ESTATE PLANNING FOR SECOND AND THIRD MARRIAGES IN RHODE ISLAND

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Half of all marriages end in divorce, and this number increases for second marriages at a rate of sixty-seven percent and for third marriages at a rate of seventy-four percent or three out of four marriages. As a result of these divorce rates, blended families (i.e. marriages where one or both spouses have children from a previous marriage) are becoming more common. Apart from the statistics, the dynamic of the blended family creates complexities in the area of estate planning. This article explores some of the estate planning issues facing all families in Rhode Island with some focus on second or third marriages.

Take for instance, the situation of an older person with adult children who is now alone. Whether due to the death of a spouse or divorce, the client may find a companion with a similar background and eventually decide to marry. Inherent in this new union is the desire to protect each spouse while also preserving assets for the children from each of the prior marriages. As a result of these competing interests, a multitude of matters must carefully be discussed with the client.

Pre-nuptial agreements

One of the first issues facing the clients and their lawyers is whether they should enter a ante-nuptial or pre-marital agreement. Also, given the size of Rhode Island, a second question arises, What jurisdiction will control? It is common for there to be a choice of law issue in Rhode Island given the proximity to neighboring states, most notably Massachusetts. If a choice of jurisdiction is possible because one party lives in Massachusetts, the individual you represent may influence which law you want to control as Massachusetts case law more readily will allow you to set aside the agreement.

Rhode Island's version of the Uniform Premarital Agreement Act (the "Act"), codified at Rhode Island General Laws § 15-17-1 *et. seq*., is fairly comprehensive, leaving only the basic tenets of statutory interpretation to the Rhode Island courts. Of particular note is section § 15-17-6 titled Enforcement. Subsection (b) states the burden of proving a premarital agreement is unenforceable falls on the party seeking to have it declared invalid. Subsection (a) establishes a two pronged approach in Rhode Island that must be proved by the party against whom enforcement is sought. Under sub-subsection (1), that party must prove he or she did not execute the agreement *voluntarily*. Under sub-subsection (2), which is itself multifaceted, that party **must also prove** (*emphasis added*) the agreement was *unconscionable when it was executed* and that before execution that party (i) did not receive fair *disclosure* of the financial situation of the other party, (ii) did not *waive* in writing fair disclosure, and (iii) did not have and could not have had adequate *knowledge* of that situation.

In *Penhallow v. Penhallow*, 649 A.2d 1016, 1022 (R.I. 1994), the Rhode Island Supreme Court took an opportunity to interpret §15-17 for the first time. The Court held that proving a premarital agreement invalid under the Act requires proving both prongs conjunctively. It therefore enforced a premarital agreement that was voluntarily entered into despite its unconscionability. "This issue is critical, because without clear and convincing evidence of involuntariness, the agreement cannot be rendered unenforceable." 649 A.2d 1021-22.

Massachusetts also provides for a two-prong analysis, which has been developed primarily through case law. In contrast to Rhode Island, an agreement will be invalidated under Massachusetts law if **either** (*emphasis added*) prong is proven.

The first prong is multifaceted, consisting of three interrelated parts, no one of which appears to be dispositive. The SJC pulled these guidelines from leading cases in other jurisdictions. The relevant factors (guided by even more language of what can be considered in analysis) are whether

> (a) it contains *fair and reasonable* provision as measured at the time of its execution for the party contesting the agreement; (b) the contesting party was *fully informed* of the other party's worth prior to the agreement's execution, or had, or should have had, independent knowledge of the other party's worth; and (c) a *waiver* by the contesting party is set forth. *Rosenberg v. Lipnick*, 377 Mass. 666, 672 (1979).(emphasis added).

The second prong of the test, the "conscionability" consideration, is sometimes referred to as the "second look" because it is only applied if the first "fair and reasonable" prong is met. Conscionability, unlike the first prong's factors, is tested at the time the antenuptial agreement is sought to be enforced. The first prong and the second prong together cover the gamut by looking into the factual circumstances at play before, during, and after marriage. As noted above, the failure of one prong defeats the agreement.

For estate planning purposes, a practitioner might want to consider including a provision that requires one or both parties to purchase long-term care insurance as a wealthier new spouse could end up paying for nursing home expenses for the poorer spouse as Medicaid regulations ignore pre-nuptial agreements.

Attention should also be made to address the Rhode Island spousal life estate in realty and whether an income interest should exist in remaining assets exclusive of principal.

