

## **After ATRA, The Escalating Importance of Classifying Yours, Mine and Ours**

Louis S. Harrison  
Katarinna McBride

### **Funding of the Credit Shelter Trust**

Percolating out there in estate planning since 1984 has been the concern about retitling assets to allow the funding of the credit shelter trust at the first spouse's passing. With the estate tax exclusion reaching \$600,000 in 1984, planning often required a retitling of assets from one spouse to another to ensure that when the first spouse passed away, there would be sufficient assets to fund that spouse's credit shelter trust.

Example 1: Circa 1984, husband had assets consisting of a \$600,000 house, an IRA of \$1,000,000 and marketable assets of \$800,000. Wife had no assets in her name. During the estate planning discussion, the planner recommended that either the house or a portion of the marketable assets be titled in the wife's name, to ensure that wife's \$600,000 credit shelter trust was funded in the event she was the first spouse to pass away.

The often glossed-over concern was whether the change in title of assets, from husband to wife in the above example, affected the marital/non marital nature of the property for divorce purposes. Given the importance of avoiding estate taxes and the justification for doing so pre-portability, that marital concern often took a back seat to the actual need to reallocate for estate tax purposes.

### **Portability**

Portability – the concept of allowing the surviving spouse to inherit the deceased spouse's estate tax exclusion -decreases the necessity of reallocating assets as between spouses to maximize the use of the estate tax exclusion. A determination of whether to rely on portability is itself a sophisticated analysis, but now the marital/non marital concerns related to asset transfers between spouses needs to be considered further because no longer is it a necessity to transfer assets to ensure full use of the estate tax exclusion.

## **Titling**

Titling is possession. And possession is nine tenths of the law. But titling does not in and of itself determine whether property is marital or non marital.<sup>1</sup>

Example 2: During marriage, wife is the sole breadwinner, and titles all earnings in her own name. Despite owning all assets, these assets are marital because they were earned in the traditional sense (not from separate assets) during marriage.

The issue that needs to be examined, however, is whether a change in titling transmogrifies — in the marital sense, “transmutes”— the nature of the property from one classification to another.<sup>2</sup>

Example 3: If husband brings into the marriage \$1,000,000 of separate assets, and during the marriage gifts those assets to his wife, has that gift changed the nature of the property from the husband’s separate property to the wife’s separate property? Yes, if the husband intends to make this distinction via the gift; no, possibly, if the intent is merely to change title for estate planning purposes (discussed below).

### **Linked Together by Marriage, but My Assets Remain Mine**

A majority of the states have adopted a dual approach to classifying property as either ‘marital property’ or ‘non-marital property’.<sup>3</sup> Property classified as marital property is property that both spouses are entitled to share in the event of divorce. Property that is classified as non-marital is awarded to the owner-spouse.<sup>4</sup>

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<sup>1</sup> The title system to determining property in divorce has been changed by state equitable distribution statutes. *See, e.g.*, Morgan, “When Title Matters: Transmutation and Joint Title Gift Presumptions” 18 *Journal on Matrimonial Lawyers* 33 (2003). Title has theoretically become rendered inconsequential.

<sup>2</sup> A transmutation is a transfer of property between spouses whereby the characterization of the property changes as a result of the transfer.

<sup>3</sup> The “dual classification” states which classify property as marital or separate are: Alabama, Alaska, Arkansas, Colorado, Delaware, District of Columbia, Florida, Georgia, Illinois, Iowa, Kansas, Kentucky, Maine, Maryland, Michigan, Minnesota, Mississippi, Missouri, New Jersey, New York, North Carolina, Ohio, Oklahoma, Pennsylvania, South Carolina, Tennessee, Utah, Virginia, West Virginia, and Wisconsin. In the remainder of the equitable distribution states, all property, however and whenever derived, is subject to equitable distribution. The “hotchpot” states which provide that all property is subject to division are: Connecticut, Hawaii, Indiana, Massachusetts, Montana, Nebraska, New Hampshire, North Dakota, Oregon, Rhode Island, South Dakota, Vermont, Wyoming.

<sup>4</sup> The courts reserve no jurisdiction to divide non-marital property, though they often find ‘equitable’ methodologies as an around, such as awarding alimony, requiring reimbursement, and applying various equitable doctrines, such as marital energies doctrine; that the effort of one spouse helped enhance the value of the non-marital property of the other spouse. Non-marital assets are generally defined as

With spouses retitling their non marital assets between themselves, and titling property in joint ownership, the character and identity of non-marital assets has become far more difficult to classify, and thereby more difficult to preserve. In marital property states,<sup>5</sup> the problem can be illustrated by the transfer of property to a species of trust know as the “joint trust.”

Particularly complicated (or seemingly so) is the analysis of whether non-marital property transferred to a joint trust results in the property losing its character as non-marital property. In the joint-trust context, consider the argument if one spouse’s property is transferred to a joint trust and falls under the control of the other spouse’s unilateral withdrawal right.

