

REVOCABLE COMPLEMENTS IN ESTATES AND  
 ESTATE PLANNING TOGETHER WITH THE  
 UNRAVELING OF PROBATE PROVISIONS FOR  
 THE FORMER SPOUSE

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## I. INTRODUCTION

All too often when a divorce occurs, the terrific, cutting-edge estate planning for the married couple takes on a different complexion. The consideration shifts to unraveling the plan, or separating the interests of the husband and wife.

If the estate planning was straightforward, such as a tax sensitive revocable trust with pour-over wills, undoing the plan may not be difficult. Similarly, when the spouses hold certain assets in joint tenancy, or have designated each other as the beneficiary of insurance, annuities, and retirement plan benefits, the elimination of the former spouse after the dissolution typically is easily accomplished.

Conversely, if there have been various sophisticated estate planning techniques for the husband and wife, challenges and complications can arise in restructuring irrevocable planning or retaining tax qualified status. The planner also can have problems when representing a propertied spouse when removing the former spouse from the planning. For example, if the husband and wife have established charitable trusts providing for both of them, irrevocable insurance trusts holding joint and survivor policies, or qualified personal residence trusts, the issues and concerns become more complex. In a divorce, unfortunately, there is no ideal exit strategy with certain types of irrevocable planning devices.

Without proper attention to the effects of the marital dissolution, adverse tax consequences can result. Can the charitable trusts be divided without jeopardizing their tax-exempt status? What are the options with an irrevocable insurance trust? Can the QPRTs with co-tenancy interests remain qualified despite the divorce?

Issues also arise in connection with whether the probate court or the family law court has jurisdiction to handle the resolution of the various matters presented in the trust and divorce context. These types of marital dissolution and family law issues and complications, which frequently arise in estate administration and estate planning, will be the focus of this article. Guidance will be suggested in handling these matters and dealing with the divorce related issues.

## II. REVOCATION OF WILL PROVISIONS AND CERTAIN NONPROBATE TRANSFERS UPON DIVORCE, EXCLUDING TRUSTS OR INSURANCE BENEFICIARY DESIGNATIONS

The Probate Code provides that unless the will expressly provides otherwise, the provisions of a will providing for the spouse and any nomination of the spouse as executor, trustee, conservator, or guardian are revoked upon the dissolution of the marriage.<sup>1</sup> In light of Probate Code § 6122, one might think that unless there is extrinsic evidence that the testator intended to exclude the former spouse's children when they are named devisees, they would take from the decedent despite the divorce. The Court of Appeal has decided differently, however, holding in two cases that a testator who provides for his former spouse's children is presumed to have intended to exclude them after the dissolution of the marriage unless a contrary intention is indicated elsewhere in the will.

In *Estate of Hermon*,<sup>2</sup> the testator executed a will on March 6, 1974 that provided, "I am married to SUZANNE HERMON and all references in this Will to 'my spouse' are to her...My spouse has four (4) children now living..." The will provided for certain property to pass to the spouse if she survived, and if she did not, to "my children and my spouse's children who survive me..." The residue of the estate passed to the spouse if she survived him for 180 days and, if she did not, to "my issue and my spouse's issue who survive me for that period." The Hermons' marriage dissolved in 1986 and the decedent died in 1993 survived by a child of his own and by all four of the former stepchildren.

The trial court ruled in favor of the former stepchildren. The Court of Appeal reversed, holding that the devises to "my spouse's children" and "my spouse's issue" failed, absent an expression of intent that the devises were to survive the dissolution of the marriage. The court noted that the will lacked any specific provision with respect to marital dissolution, and stated that "there is no reason to believe [the testator] gave any thought to that possibility at the time of execution."<sup>3</sup>

The decedent's former stepchildren argued that Probate Code § 6122 revoked only those provisions of the will in favor of the former spouse (their mother). They contended that the statute should not be construed as having the effect of nullifying any portion of the will in favor of a former spouse's children. They maintained that if the Legislature desired such an effect, it would have so specified in Probate Code § 6122.

The decedent's natural child argued that Probate Code § 6122 was not the primary issue, that the will was ambiguous "in light of the extrinsic fact of divorce," and that the bequests to "my children," "my issue," "my spouse's children," and "my spouse's issue" were class gifts with class membership being determined at the time of the testator's death. The child maintained that at the time of the testator's death, he was the decedent's sole surviving child and clearly a member of the class, while his stepsiblings no longer were

within the description of “my spouse’s children” or “my spouse’s issue.” Neither side introduced any extrinsic evidence concerning the meaning of the language used by the testator.

The Court of Appeal stated that:

We find it significant that the testator’s former stepchildren are listed by name only in the preamble to the will for identification purposes. In the dispositive portions of the will, the words “my spouse’s children” and “my spouse’s issue” are used without naming any individuals, signaling the testator’s paramount intention to describe the beneficiaries not as individuals, but as members of a group identified by familial ties. Consequently, the matter of relationship at the time of the testator’s death should be taken into consideration. There is nothing in this will to indicate that the testator wanted to provide for “my former wife’s issue” or “my former wife’s children.” We think it is a more logical construction to hold that when a testator provides for his spouse’s children, he normally intends to exclude children of an ex-spouse after dissolution, unless a contrary intention is indicated elsewhere in his will...We arrive at [this] outcome consistent with the deceased’s likely intent giving the language of his will a construction favoring the natural objects of his bounty.<sup>4</sup>

In *Estate of Jones*,<sup>5</sup> the Court of Appeal also was faced with an absence of extrinsic evidence of intent as to the continued inclusion in a will of a stepdaughter after a marital dissolution. Since there was no evidence of a contrary intent to continue to include the former stepdaughter, the court in *Jones* felt “constrained to agree with *Estate of Hermon* [cite] that ‘when a testator provides for his spouse’s children (as a class), he normally intends to exclude children of an ex-spouse after dissolution, unless a contrary intention is indicated elsewhere in his will.’”

