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Unanticipated Estate Tax Consequences of Pre-Nups

Avoiding inclusion of an obligation to provide life insurance
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Pre-nuptial agreements[1] often use life insurance as a means of providing a surviving or former spouse[2] with a continuing source of support after the insured spouse's death and as an alternative to giving the surviving spouse a share (statutory or otherwise) of the insured's property.[3] Depending on how the life insurance obligation in the pre-nuptial agreement is structured, payment of the policy proceeds at the insured's death may satisfy a legal obligation of the decedent, and, as a result, the proceeds may be includible in the decedent's gross estate for federal estate tax purposes, regardless of whether they would otherwise be excluded.

Ideally, if a couple is married at the insured spouse's death, any includible proceeds paid to the surviving spouse (or to a qualifying trust for that spouse's benefit) will be deductible under Internal Revenue Code Section 2056. If a couple is divorced and the marital deduction isn't applicable, a deduction may be available under IRC Section 2053, if payment of the insurance proceeds qualifies as indebtedness or a claim against the estate. To qualify, the obligation must be established in a: (1) divorce decree, or (2) legally binding agreement that settles marital or property rights between the insured and his spouse, provided that the couple must actually divorce within a certain time period. The risk of estate taxation is highest when a spouse (or a trust for a spouse's benefit) is designated as beneficiary of an insurance policy at the outset of a marriage, pursuant to a pre-nuptial agreement, and, upon divorce, the insurance obligation continues, but it's not specifically incorporated into a divorce decree or other legally binding agreement.[4]

Although the circumstances for concern are limited, the risk of estate tax may be avoided altogether if particular attention is paid to the drafting of the life insurance provision in the pre-nuptial agreement, so that the life insurance obligation is (or can be) satisfied currently and there's no obligation extant under state law at the insured's death. This can be accomplished by requiring the insured to designate the spouse as beneficiary of a new or existing policy and to fund the premiums and keep the policy in force during life, rather than requiring a lump sum life insurance payment at death. For further protection, if the parties separate or divorce,[5] the life insurance obligation should be incorporated into a timely separation agreement and, if possible, a divorce decree, so that any includible life insurance proceeds may be deductible as indebtedness or a claim against the estate under Section 2053.

Discharge of Legal Obligation

Various provisions in the IRC are designed to include in a decedent's gross estate any property from which the decedent (or the decedent's estate) continues to derive, directly or indirectly, certain benefits. Because the discharge of a debt or legal obligation of the decedent confers a benefit on the decedent's estate, any property used to satisfy such a debt or obligation, regardless of whether it might otherwise be excludible from the decedent's estate, may be vulnerable to inclusion. For example, proceeds of an insurance policy may be includible in a decedent's estate even if the policy is owned by an insurance trust, an instrument typically used to hold all the incidents of ownership of a policy, so that the proceeds will be available at the death of the insured to the insured's spouse and descendants in a vehicle that isn't subject to estate tax at the death of either spouse.

IRC Section 2042(1) requires the inclusion in the decedent's gross estate of the proceeds of insurance on the decedent's life to the extent the proceeds are receivable by a beneficiary other than the decedent's estate, but are subject to an obligation, legally binding upon that beneficiary, to pay a debt or charge enforceable against the estate.[6] Treasury Regulations Section 20.2042-1(b)(1) provides:

> [IRC] Section 2042 requires the inclusion in the gross estate of the proceeds of insurance on the decedent's life receivable by the executor or administrator, or payable to the decedent's estate. It makes no difference whether or not the estate is specifically named as the beneficiary under the terms of the policy. Thus, if, under the terms of an insurance policy the proceeds are receivable by another beneficiary but are subject to an obligation, legally binding upon the other beneficiary, to pay taxes, debts, or other charges enforceable against the estate, then the amount of such proceeds required for the payment in full (to the extent of the beneficiary's obligation) of such taxes, debts, or other charges is includible in the gross estate.

Depending on the nature of the insured spouse's obligations under a pre-nuptial agreement, payment of life insurance proceeds to the insured's surviving spouse (or former spouse) pursuant to the terms of a pre-nuptial agreement, may be the discharge of a debt that would otherwise be chargeable to the insured's estate. As a result, such proceeds may be includible in the insured's estate under Treas. Regs. Section 20.2042-1(b)(1).

IRC Section 2036 has a similar effect, as it requires the inclusion in a decedent's gross estate of any interest in property transferred by the decedent at any time, if the decedent retained the possession or enjoyment of the property during his lifetime. Under the Treasury regulations, this includes the application of the property to discharge a legal obligation of the decedent.[7] Specifically, Treas. Regs. Section 20.2036-1(b)(2) states that:

> The 'use, possession, right to the income, or other enjoyment of the transferred property' is considered as having been retained by or reserved to the decedent to the extent that the use, possession, right to the income, or other enjoyment is to be applied toward the discharge of a legal obligation of the decedent, or otherwise for his pecuniary benefit. The term 'legal obligation' includes a legal obligation to support a dependent during the decedent's lifetime.

In reaching property used to satisfy a decedent's legal obligations, Section 2036, like Section 2042, includes in the gross estate any property from which a decedent or decedent's estate derives even an indirect benefit, which may include the payment of life insurance to satisfy a decedent's obligation under a pre-nuptial agreement.