Example 4: Spouse 1 contributes 90% of their individual property, and spouse 2 contributes 10% of their individual property to a joint trust. Each spouse has the unilateral right to terminate the trust and withdraw an equal share of the property. On termination all property is returned to the spouses as tenants in common. Because each spouse exercises their equal and unilateral right to terminate, spouse 1 has arguably made a 40% gift to spouse 2 (90% initially contributed less 50% retained if trust is terminated). As to this 40%, if the property was spouse 1’s individual, non-marital property prior to transfer, has it now has become the non-marital property of spouse 2 because of withdrawal right? Or, alternatively, does this property become marital property to be divided equally at the termination of the trust because it was titled jointly and became a gift to the marriage?

But the mere transfer to a joint trust is ambiguous as to result.

### **To Achieve Transmutation**

In making the determination as between marital or non-marital property, courts apply a presumption that the title of the property is how the property should be classified; marital property (joint) or non-marital property (separate). When title has changed from one estate to another, the courts will review whether the parties **intended** to make a gift from the one estate to the other, thereby transmuting from one classification to another.<sup>6</sup>

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property acquired before the marriage, by gift or inheritance, or protected under the terms of a valid agreement between the parties.

<sup>5</sup> Meaning non-community property states.

<sup>6</sup> In a majority of states, the law presumes that when individual, non-marital property is transferred into the joint names of both spouses, the property has been gifted to the marital estate. Extrapolating to a joint trust (not exactly the same as a joint name), one could argue that the transfer of non marital property to a joint trust may also invoke this presumption. But because it is a presumption, that can be overcome by an intent by the parties to treat it otherwise.

Therefore, a change in title from (i) one spouse to both spouses jointly, from (ii) both spouses to one spouse, from (iii) one spouse to the other spouse, or from (iv) both spouses jointly to one spouse, will at a minimum garner scrutiny on property division in divorce.

Consider then a separate document, signed by each of the parties, indicating that transfers to the joint trust (or from one spouse to another) are being done exclusively for estate planning purposes; and are not intended to transmute the property, and that the character of property remains as prior to the transfer.<sup>7</sup> See Appendix A for an example.

More specifically, consider the following steps:

**Step one:** Know the state law to understand if there are any quirks in the state law that should be taken into account in drafting the Intent Agreement.

**Step two:** The parties, both represented by the same counsel, sign an agreement that all transfers (on the joint trust or otherwise) are being done exclusively for estate planning purposes, and are not intended to transmute the property, and that the character of property remains as prior to the transfer.<sup>8</sup>

**Step three:** Have the parties acknowledge in the agreement that the practitioner is representing both parties, and the parties consent to that representation, that the agreement may not be effective under state law to protect against transmutation, and that the parties nevertheless intend for this document to prevent transmutation, to every degree possible.

**Step four:** Effectuate the transfer but make sure the parties know to monitor the

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<sup>7</sup> The best evidence a spouse could have to rebut the joint title gift presumption is a written instrument signed by both parties with an express provision stating that no gift is intended. [Burnside v. Burnside](#), 460 S.E.2d 264, 273 (W. Va. 1995). See also [Connealy v. Connealy](#), 578 N.W.2d 912 (Neb. Ct. App. 1998) (an unsigned prenuptial agreement was evidence of the husband's lack of donative intent); [Parkinson v. Parkinson](#), 744 N.Y.S.2d 101 (N.Y. App. Div. 2002) (a document signed by both parties, though not meeting requirements of an enforceable contract, was sufficient to show evidence of intent).

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assets and reinvestments thereof. The parties should invoke tracing principles, because if a court can't identify their separate assets and they have lost their character because they cannot be traced or identified, the court may characterize the assets as marital property.

**Conclusion**

In 2013, asset allocation as between spouses must be done with extreme care, and preferably with the following memorandum of intent.

**APPENDIX A**

**Memorandum of Intent**

**Marital/Non-Marital Property Agreement**

We, Gregory E. Jones and Wendy L. Jones, husband and wife, have consulted with legal counsel to prepare our respective estate plans.

Part of the consultation addressed the estate tax benefits which may arise from severing joint tenancies, changing beneficiary designations and transferring various assets, so that the first of us to die may more strategically use the estate and generation-skipping transfer tax free amount then available, or maximize basis step up opportunities.

The consultation also made us aware that absent an agreement between us, some changes which may be beneficial for estate tax purposes may be argued to alter our respective rights in the event of dissolution of our marriage.

This Agreement is executed to document our intent that all changes made now or in the future to maximize potential estate tax savings or to avoid probate, specifically including (but not limited to) title to [our primary residence,] shall not alter our respective rights upon dissolution of marriage.

Assets and benefits acquired as marital property during our marriage shall remain as marital property without regard to which of us may be in title, and without regard to transfers between us or to or from trusts or other entities controlled by either of us. Similarly, assets and benefits currently held or acquired in the future as non-marital property shall remain as non-marital property without regard to which of us may be in title, and without regard to similar transfers.

Executed at \_\_\_\_\_, Illinois, on \_\_\_\_\_, \_\_\_\_\_, \_\_\_\_\_.

\_\_\_\_\_  
Gregory E. Jones

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Wendy L. Jones