Mr. Jones executed a will in 1988, during his marriage, that stated: “...all the rest, residue, and remainder of my property, real, personal, and mixed, at whatever time acquired by me and wherever situated, I give, devise, and bequeath (in equal shares) to the following beneficiary or beneficiaries who survive me: my stepdaughters Paula Labo and [appellant] Kathy Hardie.” In 1994, Mr. Jones and his wife divorced and in 2002 Mr. Jones died.

In ruling against the stepdaughters, the trial court had observed that, while Probate Code § 6122 is clear regarding revocation of dispositions to former spouses, the law regarding dispositions to the issue of a former spouse is less than clear. The trial court found that the intent of the testator was that his initial residual bequest to appellant was to her as a member of a class, and that upon the divorce, appellant was no longer a member of that class.

The Court of Appeal relied on the fact that “at the time the testator died, appellant was no longer a stepdaughter, because that relationship had ended with appellant’s mother’s divorce from the

testator [and thus]... a literal reading of the will excludes appellant from taking,” and also relied on *Hermon* which held that “when a testator provides for his spouse’s children, he normally intends to exclude children of an ex-spouse after dissolution, unless a contrary intention is indicated elsewhere in his will.” The court was unpersuaded with appellant’s argument that *Hermon* could be distinguished because Mr. Jones did name her by name (“my stepdaughters Paula Labo and Kathy Hardie”). The court stated that:

Moreover, we are not persuaded by appellant’s presumption that use of her name in the will displayed an intent to provide for her after divorce. It seems more likely the testator was not contemplating divorce when he prepared his last will and testament six years before the divorce. Appellant was already an adult when her mother married Jones, and so there is no issue of the bond associated with raising a child. The marital settlement agreement made apparent a desire for a clean break between the parties and expressly stated husband and wife agreed to relinquish any future claims against the estate of the other (except as provided in a will or codicil dated after the date of the marital settlement agreement), and the marital settlement agreement was binding on the parties and their heirs and successors. The general preference for upholding testamentary transfers does not speak to the circumstances of this case.<sup>6</sup>

The only extrinsic evidence of the testator’s intent was the marital settlement agreement, which, as the court noted, did not support appellant’s arguments. If appellant had a continuing relationship with the testator in the eight years between his divorce and his death, the court stated that it was incumbent upon her to introduce evidence to that effect, which she did not do.

Consistent with Probate Code § 6122, Probate Code §§ 5600 and 5601 provide generally for an automatic revocation of:

- (a) “multiple party accounts” (i.e., joint accounts, payable on death (“P.O.D. accounts”), and Totten trust accounts;<sup>7</sup>
- (b) transfer on death (“T.O.D.”) securities and securities accounts;<sup>8</sup>
- (c) joint tenancy;<sup>9</sup> and
- (d) retirement plan beneficiary designations.<sup>10</sup>

Probate Code § 5601(a) establishes the general rule that a joint tenancy between a decedent and the decedent’s former spouse is severed if, at the time of the decedent’s death, the former spouse is not the decedent’s surviving spouse, due to the dissolution or annulment of their marriage.<sup>11</sup>

Probate Code § 5600 may be preempted by federal laws with respect to employer-provided benefits. In *Egelhoff v. Egelhoff*<sup>12</sup> the United States Supreme Court held that while Washington law

provides that life insurance beneficiary designations, annuity beneficiary designations, and retirement plan or IRA beneficiary designations are revoked upon a divorce, federal law (ERISA) controls. Any inconsistent state law, therefore, is invalid for retirement plans and insurance held through the plan. After the Egelhoff divorce was final, the former husband died and the beneficiary designations for his retirement plan and insurance maintained by the plan still named the former wife. The decedent's children from a former marriage claimed the benefits based upon the automatic revocation provided by Washington law. The Supreme Court held that ERISA pre-empted state law with the result that the former spouse received the benefits.

It is therefore especially important on the dissolution of a marriage to review beneficiary designations for employer-provided benefits and to analyze the specific plan provisions or the law pertaining to them. In *Marriage of Cramer*<sup>13</sup> a former wife of a deceased San Bernardino County employee sought payment of pension benefits following the decedent's death. The decedent had retired during the marriage and his pension benefits were entirely community property. Upon retirement the decedent elected to receive a lifetime annuity and upon his death sixty percent of that amount was to be paid "to an eligible spouse or minor children." The decedent named his then spouse as the beneficiary and in the divorce they stipulated that the spouse would have rights in the plan, with the family law court retaining jurisdiction for this purpose. After the decedent's death, the plan deemed the benefits to have been terminated. The court concluded that the term "surviving spouse" as used in Government Code § 31760.1 did not include a former spouse.

No such automatic revocation of the former spouse rule exists, however, for revocable trusts, or for insurance or annuity beneficiary designations. Therefore, special attention must be given to plans utilizing living trusts instead of, or in addition to, wills, and to insuring that insurance and annuity beneficiary designations are revised before, during (with the consent of the spouse or based upon court order, as discussed below), or after the divorce to insure that these assets pass as intended.

### III. ESTATES

#### A. Divorce Related Complications

While a divorce does revoke provisions for the former spouse in a will (including a pour-over will to a living trust), nevertheless a divorce does not automatically revoke a living trust. Therefore, if a trust is not otherwise revoked and if one of the former spouses dies, there may be unintended testamentary provisions for the former spouse. Unintended testamentary provisions also could be the result of the other spouse being named as the designated beneficiary of life insurance policies or annuities. In these cases, and in the circumstance when the former spouse is a beneficiary of an irrevocable trust established during the marriage, an estate disposition to the former spouse can be unexpected and contrary to the intent of the decedent.

A number of cases have held that while a divorce decree or property settlement agreement in a marital dissolution action will resolve any marital property right claims to insurance proceeds or retirement plan benefits, there will not be a termination of the former spouse as a designated beneficiary of insurance, or retirement plan benefits, or as a beneficiary under a will, absent explicit language to that effect in the order or agreement.<sup>14</sup>

#### B. Paternity Actions For Purposes of Determining Intestate Succession

A child not of a marriage will need to bring a paternity action against an intestate decedent in order to qualify as an heir. Pursuant to Family Code § § 7610, 7611, 7611.5, and 7612, paternity can be presumed when the parents were or are married, or attempted to marry.

