returns are a common issue addressed in matrimonial agreements. These provisions should contemplate a range of trust considerations, often more than some practitioners might initially contemplate.
- **Example:** A common trust structure is referred to as a "grantor" or "defective" trust in which the settlor creating the trust is taxed on all trust income.
- **Example:** Another technique, referred to as a beneficiary defective irrevocable trust or a "BDIT" is created by a third party, such as a client's mother, but structured so that the beneficiary, e.g., your client, is taxed on trust income even though not the grantor.

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Tax Reimbursement

- Some of these trusts (if formed in a jurisdiction that permits this right) may include a tax reimbursement clause that provides an independent trustee the authority, but not the requirement to reimburse for taxes. This power might also be surrendered (turned off), or triggered (i.e., not effective initially but made effective after the trust was initially formed, and perhaps after the matrimonial agreement was executed).
- The variability of these provisions can make drafting a matrimonial agreement complex, but administering it even more so.

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Sample Clauses - 1

- *"If in connection with any joint income tax returns filed by the couple heretofore or hereafter, there is any deficiency assessment, the amount ultimately determined to be due thereon, including penalties and interest, shall be paid by the parties in proportion to his/her income (which may include income of pass through trusts or entities that are not treated as marital income), unless and to the extent that same has been caused by the failure or neglect of a party to disclose any income which should have been included in such returns, in which event and to that extent the party so failing or neglecting to disclose shall bear such expense to the extent allocable to such failure or neglect.*

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Sample Clauses - 2

- *"Each party agrees to cooperate fully with the other in the event of any audit or examination by a taxing authority of the said joint tax returns and agrees to furnish to the party being examined or his or her designees, promptly and without charge, such authorizations, powers of attorney, papers, records, documents and information as may be reasonably appropriate in connection with such audit or examination. In the event of any trust or pass through entity whose income is reflected on the joint income tax return but excluded as non-marital income hereunder the spouse to whom such income belongs, or the trustee, ...*

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Sample Clauses - 3

- *"Each party agrees to cooperate fully with the other in the event of any audit or examination by a taxing authority of the said joint tax returns and agrees to furnish to the party being examined or his or her designees, promptly and without charge, such authorizations, powers of attorney, papers, records, documents and information as may be reasonably appropriate in connection with such audit or examination, however, in the event of any trust or pass through entity whose income is reflected on the joint income tax return but excluded as non-marital income hereunder the spouse to whom such income belongs, or the trustee, officer, director, manager or other appropriate person of such trust or entity of that spouse, shall handle*

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Sample Clauses - 4

- "...officer, director, manager or other appropriate person of such trust or entity of that spouse, shall handle such audit. In the event a refund is hereafter paid under the parties' joint income tax returns, the refund shall be divided by the parties in the same proportion as their respective Separate Property shall have generated such refund for the respective year."

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Sample Clauses - 5

- "If either party has a trust that is characterized as a grantor trust, or an interest in a pass through entity, or any income from separate property, and if the other spouse's assets are used to pay for income tax on income attributable to such separate property that shall not provide any right or claim to that entity, trust or property but merely to be reimbursed for the tax cost paid and improperly allocated. If either party is a grantor of a trust that permits now or in the future the trustee to reimburse that spouse as grantor for income tax costs he or she paid on income from the trust neither party shall have any right to demand such reimbursement nor shall either party have any claim if that right to reimbursement is waived or terminated."

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1040 Tax Filing Considerations

- Should clients be advised not to file a joint return given all that has occurred? It depends on the circumstances.
- The joint return will show flow through income from family entities and trusts. It would seem more prudent to file married filing separately.
- If they believe that there will be an income tax savings from married filing joint status that they are unwilling to forgo then perhaps a more detailed mechanism can be specified. The client could (and really should) hire her own CPA.
- Each spouse shall hire his or her own CPA.

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1040 Tax Joint Filing Approach

- Each party's CPA shall collect relevant tax information and submit that information in the form of a Married Filing Separate return to an independent CPA selected each year by the couple who shall then prepare a Married Filing Joint income tax return from the Married Filing Separate return data provided by each separate CPA.
- If the couple cannot agree on an independent CPA to complete and file the Married Filing Joint return then they shall file Married Filing Separate returns for that year. As part of the engagement to prepare the Married Filing Separate return the CPA shall also determine a reasonable allocation of the overall tax liability for the year attributable to each party and any entities or trusts from which they reported income and determine how much each party must contribute or receive for that tax year.

