New Jersey Law Journal

VOL. 204 - NO 11 JUNE 13, 2011 ESTABLISHED 1878

Family Law

For Love, Money and the Exemption

Preparing premarital and property-settlement agreements after the 2010 Tax Act

By Catherine Romania

The Tax Relief Unemployment Insurance Reauthorization and Job Creation Act of 2010 (2010 Tax Act), enacted into law on Dec. 17, 2010, has created a multitude of interesting possibilities for estate planning attorneys. But it also gives rise to negotiating opportunities and drafting pitfalls for attorneys preparing premarital and property-settlement agreements.

Under the 2010 Tax Act, in the years 2011 and 2012, the amount one person can transfer by gift or at death without incurring a federal estate tax, known as the exemption or exclusion amount, is $5 million. Thereafter, absent further action by Congress, the exemption will be reduced to $1 million. Also included in the 2010 Tax Act, and new to the area of federal estate and gift tax law, is a provision allowing portability of the exemption. This allows one spouse to utilize the deceased spousal unused exclusion amount (DSUEA), therefore making it possible for a married couple to transfer $10 million free of federal estate tax, without using bypass or credit-shelter trusts or disclaimers, and regardless of the titling of assets. Like the $5 million exemption, portability is also set to expire on Dec. 31, 2012. The maximum federal-estate and gift-tax rate during this time frame is set at 35 percent (increasing to 55 percent in 2013). So, for example, if a client's worth is $7 million, the ability to use a spouse's exclusion may save as much as $700,000.

Premarital agreements generally include a couple's agreements regarding what happens upon death or divorce, so providing for use of the less wealthy spouse's otherwise unused exemption naturally follows and is not prohibited under N.J.S.A. §37:2-34. The ability to utilize the less wealthy spouse's exemption in order to save substantial taxes, both in life and at death, may actually result in more premarital agreements being prepared as more couples decide to marry instead of continuing to cohabit in order to take advantage of the exemption. The existence and use of an available DSUEA from a prior marriage must be carefully considered before entering into a second marriage, as portability is only permitted with respect to an individual's immediately prior predeceased spouse's exemption.

Preserving DSUEA

Absent any proposed lifetime transfers to make immediate use of the less wealthy spouse's available exemption, a premarital agreement must address the possibility of the less wealthy spouse predeceasing the wealthier spouse. In order for the DSUEA to be available for use by the wealthier spouse, it must be preserved in a timely filed federal estate tax return by the executor of the deceased spouse's estate. In situations where the deceased spouse's child from a prior marriage or another person is executor, the wealthy spouse may not have a right to file the return and preserve the DSUEA. The premarital agreement must direct the filing of the return by the executor to preserve the right of the wealthier spouse to utilize the DSUEA.

Timing of the marriage and lifetime gifts is also important. If a wealthy spouse intends to remarry after the death of a first spouse, it may be beneficial to utilize the DSUEA of the first spouse before entering into the second marriage. This is because the DSUEA is only available with respect to an immediately prior predeceased spouse. By utilizing the DSUEA of a first spouse before entering into a second marriage, the DSUEA of the first spouse is not lost should the second spouse also predecease (then becoming

Romania is a member of the law firm of Witman Stadtmauer, P.A., in Florham Park.

the immediately prior deceased spouse of) the wealthy spouse. Note, the DSUEA of the first spouse is not lost merely upon remarriage but upon the death of the second spouse after remarriage.

Utilizing a spouse's otherwise unused exemption

One example of utilizing a spouse's otherwise unused exemption involves creating a lifetime qualified terminable interest property (QTIP) trust, which in sum provides income to the less wealthy spouse for life, and upon such spouse's death, the property passes to the wealthy spouse's descendants. IRC § 2056(b)(7). The QTIP trust would be created after execution of the premarital agreement and marriage or, if created in connection with a property settlement agreement (PSA), then after execution of the PSA and incident to divorce. The trust would be funded with up to $5 million, thus fully covered by the federal exemption, and because it is a QTIP trust, it will be included in the estate of the less wealthy spouse upon death. Since the less wealthy spouse has few other assets, the wealthy spouse has managed to pass $5 million to his heirs federal-estate-tax free in his own estate, as well as another $5 million federal-estate-tax free through his spouse's estate.