When the child cannot establish the fact of marriage or attempted marriage, however, Probate Code § 6453 provides that paternity may be established if (1) there is an order determining paternity entered during the father's life, or (2) by clear and convincing evidence that the father openly held out the child as his own, or (3) by clear and convincing evidence if it was impossible for the father to hold out the child as his own.

In *Estate of Sanders*,<sup>15</sup> the decedent's will and his death were years after the birth of the child, and prior to the impossibility provision being included in Probate Code § 6453, and so DNA testing was not allowed. In that case paternity was not established because the decedent and the mother were never married and never attempted to marry, there were no paternity orders, and there was no clear and convincing evidence that the father openly held out the child as his own and, therefore, an omitted child claim against the decedent's probate estate could not be made.

In *Cheyana M. v. A.C. Nielsen Co.*,<sup>16</sup> in contrast, paternity was established in a wrongful death action when the father had died before the birth. Death precluded the father from being able to hold out the child openly as his own. This case was the first appellate decision addressing the impossibility provision of Probate Code § 6453. Presumably, DNA testing would have been allowed to prove paternity by clear and convincing evidence if it was impossible for the father to hold out the child as his own.

### IV. ESTATE PLANNING AFTER DIVORCE COMMENCED AND BEFORE DIVORCE IS FINAL

In light of the complications that divorce can cause on an estate plan, both family lawyers and trust and estate counsel should advise the divorcing spouses to review their plan to make certain that their testamentary intentions are fulfilled. Ideally, the estate planner will be consulted prior to the filing of the petition for dissolution. Such prior consultation has the advantage of planning before the automatic restraining order in the dissolution action becomes effective.

**A. Effect of Automatic Restraining Order (“ATRO”)**

When a petition for marital dissolution is filed, and after the summons is served, an automatic restraining order becomes effective against both spouses.<sup>17</sup> The ATRO generally precludes the transfer of assets, changing beneficiaries of insurance policies, or the modification or creation of a trust or another type of nonprobate transfer without the consent of the other spouse or an order of court. The execution or revocation of a will or codicil, however, is not prohibited. Similarly, the revocation of a trust or other nonprobate transfer is permitted, as is the elimination of a right of survivorship, if the other spouse is noticed and served prior to the change taking effect. The establishment of an unfunded trust also does not violate the ATRO. The revocation of a power of attorney or health care directive also is not prohibited.

Family Code § 2040 creates timing issues and considerations concerning revocation of testamentary instruments, and title or beneficiary changes for nonprobate transfers. Thus, the ability of one spouse to transfer assets out of an existing trust or into a newly created trust or to remove the other spouse as the beneficiary of life insurance or retirement plan interests will be affected once the dissolution action is commenced. Prior to the filing and service of the dissolution action, these changes can occur subject to the fiduciary duties imposed on the spouses by various sections of the Family Code.<sup>18</sup>

**V. ESTATE PLANNING AND REVOCATION OF PLANNING FOR THE FORMER SPOUSE**

Regardless of when the divorce actually commences, altering the estate plan to eliminate the former spouse will become a paramount issue for the client.

**A. Revocable Trust**

As noted above, dissolution does not automatically revoke a living trust. This statutory omission requires that the trust will have to be revoked according to its terms, or pursuant to the provisions of Probate Code § 15401(a)(2).

Probate Code § 15401(a)(2) provides that a “[t]rust that is revocable by a settlor may be revoked in whole or in part by ... a writing (other than a will) signed by the settlor and delivered to the trustee during the lifetime of the settlor....” The statute does not apply if the trust instrument explicitly makes the method of revocation the exclusive method of revocation.<sup>19</sup> Typically, the trust will permit revocation upon the unilateral act of one of the spouses.

In the unusual circumstance of the trust providing for revocation only upon the consent of both spouses, however, it is conceivable that unless the other spouse agrees, or the court orders the trust revoked, the trust will remain in existence during the dissolution action. The possibility therefore arises that an unintended or undesirable disposition of the estate could occur if the “wrong” spouse dies prior to the divorce becoming final. For example, if the spouses had established a living trust providing for

a typical “zero-tax” plan upon the first death, and the “wrong” spouse dies during the pendency of the divorce, the bypass and QTIP trusts will still need to be funded upon the conclusion of the property settlement. Such a disposition, obviously, would be contrary to the decedent’s intentions. The termination of the trust would therefore provide certainty that the (now-changed) testamentary desires of the spouses would not be erroneously implemented.

When the other spouse is unwilling to consent to a joint revocation, when required by the trust instrument, the probate court may be unwilling to issue an order terminating the trust even though Probate Code § 17000(a) confers exclusive jurisdiction on it for matters pertaining to the internal affairs of the trust. The probate court may defer to the family law court on such matters. The family court may in turn feel reluctant to issue such interim orders until the conclusion of the property settlement. Such judicial reluctance would leave the marital estate in an untenable position vis à vis the estate disposition if one of the spouses dies before finalization of the dissolution. The jurisdictional issues involving the probate court and the family law court will be discussed more fully below.

**B. Irrevocable Trusts**

*1. Joint and Survivor Charitable Remainder Trusts (CRATs or CRUTs)*

If the spouses had jointly established a charitable remainder trust, their marital dissolution may cause them to desire to divide the trust into two separate trusts, each having identical terms. Each spouse would become the sole beneficiary (and perhaps trustee) of one trust. The assets of the original trust would be allocated and divided on an equal basis between the two new trusts. Alternately, the spouses could provide for survivor rights of the other after the death of one of them and prior to the ultimate distribution to the charitable remainder beneficiaries.