Estate Taxes

Beyond federal annual exclusion gifts of $13,000 per donee per year, a person can transfer up to $1 million during his or her lifetime (lifetime gift tax exemption) and up to $3.5 million at death (estate tax exemption). Therefore, an individual can die with a taxable estate of $3.5 million in 2009, assuming no significant lifetime transfers were made, without creating a federal estate tax. At the time of publication, this figure was expected to be extended and remain in place for an indefinite time with the enactment of legislation by year end 2009 or some time in 2010.

These figures, however, are slightly different for Rhode Island residents. Although the state does not impose a gift tax on lifetime transfers no matter what the size, it imposes a tax on estates in excess of $675,000 for those dying on or before December 31, 2009 and then $850,000 on January 1, 2010[1]. As a result, clients that otherwise might not consider estate tax planning at the federal level will often need to plan for the tax imposed at the state level.

Spouses have the ability to transfer any amount to each other, during life or at death, with out imposing an estate tax. This is known as the unlimited marital deduction. But, how will the couple use this to their advantage, particularly in second or third marriages? Let's assume a client has expressed a desire to leave assets to his or her children but also wants to provide for the surviving spouse upon death. Below is one option.

Qualified Terminable Interest Trust

Leaving assets to the poorer surviving spouse addresses estate tax concerns, but does not ensure that those assets will ultimately pass to the wealthier spouse's children. This dichotomy is typically addressed by placing the money to the surviving spouse in a qualified terminal interest property ("QTIP") trust.

Because it is a trust for the benefit of the spouse, it qualifies for the unlimited marital deduction and there are no gift tax implications (as noted above, spouses can transfer an unlimited amount of assets to each other). Under the terms of the QTIP trust, the spouse will receive all the income from the trust annually for life. If the trust provides for other beneficiaries during the spouses lifetime, then the transfer will not be eligible for the marital deduction. The terms of the trust may also provide for the trustee to provide distributions of principal for the spouse as needed.

By leaving the property in the QTIP trust the second spouse will not have control over what happens to the principal at his or her death. Furthermore, the grantor of the trust will decide the final distribution of the assets. For example, husband/grantor creates a QTIP trust that provides income to his wife annually and gives the trustee the discretion to distribute principal for her maintenance and support. Upon her death, the remaining trust principal will be distributed to the grantor's children. The result is the surviving spouse

[1] See. 2009 Ch. 068 H5983Aam (June 30, 2009)

having assets available for his or her benefit while ensuring the distribution of the remaining principal to the decedent's children.

A QTIP trust is generally created at the death of the individual as part of his or her revocable living trust. But, the client should consider a lifetime QTIP trust as well. The couple could also provide for the creation of a lifetime QTIP under the terms of the pre-nuptial agreement. This would require an irrevocable transfer of assets, but may provide some peace of mind to the spouse that his or her care will be provided for since a QTIP created by a revocable living trust may be altered or deleted any time prior to the grantor's death.

There are other options as well.

Asset Protection Trust Alternative

Suppose for whatever reason your client believes a pre-marital agreement is not an option, but wishes to avoid certain property being deemed marital assets. As an alternative to the pre-marital agreement he or she may wish to consider a Rhode Island asset protection trust to shield assets prior to the marriage.

Rhode Island is currently one of eleven states that allows for an individual to establish a self settled trust for asset protection.[2] The statute is contrary to the common law, which prohibits spendthrift protection to a grantor who retained an interest in a self settled trust. Pursuant to R.I.G.L. § 18-9.2-1 *et seq*, an individual may create a trust with his or her own assets and be a current beneficiary and still shield the assets from future creditors.

An asset protection trust ("APT") is created in Rhode Island when the grantor transfers assets to the trustee of an irrevocable trust and retains an interest in the assets under the terms of the trust. The trustee must be a Rhode Island resident or a Rhode Island bank or trust company and must be located in Rhode Island. The grantor cannot serve as trustee but may retain some authority with respect to investment decisions and veto power over distributions.

It's important to note the statute provides future creditors the opportunity to challenge the transfer within four years of the creation of the trust. After that period, all creditors arising after the trusts creation are barred from attaching the assets. Creditors existing prior to the creation of the trust are afforded greater flexibility. Although the same four year rule applies, such creditors may also challenge the trust within a year the transfer was or could have been reasonably discovered by the creditor. Be advised, however, that the statute of limitations is ten years under the bankruptcy code for any fraudulent transfer to a self settled trust[3].

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[2] The other states with similar legislation include Delaware, Alaska, Nevada, Utah, Oklahoma, Tennessee, Missouri, Colorado, Wyoming and South Dakota
[3] 11 U.S.C. § 548(e)(1)(A)

The state statute provides for a special class of exempt creditors that can defeat transfers to trust, notably trust assets will not be protected against child support claims or claims for alimony or marital property asserted by one who was married to the grantor *at or before* the time of the *transfer to trust*. Since one does not acquire the status of "spouse" under this exemption if the grantor's transfer pre-dates the marriage, an APT is a discreet alternative to a pre-nuptial agreement. Therefore, the APT can be an effective vehicle if the trust is created prior to the marriage with assets the grantor wishes to ensure remain non-marital assets. For practical purposes, establishment of the trust well in advance of a marriage would be advisable.