More specifically, the wealthy spouse makes a gift to the less wealthy spouse by establishing the trust. Gifts between spouses are tax free no matter the amount, which is why the gift must be made during the marriage. The wealthy spouse has not used up any of his federal gift/estate tax exemption in making the spousal gift; therefore upon the wealthy spouse's death he can also leave $5 million estate-tax free. Pursuant to the terms of the premarital agreement or PSA, the wealthy spouse is required to establish the QTIP for the less wealthy spouse. The income from such trust, a significant amount if funded with $5 million, may very well be the only sums the less wealthy spouse receives upon death or divorce. In order to qualify for the marital exemption under the tax code, the QTIP must provide the spouse with income for life: thus the income stream cannot end on the remarriage of the less wealthy spouse. Upon the death of the less wealthy spouse, pursuant to the marital agreement, the less wealthy spouse is obligated to apply her entire exemption amount to the QTIP funds which will be included in her estate.

The marital agreement must contain a provision requiring the allocation of the less wealthy spouse's $5 million exemption to the QTIP funds. Although such a provision is irrelevant if the less wealthy spouse never wins the lottery or remarries (as then the amount in the QTIP will be the only assets to allocate the exemption to), it is very important should the less wealthy spouse later remarry or otherwise obtain substantial additional assets. By allocating the exemption in the premarital agreement or PSA, the exemption will not be available to apply to any later acquired assets or assets outside of the QTIP trust.

Unfortunately, the above example assumes the $5 million exemption and portability will be available beyond 2012. If further assurance as to the availability of the exemption is required, an alternative to transferring the sums to a QTIP trust would be to make a gift outright to the less wealthy spouse, during the marriage, of a sum greater than the $5 million exemption. Again to avoid utilizing the wealthy spouse's exemption amount by gift to the less wealthy spouse, the gift must be made during the marriage, not before the marriage. In this case, the wealthy spouse needs to trust the less wealthy spouse to shortly thereafter make a gift of up to the $5 million exemption amount to the wealthy spouse's heirs, while keeping the excess in return and as support or equitable distribution should the marriage end in divorce or death of the wealthy spouse. The gift can be accomplished in 2011 and 2012 before the law expires.

Practical and emotional considerations as well as tax concepts such as the step transaction doctrine, whereby the taxing authority views the cumulative steps as one entire transaction and voids them as a result, may also make the approach not viable. Moreover, a marital agreement cannot make the gift to the less wealthy spouse contingent upon a gift over to the wealthy spouse's heirs, as such a contingency most likely would cause the nature of the transaction to be deemed a loan or contingent gift, thus not qualifying it for the marital deduction and present exemption.

Other Considerations

This article is intended to give a brief synopsis of the impact of the 2010 Tax Act on the use and drafting of marital agreements. Postmarital agreements, if otherwise enforceable, may also encompass the concepts discussed in this article. Other issues and ambiguities in the law, including what may happen in 2013 if the exclusion amount is reduced making recaptures or claw backs possible, are not addressed.

The planning techniques discussed above may also impact state estate and inheritance taxes. New Jersey currently imposes an estate tax on estates valued in excess of $675,000 and although it recognizes a marital deduction, it does not recognize portability. Additionally, New Jersey requires consistency on the federal and New Jersey estate tax returns. This requires certain tax elections made with respect to federal estate taxes also to be made on the New Jersey estate tax return. As a result, the impact on both taxes must be considered in drafting the premarital agreement and PSA, including who is responsible for the New Jersey estate tax.

If cash is not used to fund the gifts, the nature of the assets used for the gift must also be considered for income tax planning because upon death the assets receive a step-up in basis whereas gifts carryover the basis of the donor.

Portability does not apply to the generation-skipping transfers, thus gifts to grandchildren in excess of one's own $5 million exclusion will incur the generation-skipping transfer tax. Additionally, portability and unlimited gifts to a spouse do not apply where one spouse is not a citizen.

Attorneys preparing premarital agreements and PSAs need to work closely with the couple's estate planning attorneys in order to maximize the potential benefits afforded under the 2010 Tax Act. As a result of an increase in the available federal-estate-tax exemption and portability, a less wealthy spouse has an important economic attribute not to be overlooked nor underused. ■