Probate Code § 15412 allows the court to divide a single trust into two trusts.<sup>20</sup> This statute appears to provide the authority in which to separate the interests of the spouses in any joint trust that they may have established. The Internal Revenue Service has ruled in a number of Private Letter Rulings<sup>21</sup> that such a division can be accomplished so that:

- The division of the trust into two separate and new trusts will not cause either of the new trusts to fail to qualify as a charitable remainder trust under § 664 of the Internal Revenue Code (“I.R.C.”);
- The division of the trust assets would not cause the trusts or the co-trustees to have income or gain under Code §§ 61(a)(3) or 1001;
- The basis and holding period of the trust assets after the division will remain the same as they were immediately before the separation of the trust;

- The division of the trust will not terminate the trust's status as a trust described in, and subject to, the private foundation provisions of I.R.C. § 4947(a)(2), and will not result in the imposition of an excise tax under I.R.C. § 507(c);
- The two new trusts will not be treated as newly created organizations, and the aggregate tax benefits of the trust under I.R.C. § 507(d) will carry over to the new trusts in proportion to the amount of the original trust's assets transferred to the new trusts, subject to any liability which the trust has under Chapter 42 of the I.R.C. to the extent not already satisfied by the trust;
- The division of the trust into two new trusts will not be an act of self-dealing under I.R.C. § 4941;
- The division of the trust into two new trusts will not be a taxable expenditure under I.R.C. § 4945; and
- If reasonable in amount, the legal and other expenditures incurred by the trust to effect the proposed division will not constitute an act of self-dealing under I.R.C. § 4941, or constitute a taxable expenditure under I.R.C. § 4945.

After the division of the original trust into the two new trusts, the total unitrust or annuity amount to be paid annually should remain the same. As a result, the charitable remainder beneficiaries will continue to receive the same amount. By this method the single charitable remainder trust for the husband and wife can be split into separate trusts for each of them over which they each can solely act as trustee.

## 2. Insurance Trusts

If the spouses also established an irrevocable insurance trust holding a joint and survivor policy of insurance, they may be disinclined, in light of the divorce, to continue the coverage. Other considerations, such as elimination of the need for estate liquidity, may also encourage them to seek abandonment of the life insurance.

Therefore, one spouse may request the other to stipulate that they are not entitled to reimbursement for the premiums paid by him or her since the date of separation, and that he or she will pay the future premiums himself. *Marriage of Epstein*<sup>22</sup> entitles a spouse to a credit for community debts maintained with separate property during the pendency of a divorce proceeding. It is arguable, however, that gratuitous transfers to an irrevocable trust do not maintain a community debt. Thus, the paying spouse would not be entitled to reimbursement for maintaining, by gifts to the trust, insurance that was pre-existing as of the date of separation.

If one spouse refuses so to stipulate, or the spouses desire to maintain the insurance coverage, an option would be to split the joint and survivor policy into separate policies on each of their lives. This division typically is permitted by joint and survivor policies.

To accomplish the division, the trustee of the trust must submit applications to split the policy into separate policies on

each spouse's life. Husband and wife each would have to sign medical declarations as to their present health conditions and additional medical examinations may be required.

If the new, separate policies are whole life, they will have effective dates that typically are the same as the original issuance date. The carrier will re-calculate their charges as if the policies always were separate whole life policies, which will result in additional coverage charges that will be owed at the time the policy is split. Due to the present policy being joint and survivor coverage with the mortality rates having been reduced, a split of the policy results in a charge to bring the policies current. Because the policies will have this additional charge, the values of each policy will increase, even though the death benefits will not. The new policies that are issued, however, likely will be considered by the IRS to be modified endowment contracts with the attendant tax consequences on, among other things, the undistributed investment income (i.e., "inside buildup").<sup>23</sup>

If the new, separate policies are universal life policies, the effective dates will be as of the date the policy is split. There will be no additional coverage charges since these will be new policies with current effective dates.

If neither of these alternatives is acceptable to both spouses, then either or both of them could seek an order of the probate court terminating the trust under Probate Code § 15409.<sup>24</sup> The spouses could argue to the probate court that:

(1) The trust should be terminated based upon the changed circumstances involving the marital dissolution and changes to the federal estate tax law; and

(2) Since the trust was designed to provide liquidity to pay estate taxes due on the combined estates of husband and wife, after the marital dissolution its specific design and purpose will cease to exist.<sup>25</sup>

## 3. Qualified Personal Residence Trusts— Disqualification if Co-Tenancies Involved; Possible Substitution of Income Interests as Part of Property Division

A qualified personal residence trust ("QPRT") is a particular form of a grantor retained income trust. It is a tax planning device available for "principal residences" and "one other residence," and the latter must be a "dwelling" used for personal use each year for the greater of 14 days or 10% of the number of days during which it is rented.<sup>26</sup> A QPRT has a defined term, and at the end of the term the trust terminates and the trust estate is distributed to the remainder beneficiaries. If the settlor survives the term of the trust, the utilization of a QPRT will typically result in a greater transfer of wealth to the remainder beneficiaries than would occur if the settlor merely made an outright gift. Thus, the trust estate can be transferred to the remainder beneficiaries at a reduced transfer tax cost.

If during the term of a QPRT the trust becomes disqualified, the QPRT is converted into a grantor retained annuity trust

(GRAT). Annuity payments must then be paid to the settlor. The trust will be disqualified if the income beneficiary does not satisfy the use or residency test and annuity payments must commence to the income beneficiary for the remainder of the term of the trust. However, the annuity cannot be paid unless the property (or some portion) is sold because the property typically is the only asset of the trust and the annuity cannot be paid with a promissory note or with the property itself.<sup>27</sup>

Oftentimes in planning for QPRTs, when the residence is community property, the property will be transmuted first so that the discounting can be maximized. For example, the property may be transmuted into respective 47.5% interests. Each of these interests would be conveyed to two separate QPRTs for the husband and wife with similarly designated terms, and the husband and wife may each retain 2.5% each individually. The QPRTs typically will appoint both the husband and wife as co-trustees of the two trusts, and each will be the sole income beneficiary of their own trust. Therein lies the troublesome issue in a divorce.