Although domestic APT's are becoming increasingly common, their effectiveness has not been thoroughly tested in US courts, including Rhode Island. APT's may be vulnerable to being set aside in bankruptcy court or in accordance with an out-of-state judgment. This concern, however, is arguably not as great in the pre-marital context. Rhode Island law controls the rights and obligations of the married couple, so laws with respect to property rights set forth under Rhode Island law would have to be respected as well.

Spousal Election

A spouse has the right to claim a portion of the decedent's spouse estate instead of taking the devise or bequests left in a will. If there is not a premarital agreement in place whereby each spouse waives his or her right to make such an election, this can result in unintended consequences. If the decedent's intention was to leave assets to his or her children from a previous marriage, then there is nothing precluding the surviving spouse to making such an election without a written agreement to the contrary.

R.I.G.L. § 33-25-2 states "whenever any person shall die leaving a husband or wife surviving, the real estate owned by the decedent in fee simple at his or her death shall descend and pass to the husband or wife for his or her natural life..." Therefore, the statute gives the surviving spouse a life estate in the decedent's real estate. In the absence of a pre-nuptial agreement as mentioned above, the decedent can avoid this result through the use of a revocable trust.

This position was confirmed by the Rhode Island Supreme Court in *Barrett v. Barrett*[4]. The plaintiff in *Barrett* argued that the transfer of real estate to a revocable trust was an illusory transfer and, because the decedent retained all rights incident to ownership in fee simple despite it being in trust, her life estate was not defeated. The plaintiff relied on the Court's previous holding, *Pezza v. Pezza*[5], which found that the transfer of real estate to a revocable trust was illusory and thus still subject to the statute.

This case arose from a dispute between the decedent's second wife and his child from a first marriage. The decedent's estate plan consisted of a will that left his surviving spouse a bequest the amount of which was determined by the length of their marriage as well as a proportional share of the residue of his estate. Shortly after executing his will, the

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[4] 894 A.2d 891 (R.I. 2006)
[5] 690 A.2d 345 (R.I. 1997)

decedent also created a revocable trust and transferred real estate to said trust with a reserved life estate. The decedent's wife was excluded as a beneficiary under the trust.

The Court rejected the surviving spouse's claim, noting that the applicable statute had been modified since the ruling in *Pezza*. The court examined the legislative history of R.I.G.L. § 33-25-2(b) and concluded that it supplanted the illusory transfer test. That section specifically states that a conveyance with or without monetary consideration shall not be subject to the statutory life estate if the instrument evidencing such transfer is properly recorded. Although this section conflicts with the *Pezza* ruling, it is given preference since it was enacted afterwards and thus defeats the statutory life estate claim.

<u>Medicaid Planning</u>

Unfortunately estate tax planning and Medicaid or nursing home planning do not complement each other. That is because the use of revocable trusts and QTIP trusts do not properly protect assets under the Medicaid regulations because such trusts, provide for support, health and maintenance. Given a month in a nursing home can easily cost between $8,000 and $10,000, it is important to determine which issue is the client's principal concern.

Medicaid eligibility is determined in part by the applicant's resources. In Rhode Island, an applicant will not be eligible if his or her assets exceed $4,000 (excluding the value of certain exempt assets such as the principal residence) and the applicant's spouse is allowed to keep $109,560 in resources as of year end 2009[6].

One of the principal concerns is the treatment of the couples separate assets. Despite intentions to keep premarital assets separate, Medicaid will evaluate all assets of the couple, essentially treating property as jointly owned regardless of how it is titled. Therefore, assets titled in the name of the healthy spouse will still be attributable to the spouse in the nursing home. For example, suppose a couple has $300,000 of combined assets. But, because this is a second marriage, nothing is held jointly and the healthy spouse has $250,000 of assets and the nursing home spouse has $50,000. Under the Medicaid regulations, approximately $109,000 will be allocated to the healthy spouse (this is known as the community spouse resource allowance) and the remaining $191,000 is allocated to the nursing home spouse. As a result, the individual will remain ineligible for benefits until the $191,000 is spent down below $4,000.

Therefore, the estate planning attorney may advise an older couple that the second or third marriage is not in their best interest, especially if significant health issues already exist. Unfortunately, the balance between financial pragmatism and the emotional and religious motivations for marriage can make such a decision very difficult. It is another reason why it can be unsettling to one or more groups of the children.