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Further Assurances



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Further Assurances

- A common point in marital agreements is obtaining a commitment by the parties to execute further documents.
- *"Upon the request of either party or of his or her Fiduciaries, the other party, or his or her Fiduciaries, as appropriate, will promptly execute, acknowledge, if requested, and deliver to the other party or to his or her Fiduciaries, as appropriate, any and all further documents necessary, and take such other action, that may be appropriate or expedient to effectuate the provisions of this Agreement, including such instruments as may be required by the laws (now in effect or hereinafter enacted) in any domestic or foreign jurisdiction that may affect the property rights of the parties between themselves or with others."*

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Fiduciaries

- Should fiduciaries be included? Isn't it inadvisable to make them parties to the marital agreement? Can they be bound without signing a counterpart to the agreement? What if the trust benefits multiple beneficiaries and not just the spouse? Would it be even appropriate for such a fiduciary to commit to terms under a marital agreement for just one of those beneficiaries? If the spouse's trust is located in a different jurisdiction, e.g., a New York spouse with a trust based in Nevada trust is bound by an agreement under New York law it would seem that it could undermine the integrity of the trust by subjecting the trust to New York law.

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Binding Agreement

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Binding Agreement

- "The provisions of this Agreement are binding upon the parties and upon their respective Fiduciaries." Caution should be exercised in making a marital agreement applicable to or binding on a fiduciary especially if the trust instrument is governed by the laws of a different state. For example, you might not want to make an agreement governed by New York law binding on trustees and other fiduciaries of a trust with a situs in Delaware and governed by Delaware law. Applying New York law to a fiduciary could undermine, for example, a Delaware trust.

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Additional Considerations



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Who Makes Portability Election

- What should the non-moneyed spouse agreeing to file to secure portability be paid? In Swisher the spouse agreed to relinquish DSUE for \$5,000 even though worth millions. Whoever advised them to accept \$5,000 may be subject to the next suit. *Walton v. Swisher*, 3 NE 3d 1088, 2014 WL 325666 (Ind. App. 2014).

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Swap Powers

- Trustee was wife and mother of daughter who was beneficiary of trust. Divorced. Now ex-husband tried to exercise swap power and now ex-wife trustee refused. He tried to swap in a note and the ex-wife/trustee objected saying it was not of equivalent value as required by the trust.
- *Schinazi v. Eden* 2016 WL 5867215.
- In the divorce the issue of trustee and trust actions should have been addressed. It may have been preferable for all involved to have had the wife/ex-wife to be resign as trustee in favor of an independent and ideally an institutional trustee.

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Qualified Plan v. IRA in Divorce

- Qualified plan need QDRO which is a divorce court order with precise requirements for 401(k). An IRA will not require a QDRO and can divide by property settlement agreement.
- Options to consider:
- Rollover - but the surviving spouse has control and can name her kids from her first marriage.
- Consider use of life insurance – plan to new spouse and insurance to children from prior marriage.
- Split retirement plan between kids and spouse.
- Name a two generation CRT – spouse 5% for life then 5% kids, then remainder to charity.

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Qualified Plan v. IRA in Divorce

- Qualified plan law supersedes state law.
- Children from prior marriages named as beneficiaries. Federal law trumps this and if you die your spouse is entitled to 100% of assets in your 401(k) unless she exercised a waiver.
- A prenuptial agreement is not effective as a waiver. To be a valid waiver you must be married. In prenup say "we will sign all documents after marriage to make the waiver valid." But must follow up.
- With an IRA the kids from the first marriage will get the IRA assets.

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Trust Accessibility in Divorce - 1

- Is trust to be considered as part of the marital estate?
- Mass. Has considered trusts as part of marital estate if more than an expectancy and then subject to division.
- Court decided when divorce took place 11 beneficiaries, Husband, 2 siblings and grandchildren and not a closed class because other descendants would be added as born.
- Ascertainable standard of sorts was included: support, etc.
- Lower court said it was part of the marital estate and said value was 1/11 x full value since husband was one of 11 beneficiaries and gave wife 60% to wife.
- Appealed. Court noted that it was manipulative of trustees to stop making payments on eve of divorce

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Trust Accessibility in Divorce - 2

- SJC decision. Found that it was a mere expectancy so it is not subject to division. Note that does not mean it cannot impact how marital assets are divided.
- Lessons
 - Don't include ascertainable standard.
 - Better to have pooled trust for many beneficiaries than a trust just for one child.
 - Even if you don't practice in Mass. You have no idea where beneficiaries may eventually reside.
- State law is changing. Mass. Is out there but it is not that unusual a case. Under a conflicts of laws application, it will be the laws of the jurisdiction that governs the divorce that may determine the rights of the beneficiaries.

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Conclusion and Additional Information



Conclusion

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Conclusion

- Practitioners should exercise care in tailoring pre-nuptial and post-nuptial agreements to reflect trusts and other estate planning of their clients. The increased flexibility and complexity of modern trusts will require special care and provisions in marital agreements.
- Both matrimonial and estate practitioners must address the new variability and trust mechanism in pre and post nuptial agreements.

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Additional information

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