John A. Hartog and Linda L. McCall assert that the Service takes the position that fractional or co-tenancy ownership with anyone other than a spouse or a dependent child disqualifies a QPRT.<sup>28</sup> So if the husband and wife both establish separate QPRTs and then divorce, both trusts are disqualified. The property would then have to be sold to convert the trusts to GRATs. If the spouses, despite their divorce, wanted to keep the property, there is no option available if the property is a typical residential property with a relatively small lot and one residence. They would either have to sell the property before the divorce and buy separate substitute properties or face the conversion of the QPRT to a GRAT.

In the unusual circumstance of a large secondary residence consisting of a main residence (occupied, for example, by one spouse after the date of separation) and separate guest quarters, neither spouse after the divorce will probably desire the other to have the ability to use the property. If the husband desires to utilize the property as his primary residence after the divorce, he will not want the property sold, in which case replacement residences would have to be obtained. However, if the required use by qualified individuals does not occur, the trusts become disqualified and must be converted to a fixed annuity trust based upon the factors from the IRS tables when the trust was set up and based upon the values used for the gift.

If the property has been discounted and thus is worth more at the time of the conversion to a fixed annuity trust, there is another caveat. The issue is if the trust does not contain special language, the annuity payment can possibly be construed by the Service as a taxable event to the remainder beneficiaries. If the annuity payment is based on the value gifted, rather than the present value, the difference arguably constitutes a gift to the remainder beneficiaries. This problem would not be of concern if the trusts provided for the annuity amount to be calculated using the greater of the value at the time of establishment or the current value at the time the annuity commences.

This type of language was approved in Priv. Ltr. Rul. 9441039<sup>29</sup> when the Internal Revenue Service stated that it "insure[d] that the grantor will avoid making a gift in the future if the qualified personal residence trust is converted to a qualified annuity trust and the property in the trust has appreciated after it was transferred to the trust." A subsequent Letter Ruling issued in May 2002 suggests, however, that the Service would not assert that gift tax would be owed.<sup>30</sup> This ruling dealt with a QPRT when appreciated property was later sold and part of the net sales proceeds were reinvested in a replacement residence. The annuity amount was based on the initial value of the property. The ruling sought advice on any gift tax issues, and the Service indicated that none existed. To be prudent when this issue arises, the author suggests that a letter ruling should be obtained. Furthermore, the annuity cannot be paid by anything but cash, so the property has to be sold, which could exacerbate the tension between the husband and wife in the circumstance where the husband desires to continue his use of the property.

Additional complications may arise if these trusts are drafted as grantor trusts. If the property is sold, the husband and wife will have to recognize the gain individually and then pay the tax on the income of the reinvested assets. In the typical case when the children are the remainder beneficiaries, but they have aligned differently with their father and mother over the divorce, the parents may be disinclined to make any further gifts or transfers to the estranged children. Awkward parent-child relations could also influence the parent's decision-making about whether a replacement residence would be acquired, because the parent would be required to pay rent to the (disfavored) children for the replacement property upon the expiration of the QPRT term.

Recently, in informal discussions with the Service on this topic, two different branches in Washington D.C. assigned to these types of matters have indicated differing opinions for other resolutions of the co-tenancy disqualification problem. These cases had the unusual circumstance of a large secondary residence consisting of a main residence (occupied by husband after the date of separation) and separate guest quarters.

One method of resolution is to continue the spouses' joint use of the property. The property can be severed by a lot line adjustment, which would then eliminate the co-tenancy. Each spouse's trust would then own a prorata portion of the entire property, without disqualifying the trust. Emotional factors may prevent adoption of this alternative.

Alternately, individual lots could be conveyed to the respective trusts. One of the branches of the IRS National Office has concurred that this would solve the problem and avoid disqualification upon the divorce. Another related yet distinct branch of the IRS National Office has offered another solution. This branch has suggested the submission of a ruling request and has indicated (very surprisingly) that as part of the property settlement in the divorce, the Service would permit the husband to substitute in as the income beneficiary in the place of the wife in

her QPRT and not treat this substitution as a cessation of use. Thus, as part of the property settlement, the wife could receive other assets to equalize the distributions.

The Service has indicated that it feels that this issue is of such national importance that any such ruling request would likely be later issued as a Revenue Ruling. The Service ostensibly feels that, with a 50% divorce rate and the frequent use of separate QPRTs by a husband and wife, this warrants clarification.

Unfortunately, in this type of unusual circumstance there are no ideal methods to deal with the issues associated with the co-tenancy QPRTs in light of a marital dissolution. The primary goal certainly would be to keep the two QPRTs qualified and avoid adverse gift and income tax consequences, with secondary goals of perhaps keeping the property intact. These goals cannot be accomplished by most of the various alternatives. These alternatives include:

a. Purchase By Spouse

A purchase by an (ex)spouse individually has the same tax consequences as a purchase by a third party, and therefore is disadvantageous.

b. Sale of Property to Third Party

In addition to being contrary to the secondary goal of keeping the property intact, the major problem with a sale to a third party is the income and gift tax consequences. If the property were sold and the QPRTs were structured as grantor trusts, one-half of the capital gains tax would be paid by each husband and wife. Each of them would then have to reinvest the proceeds in new houses. If less expensive houses were purchased, then annuities must commence for the balance of the funds not reinvested. Again, due to the grantor trust status of the trusts, the income tax on income generated by the amounts not reinvested would be taxed to husband and wife as additional phantom income.

C. Family Limited Partnerships

If the spouses have established family limited partnerships, attention likely will need to be given to the distribution of the partnership assets between the husband and wife.

Assume that the husband and wife, their revocable trust, and four trusts that had been established for their children formed four family limited partnerships and that the partners on a pro-rata basis had contributed highly appreciated securities and cash to the partnerships. Assume that husband and wife each received a one percent general partnership interest in each partnership and, through their revocable trust, that they received a fifty percent limited partnership interest. Assume each of the trusts for each child received the remaining forty-eight percent limited partnership interests. When the divorce occurs, assume that husband and wife continue to hold collectively fifty-two percent of the equity in each of the partnerships and that wife desires to have the partnerships distribute her interests to her.