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[6] Rhode Island Dept. of Human Services Policy Manual 0380.40.15

If, however, long term care is a primary focus and there are no present health issues, the clients should consider the purchase of long-term care insurance or the creation of irrevocable trusts to preserve the separate assets.

Transferring assets to an irrevocable trust will result in a five year period of ineligibility, but the trust provides much greater protection than if assets are transferred outright to children. While gifting assets to a child may be straight forward, the assets would be subject to that child's potential creditors and the donor would lose all control over the property. The grantor, however, cannot be a beneficiary of the principal of the trust otherwise the assets will be deemed available resources. As a result, the APTs discussed above would not be advisable in this context. But, the grantors can retain an income interest in trust so any income generated will be payable to them on a regular basis. Furthermore, by retaining a limited power of appointment over the trust principal, the grantor has greater flexibility determining the beneficiary of the trust (as long as the grantor does not have the power to appoint to himself) to accommodate a change in circumstances or wishes.

This technique can be very effective in protecting the principal residence. By transferring the real estate to trust and making it through the five year ineligibility period, the home will be protected from any lien imposed by the state. The trust will also provide that the grantors can occupy the home during their lifetime and that it cannot be sold without their consent. If the house is sold, the proceeds will remain in trust and can be used to purchase other real estate. This is opposed to the common scenario where the individual transfer the real estate to children with a reserved life estate. In that case, a subsequent sale would result in the life tenant being allocated a portion of the proceeds resulting in excess assets. Therefore, the irrevocable trust provides significantly more protection and flexibility.

Conclusion

A client's principal concerns and priorities always direct the estate planning process. This does not change in the second or third marriage context, but it is important to note how issues unique to blended families, most notably the competing interests of children and the second or third spouses, influences these priorities. Pointing out some of these distinctions and the impact it has on planning recommendations will hopefully eliminate much of the conflict that may arise in the blended family context.

Side bar – Estate Tax Update

The Rhode Island legislature has increased the Rhode Island estate tax exemption from $675,000 to $850,000 for the calendar year 2010. This was passed as part of the 2010 fiscal year budget in July 2009. As a result, only taxable estates in excess of $850,000 will be subject to the payment of taxes. Furthermore, the threshold will be adjusted for inflation based on the consumer price index. Any adjustments will take place as of January 1 each year.

At the time of publication, the federal estate tax was scheduled to be eliminated for decedent's dying in 2010. But, the elimination would only be for one year and the tax would be reinstated in 2011 to the levels that existed prior to the enactment of the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA"). That consisted of a $1 million filing threshold and 55% highest marginal tax rate.

All signs were pointing to a temporary extension of the current estate tax levels (i.e. $3.5 million exemption and 45% tax rate) until a final resolution could be reached. However, based on the various bills introduced it is clear there are still a number of issues to resolve even if Congress chooses the temporary extension. These bills include:

1) House Bill 3905 – Estate Tax Relief Act of 2009: Introduced October 22, 2009, this bill would repeal the one-year termination of the estate tax in 2010. It would phase in an increase the estate and gift tax unified credit from $3.5 million in 2009 to $5 million in 2019 and thereafter. It also proposes a reduction of the maximum tax rate from 45% to 35% over the same timeframe.

2) Senate Bill 722 – Taxpayer Certainty and Relief Act of 2009: This would make the $3.5 million federal exemption permanent and a top rate of 45%, and index the exemption amount for inflation. Furthermore, the gift and estate tax would be reunified. This means an individual would be able to transfer $3.5 million at death or during lifetime. This bill would also allow any of decedent's unused exemption to be transferred to the surviving spouse under a portability provision.

3) House Bill 2023 – Sensible Estate Tax Act of 2009: Would set the exemption level at $2 million, indexed for inflation and provide a progressive tax rate. The rate would start at 45% and move to 55% for estates over $10 million. This bill also provides for reunification of the estate and gift tax and exemption portability to a surviving spouse which would allow a bundling of exemptions if unused by the first spouse to die as in Senate Bill 722. Finally, it would restore the state estate tax credit that was phased out under EGTRRA (currently there is a deduction for a portion of state estate taxes).

4) House Bill 436 – Certain Estate Tax Relief Act of 2009: Proposes a freeze at the current exemption level at $3.5 million and rate along with gift and estate tax unification. The most notably distinction under this bill is the limit on valuation

discounts for joint interests, family limited partnerships and new valuation rules for transfer of non-business assets.

It is unclear if any of these bills will pass in their current form. It is also possible for Congress to extend the current legislation on a temporary or permanent basis. Regardless, it certainly appears that the estate tax is here to stay.