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Estate Planning & Elder Law

Unintended Consequences of ILITs And QPRTs When Clients Divorce

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When most couples are in the midst of handling their estate plans, divorce is not only a subject that is not top of mind, it may also be taboo. However, attorneys that recommend trusts and other estate planning tools should be conscious of the possibility that this very happy couple may not remain so forever. As a result, practitioners should include provisions in their agreements that either address what should happen in the event of a divorce or implement plans that would not be impacted by divorce.

Two of the most common planning tools — Qualified Personal Residence Trusts ("QPRTs") and Irrevocable Life Insurance Trusts ("ILITs") — can create unique problems during divorce if the proper planning was not done at the outset. Client confusion over the nature of these estate-planning vehicles often results in disappointment and surprise when they realize that the home they think of as theirs isn't, or the insurance policy they think they own, they don't.

Irrevocable Life Insurance Trusts

An ILIT is one of the most common (and effective) estate-planning tools available to clients today. As a general rule, the death benefit payable upon the death of an insured is included in the taxable estate of the insured, if the insured owns the policy at the time of his or her death. An ILIT is generally created by an individual to purchase life insurance on their life, so that the ILIT is the owner of the policy, not the insured. The trust will be designated as not only the owner of the policy, but also as the beneficiary. Thus, when the insured dies, the trust will receive the death benefit and the death benefit will not be included in the insured's estate.

It is not uncommon for a client going through a divorce to advise their counsel that they own a life insurance policy under which they are insured, only to find out later that the policy is, in fact, owned by an ILIT. Therefore, it is absolutely incumbent upon divorce counsel to verify the ownership of all policies.

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If the ILIT was properly drafted, then the grantor-insured has surrendered any ability to change the beneficial interests in the trust. Often the beneficiary is a further trust for the surviving spouse and the children. Sometimes the ILIT provides that any benefit which the spouse may be entitled to under the trust is surrendered if the spouses divorce. Often in a divorce settlement, one spouse is required to maintain life insurance for the benefit of the other spouse. If the divorcing spouse's interest is surrendered by the terms of the trust upon a divorce, the policy owned by the ILIT may not be sufficient to satisfy the ex-spouse, and another policy may need to be purchased.

However, the biggest issue facing grantors of ILITs after a divorce, is the possibility that the former spouse may still be entitled to some benefit for surviving the insured, when that was not bargained-for in the divorce. For example, assume an ILIT is established to provide lifetime benefits for the spouse alone, naming the children as remainderman. The attorney who drafted the ILIT never contemplated the possibility that the parties might divorce down the road, and made no special provisions in the trust agreement to address this issue. After the divorce, the insured spouse dies and the death benefit is paid to the trustee. N.J.S.A. 3B:3-14 provides that a divorce results in the revocation of any revocable disposition to a former spouse in a governing instrument and, likewise, removes the former spouse as a fiduciary thereunder. However, the provi-

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sions of this law only apply to a revocable instrument — not an ILIT. Thus, the former spouse would not automatically lose his or her rights as a result of the divorce.

Thus, drafting attorneys must consider the possibility of a future divorce of the parties, and divorce counsel must determine if a policy is, in fact, owned by a trust, and what the governing instrument provides to the spouse.

Qualified Personal Residence Trusts

In its simplest form, a QPRT is a trust designed to receive a gift of the personal residence of the grantor, with the grantor retaining the right to the use of the residence for a period of years. At the end of the term of the grantor's use, the residence will typically belong to the grantor's children or a trust for the benefit of the children. While a gift has clearly been made for the benefit of the remainderman children, the value of the gift is not equal to the value of the residence. Rather, the gift is equal to the fair market value of the residence less the value of the grantor's retained interest. If the grantor survives to the end of the retained residency period, the property passes to the beneficiaries, and has effectively been removed from the grantor's estate, thus escaping estate taxation.

So what happens if the QPRT owns the marital residence and the parties divorce prior to the end of the retained residency period? The options available are often dependent upon a number of different issues including: (i) who is the remainderman, (ii) the value of the remaining assets of the marital estate, and (iii) the common goals of the parties. Among the limited options are:

Let the QPRT run its course. The best option may be to leave the QPRT intact with the expectation that this will redound to the benefit of the children. While a shared continued use of the property by both parties is typically unhealthy, appropriate arrangements could be made to compensate the vacating spouse for his or her lost occupancy rights through a negotiated settlement.

Sell the house on the open market and convert to an annuity. According to Treas. Reg. 25.2702-5(c)(8), the governing instrument of a QPRT must provide that if the trust ceases to hold a personal residence, either the assets must be distributed outright to the term holder or the assets will be converted to a qualified annuity interest for the remainder of the term. Depending upon how far the parties have progressed into the retained term when the marriage ends, the qualified annuity may preserve much of the intended estate tax benefit. However, if little of the term has passed at the time of the marital dissolution, there may be limited benefit to continuing the annuity. In the event that only one spouse is entitled to the annuity, the divorce agreement could have a "make-up" provision to compensate the other spouse.

Step-down in residence. Frequently, in a divorce, the marital residence will be sold and the net proceeds reinvested into new residences for each spouse. If only one spouse has a retained interest, then the trustee may sell the residence and purchase a replacement residence for the grantor-spouse for a fraction of the proceeds. The nonreinvested proceeds would convert to an annuity satisfying the requirements of Treas. Reg. 25.2702-5(c)(8), payable to the grantor-spouse. That annuity could, pursuant to the terms of a property settlement agreement, be for the benefit of the nongrantor spouse.

Sale to the nongrantor spouse. Treas. Reg. 25.2702-5(c)(9) provides that the governing instrument must prohibit the trust from selling or transferring the residence, directly or indirectly, to the grantor or the grantor's spouse during the retained term of the trust (for QPRTs established after December 22, 1997). The law does not permit a substitution of the nongrantor spouse as the residing spouse for the duration of the QPRT. While there is no direct law on point, query whether or not the nongrantor spouse could agree to purchase the residence from the trust after the divorce, when he or she is no longer a spouse, at fair market value.

Frequently, QPRTs are drafted with a trust designated as the remainderman. The trust will often provide that the nongrantor spouse retains a life estate in the property. In this way, the grantor-spouse may continue to reside in the home without paying rent to the remainderman so long as the nongrantor spouse plays nice. So what happens when the parties divorce? If the non-grantor spouse may continue residing in the property, this could be a significant windfall to him or her. Perhaps a better approach would be for the provisions of the remainderman trust to state that in the event of a divorce, the nongrantor spouse's interest would terminate — as it may in an ILIT.

It is not uncommon for clients to establish a QPRT, continue to reside in the home and forget that the QPRT was even established. In a divorce, the parties may very well neglect to share this information with their respective attorneys. This would certainly result in unintended consequences when the property settlement agreement addresses the ownership of the house without considering the fact that neither party is the owner. For this, and many other reasons, it is always prudent to complete a title search with respect to all real property in a divorce. If a QPRT was established, that fact would be discovered in the search.

Estate attorneys must consider the impact divorce would have on the planning they do for couples. QPRTs should be explained to clients so that they understand the complications and consequences that could result from divorce. Further, when drafting ILITs, be careful when providing lifetime benefits for a surviving spouse, since that may not be desired in the event of a divorce. ■