1. Liquidation of Wife's Partnership Interests

Each family partnership can distribute to wife her twenty-six percent share of the capital in the partnership, based on the fair market value of all partnership assets as of the distribution date, in complete liquidation of her general and limited partnership interests. The partnership tax rules for distributions will either cause her to recognize gain and pay tax currently on her share of all such appreciation or give her a substituted basis in the partnership assets received, thereby preserving for future recognition her share of the unrecognized appreciation. The rules for distributions are as follows:

- **Taxable Distribution.** If a partnership makes an all-cash distribution to wife, she will recognize her entire share of the built-in gain under § 731(a) of the I.R.C. Under I.R.C. § 734, the partnership, by making a I.R.C. § 754 election, can increase the tax basis of its appreciated assets by the amount of gain recognized by wife.

For example, if wife has a \$100,000 tax basis in a partnership interest and receives \$500,000 cash as her twenty-six percent share of that partnership's capital, she will recognize \$400,000 of gain. The \$400,000 gain recognized by her will be allocated as additional basis to the partnership's appreciated assets, provided a § 754 election is made. The remaining partners will thus not be taxed on the \$400,000 gain when the assets to which the basis is allocated are sold.

- **Nontaxable Distribution.** A partnership can distribute cash and property to wife on a nontaxable basis as follows. Under I.R.C. § 731, the partnership can distribute (1) cash in an amount equal to her basis in her partnership interests and (2) securities for the balance without causing her to recognize gain. Because the cash absorbs all of wife's basis in her partnership interests, the securities received by her will take a zero basis under I.R.C. § 732(b). Consequently, she will recognize her share of the partnership's inherent gain in all of its assets when she sells the securities in the future. Under I.R.C. § 734, provided a § 754 election is made, the partnership will be entitled to reallocate any "excess" basis in the assets distributed to wife, in which she receives a zero basis, among the appreciated assets which it retains.

For example, again assuming wife has \$100,000 net basis in her partnership interests and her share of the partnership's capital is \$500,000, she can receive \$100,000 of cash and \$400,000 of securities. The securities will have a zero basis, so that if she subsequently sells them for \$400,000, she will recognize \$400,000 of gain. Assuming the partnership has a \$300,000 basis in the distributed securities and makes a § 754 election, that \$300,000 basis will be reallocated among the other appreciated assets held by the partnership.

- **Transfer or Exchange of Partnership Interests.** Wife can trade her twenty-six percent interests in one or more of the partnerships for the twenty-six percent interests held by husband in other partnerships. Cash or other property also could be exchanged by husband and wife to account for any disparities in

the net values of the partnership interests. For example, the exchanges can be accomplished so that wife becomes the sole two percent general partner and fifty percent limited partner of two of the partnerships, and husband becomes the sole two percent general partner and fifty percent limited partner of the other two partnerships. Alternately, wife could transfer her twenty-six percent partnership interests for husband's separate property or for his interests in other community assets. Any such exchanges or transfers will not be taxable by reason of I.R.C. § 1041. The recipient of a family partnership interest in such case will succeed to the transferor's share of the built-in gain in partnership assets. The recipient of other marital assets will succeed to the transferor's gain in such other assets.

- Combination of Approaches. Husband and wife could utilize a combination of the options described above. For example, they could exchange their interests in two of the partnerships, liquidate husband's interests in the third partnership, and liquidate wife's interests in the fourth partnership. Any such combination of approaches can be structured to achieve equitable nontax results for both husband and wife.

**VI. JURISDICTIONAL ISSUES - THE PROBATE COURT VERSUS THE FAMILY LAW COURT**

**A. Probate Court Exclusive Jurisdiction of Trust Matters**

Probate Code § 17000(a) provides that the probate court shall have the exclusive jurisdiction concerning internal affairs of trusts, including any modification or revocation of a trust.<sup>31</sup> Probate Code § 17001 provides that "the [probate] court is a court of general jurisdiction and has all the powers of the superior court."<sup>32</sup>

Compared to the probate court, the family law court jurisdiction is very restrictive. Family Code § 2010 states that the jurisdiction is limited to orders concerning marital status, custody of minor children, child and spousal support, division of assets, and attorney's fees and costs. Since subject matter jurisdiction cannot be expanded by the parties' consent,<sup>33</sup> any judgment rendered on defective subject matter jurisdiction (such as the family law court attempting to issue orders pertaining to the various trusts established by a husband and wife) arguably is void.<sup>34</sup> Nonetheless, the probate court may feel inclined not to intercede in divorce matters even though clearly the trust matters are within its exclusive province and due to the specialty of the probate court, its judicial officers are best suited to render appropriate orders. Deference to the family law court, while providing the utility of a judge for all purposes, results in the family law judicial officer having to decide upon trust matters to which they are likely unaccustomed.

**B. Family Law Court Losing Jurisdiction if Status Not Terminated and Spouse Dies**

Even if the probate court does defer to the family law court on trust matters based upon, for example, impressions of judicial economy and reluctance to issue orders that possibly could be inconsistent with the family law court's decisions, clearly, however, the family law court loses all jurisdiction if one of the

spouses dies prior to the marital status being terminated. Family Code § 310(a) indicates that a marriage is dissolved on death of one of the parties. Thus, the property issues would need to be litigated in the probate court with the surviving spouse bringing a petition to determine title pursuant to Probate Code § 850.

**C. Family Court Retains Jurisdiction If Marital Status Terminated Before Death**

Conversely, the family law court retains jurisdiction to decide property issues if one of the spouses dies after the marital status has been terminated.<sup>35</sup>

**VII. CONCLUSION**

Certainly, a myriad of other types of problems and issues will arise in the divorce context that have not been the focus of this article. Other types of estate planning techniques may have been utilized and other types of methods for resolution may be appropriate or needed. Basically, divorce related cases truly call for creative thinking and planning to overcome the obstacles in the way of the goal of sending the spouses into the future separate and apart from one another financially. Thinking "outside the box" will pay substantial dividends for the client's ability to achieve this goal.

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**ENDNOTES**

1. Prob. Code § 6122 provides:
  - (a) Unless the will expressly provides otherwise, if after executing a will the testator's marriage is dissolved or annulled, the dissolution or annulment revokes all of the following:
    - (1) Any disposition or appointment of property made by the will to the former spouse.
    - (2) Any provision of the will conferring a general or special power of appointment on the former spouse.
    - (3) Any provision of the will nominating the former spouse as executor, trustee, conservator, or guardian.
  - (b) If any disposition or other provision of a will is revoked solely by this section, it is revived by the testator's remarriage to the former spouse.
  - (c) In case of revocation by dissolution or annulment:
    - (1) Property prevented from passing to a former spouse because of the revocation passes as if the former spouse failed to survive the testator.
    - (2) Other provisions of the will conferring some power or office on the former spouse shall be interpreted as if the former spouse failed to survive the testator.
  - (d) For purposes of this section, dissolution or annulment means any dissolution or annulment which would exclude the spouse as a surviving spouse within the meaning of Section 78. A decree of legal separation which does not terminate the status of husband and wife is not a dissolution for purposes of this section.
  - (e) Except as provided in Section 6122.1, no change of circumstances other than as described in this section revokes a will.
  - (f) Subdivisions (a) to (d), inclusive, do not apply to any case where the final judgment of dissolution or annulment of marriage occurs before January 1, 1985. That case is governed by the law in effect prior to January 1, 1985.

2. *Estate of Hermon*, 39 Cal.App.4th 1525 (1995).
3. *Id.* at 1527.
4. *Id.* at 1531. The court also alluded to § 2-804 of the Uniform Probate Code, which California has not enacted, that revokes not only testamentary devises to a former spouse, but also devises to the former spouse's relatives.
5. *Estate of Jones*, 18 Cal.Rptr.3d 637, 4 Cal. Daily Op.Serv. 8502, 2004 Daily Journal D.A.R. 11,539 (2004).
6. *Id.* at 643.
7. Prob. Code § 5100 *et seq.*
8. Prob. Code § 5500 *et seq.*
9. Prob. Code § 5601(a).

10. Prob. Code § 5600 provides that:

(a) Except as provided in subdivision (b), a nonprobate transfer to the transferor's former spouse, in an instrument executed by the transferor before or during the marriage, fails if, at the time of the transferor's death, the former spouse is not the transferor's surviving spouse as defined in Section 78, as a result of the dissolution or annulment of the marriage. A judgment of legal separation that does not terminate the status of husband and wife is not a dissolution for purposes of this section.

(b) Subdivision (a) does not cause a nonprobate transfer to fail in any of the following cases:

- (1) The nonprobate transfer is not subject to revocation by the transferor at the time of the transferor's death.
- (2) There is clear and convincing evidence that the transferor intended to preserve the nonprobate transfer to the former spouse.
- (3) A court order that the nonprobate transfer be maintained on behalf of the former spouse is in effect at the time of the transferor's death.

(c) Where a nonprobate transfer fails by operation of this section, the instrument making the nonprobate transfer shall be treated as it would if the former spouse failed to survive the transferor.

(d) Nothing in this section affects the rights of a subsequent purchaser or encumbrancer for value in good faith who relies on the apparent failure of a nonprobate transfer under this section or who lacks knowledge of the failure of a nonprobate transfer under this section.

(e) As used in this section, "nonprobate transfer" means a provision, **other than a provision of a life insurance policy**, of either of the following types:

- (1) A provision of a type described in Section 5000.
- (2) A provision in an instrument that operates on death, other than a will, conferring a power of appointment or naming a trustee.

11. Prob. Code § 5601 provides as follows:

(a) Except as provided in subdivision (b), a joint tenancy between the decedent and the decedent's former spouse, created before or during the marriage, is severed as to the decedent's interest if, at the time of the decedent's death, the former spouse is not the decedent's surviving spouse as defined in Section 78, as a result of the dissolution or annulment of the marriage. A judgment of legal separation that does not terminate the status of husband and wife is not a dissolution for purposes of this section.

(b) Subdivision (a) does not sever a joint tenancy in either of the following cases:

- (1) The joint tenancy is not subject to severance by the decedent at the time of the decedent's death.
- (2) There is clear and convincing evidence that the decedent intended to preserve the joint tenancy in favor of the former spouse.
- (c) Nothing in this section affects the rights of a subsequent purchaser or encumbrancer for value in good faith who relies on an apparent severance under this section or who lacks knowledge of a severance under this section.

(d) For purposes of this section, property held in "joint tenancy" includes property held as community property with right of survivorship, as described in Section 682.1 of the Civil Code.

12. *Egelhoff v. Egelhoff*, 532 U.S. 141 (2001).
13. *Marriage of Cramer*, 20 Cal.App.4th 73, 80 (1993).
14. *Gallaher v. State Teachers' Retirement System*, 237 Cal.App.2d 510 (1965); *Grimm v. Grimm*, 26 Cal.2d 173, 176 (1945); *Shaw v. Board of Administration*, 109 Cal.App.2d 770 (1952); *Nichols v. Board of Retirement*, 121 Cal.App.2d 176 (1953)(all of which found no termination); *Sullivan v. Union Oil Co.*, 16 Cal.2d 229 (1940); *Meherin v. Meherin*, 99 Cal.App.2d 596 (1950); *Thorp v. Randazzo*, 41 Cal.2d 770, 774-776 (1953); *First Western Bank & T. Co. v. Omizzolo*, 176 Cal.App.2d 555 (1959) (all of which found for termination). The *Gallaher*, *Shaw*, *Nichols*, *Sullivan* and *First Western* decisions would still have application to cases that are not subject to Prob. Code §5600.
15. *Estate of Sanders*, 2 Cal.App.4th 462 (1992).
16. *Cheyana M. v. A.C. Nielsen Co.*, 66 Cal.App.4th 855 (1998).
17. Fam. Code § 2040 provides that the summons in a marital dissolution action shall contain a temporary restraining order:

\* \* \*

(2) Restraining both parties from transferring, encumbering, hypothecating, concealing, or in any way disposing of any property, real or personal, whether community, quasi-community, or separate, without the written consent of the other party or an order of the court, except in the usual course of business or for the necessities of life, and requiring each party to notify the other party of any proposed extraordinary expenditures at least five business days before incurring those expenditures and to account to the court for all extraordinary expenditures made after service of the summons on that party.

\* \* \*

(3) Restraining both parties from cashing, borrowing against, canceling, transferring, disposing of, or changing the beneficiaries of any insurance or other coverage, including life, health, automobile, and disability, held for the benefit of the parties and their child or children for whom support may be ordered.

(4) Restraining both parties from creating a nonprobate transfer or modifying a nonprobate transfer in a manner that affects the disposition of property subject to the transfer, without the written consent of the other party or an order of the court.

(b) Nothing in this section restrains any of the following:

- (1) Creation, modification, or revocation of a will.
- (2) Revocation of a nonprobate transfer, including a revocable trust, pursuant to the instrument, provided that notice of the change is filed and served on the other party before the change takes effect.
- (3) Elimination of a right of survivorship to property, provided that notice of the change is filed and served on the other party before the change takes effect.
- (4) Creation of an unfunded revocable or irrevocable trust.
- (5) Execution and filing of a disclaimer pursuant to Part 8 (commencing with Section 260) of Division 2 of the Probate Code.

(c) In all actions filed on and after January 1, 1995, the summons shall contain the following notice:

"WARNING: California law provides that, for purposes of division of property upon dissolution of marriage or legal separation, property acquired by the parties during marriage in joint form is presumed to be community property. If either party to this action should die before the jointly held community property is divided, the language of how title is held in the deed (i.e., joint tenancy, tenants in common, or community property) will be controlling and not the community property presumption. You should consult your attorney if you want the community property presumption to be written into the recorded title to the property."

(d) For the purposes of this section:

(1) "Nonprobate transfer" means an instrument, other than a will, that makes a transfer of property on death, including a revocable trust, pay on death account in a financial institution, Totten trust, transfer on death registration of personal property, or other instrument of a type described in Section 5000 of the Probate Code.

(2) "Nonprobate transfer" does not include a provision for the transfer of property on death in an insurance policy or other coverage held for the benefit of the parties and their child or children for whom support may be ordered, to the extent that the provision is subject to paragraph (3) of subdivision (a).

(e) The restraining order included in the summons shall include descriptions of the notices required by paragraphs (2) and (3) of subdivision (b).

18. Fam. Code §§ 721, 1100 and 1101.

19. Prob. Code § 15401(a)(2).

20. Prob. Code § 15412 provides in pertinent part that "[o]n petition by a trustee or beneficiary, the court, for good cause shown, may divide a trust into two or more separate trusts, if the court determines that dividing the trust will not defeat or substantially impair the accomplishment of the trust purposes or the interests of the beneficiaries."

21. Division of Trust: Priv. Ltr. Ruls. 200333013, 200035014, 200120016, 200143028, 200301020; Rescission of Trust: Priv. Ltr. Rul. 200219012.

22. *Marriage of Epstein*, 24 Cal.3rd 76, 84 (1979).

23. Code § 72(e)(10) pertaining to the tax treatment of amounts received under modified endowment contracts, which are defined in Code § 2207A as a contract entered into after June 21, 1988 that meets the requirements of Code § 2207, but fails to meet the "7-pay" test of § 2207A.

24. Prob. Code § 15409 provides that "[o]n petition by a trustee or beneficiary, the court may ... terminate the trust if, owing to circumstances not known to the settlor

or not anticipated by the settlor, the continuation of the trust by its terms would defeat or substantially impair the accomplishment of the purposes of the trust."

25. Additionally, the spouses could argue that if the tax relief measures of the Economic Growth and Tax Relief Reconciliation Act of 2001 become permanent, and as the estate tax exemption increases and the maximum estate tax rate declines, the amount of insurance to maintain to provide for estate taxes decreases and eventually is eliminated.

26. Treasury Reg. § 25.2702-5(c)(2)(i)(B).

27. Treasury Reg. § 25.2702-3(b)(1)(i).

28. John A. Hartog and Linda L. McCall, *QPRT Co-tenancy Interests—Do they Work?* CALIFORNIA TRUSTS AND ESTATES QUARTERLY, Volume 6, No., 3 (Fall 2000).

29. Similar language was approved in Priv. Ltr. Ruls. 9447036 and 9448035.

30. Priv. Ltr. Rul. 200220014.

31. The Law Revision Comment states, "It is intended that the department of the superior court that customarily deals with probate matters will exercise the exclusive jurisdiction relating to internal trust affairs." 20 Cal.L.Rev.Comm.Reports 1001 (1990).

32. The Law Revision Comment to this statute also states that, "This section makes it clear that the department of the superior court exercising the exclusive jurisdiction to determine internal trust affairs provided by § 17000(a) has all the powers of the superior court when exercising its general jurisdiction...This [amendment to the statute made in 1990] also reaffirms the original intent of this section, along with § 17000 and 17004, to eliminate any limitations on the power of the court hearing matters under this division, ...to exercise jurisdiction over all parties constitutionally before it and completely dispose of the dispute." 20 Cal.L.Rev.Comm.Reports 1001 (1990).

33. *Marriage of Arnold & Cully*, 222 Cal.App.3d 499, 503 (1990).

34. *West v. Sup. Ct.*, 59 Cal.App.4th 302, 309 (1997).

35. *Kinsler v. Superior Ct.*, 121 Cal.App.3d 808, 812 (1981).

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