Termination of Legal Obligation

If the insured's legal obligation to pay insurance proceeds to his surviving spouse is extinguished because the decedent's spouse predeceases the insured, the couple divorces or the pre-nuptial agreement is amended to nullify the life insurance provision, the proceeds will no longer fall within the purview of Sections 2042 or 2036. Arguably, however, because the termination of the legal obligation effects a transfer by the insured of the proceeds from the spouse as primary beneficiary to contingent beneficiaries, IRC Section 2035, which applies to transfers made by the decedent within three years of death, may become operative. Section 2035 provides:

> (a) If—
>
> (1) the decedent made a transfer (by trust or otherwise) of an interest in any property, or relinquished a power with respect to any property, during the 3-year period ending on the date of the decedent's death, and
>
> (2) the value of such property (or an interest therein) would have been included in the decedent's gross estate under [IRC] [S]ection 2036, 2037, 2038, or 2042 if such transferred interest or relinquished power had been retained by the decedent on the date of his death,

> the value of the gross estate shall include the value of any property (or interest therein) which would have been so included.

As discussed above, if the insured's spouse survives the insured, the life insurance proceeds may be includible under Sections 2042 and 2036, if the spouse can enforce the decedent's obligation to pay the proceeds against the decedent's estate, and, as a result, the life insurance proceeds would be deemed payable to the insured's estate. To be includible under Section 2035, the insured must have made a transfer or relinquished a power with respect to these otherwise includible, life insurance proceeds.[8]

Although the insured's obligation may be extinguished by the death of the insured's spouse, the divorce of the insured from his spouse or the amendment of the pre-nuptial agreement, the insured isn't independently and affirmatively relinquishing a power or making a transfer. Each of these events is an act of "independent significance," which results in the relinquishment of the estate's rights to the funds and the termination of the insured's obligation.[9] Based on this determination of independent significance, the life insurance proceeds should be protected from inclusion in the insured's gross estate under Section 2035. The estate tax benefit is merely a byproduct of the independent event. Accordingly, the use of a life insurance trust would be effective to pass the proceeds to contingent beneficiaries without estate tax inclusion under the 3-year tail.

Marital Deduction

The most likely deduction to offset an inclusion of life insurance proceeds in a decedent's gross estate is the marital deduction under Section 2056, which will generally apply if: (1) the insured's spouse survives the insured, (2) the insured spouse continues to qualify as a "spouse," and (3) the proceeds pass to the surviving spouse outright or are retained in a trust that qualifies as a qualified terminable interest property or qualified domestic trust.[10] Section 2056 allows a deduction from the value of the gross estate of:

> … an amount equal to the value of any interest in property which passes or has passed from the decedent to the [decedent's] surviving spouse, but only to the extent that such interest is included in determining the value of the gross estate.

Under IRC Section 2056(c)(7), proceeds of insurance on the life of the decedent receivable by any person will constitute an interest in property passing from the decedent to such person.[11] A person is considered a "surviving spouse" for purposes of this IRC provision if such person is determined under state law to have been married to the decedent at the time of the decedent's death.[12] Generally, for purposes of the marital deduction, a couple will be deemed to have been married unless there's an actual decree of divorce. A legal separation agreement or any other judicial action or legally binding agreement won't void the availability of the deduction.[13] Note that the marital deduction is reduced by amounts payable to the decedent's spouse in satisfaction of a debt that's deductible under Section 2053 as indebtedness or a claim against the estate.[14] As discussed below, however, a life insurance obligation under a pre-nuptial agreement won't likely qualify for the Section 2053 deduction, as it's not considered to be contracted for at arm's length for adequate and full consideration in money or money's worth; this deduction will only be available in the case of divorce.

Indebtedness or Claim

The availability of a deduction under Section 2053 for indebtedness or claims against the estate hinges on whether the indebtedness or claim was contracted for at arm's length for adequate and full consideration in money or money's worth.[15] In addition, to be deductible, a claim must represent a personal obligation of the decedent at the time of death.[16]

Generally, under the terms of a pre-nuptial agreement, the insured's spouse relinquishes certain rights in exchange for the promise of life insurance proceeds payable to the insured spouse at the insured's death. In relevant context, IRC Section 2043(b)(1) provides that the:

> … relinquishment or promised relinquishment of dower or curtesy, or of a statutory estate created in lieu of a dower or curtesy, or of other marital rights in the decedent's property or estate, should not be considered to any extent a consideration 'in money or money's worth.'

Generally, marital rights refer to rights in a decedent's property, which accrue to a surviving spouse upon the decedent's death and don't include any rights a spouse may have by virtue of marriage in the other spouse's property during their joint lives.[17] Therefore, if the insured's spouse agrees to receive life insurance proceeds in lieu of a share of the insured's estate at his death, such spouse is deemed to have waived marital rights, and payment of the proceeds to the insured's spouse won't be deductible as a claim against the estate.

Unlike marital rights, the relinquishment of support rights, which have been defined as presently enforceable rights held by one spouse in the other's property during marriage and exercisable upon divorce, has been found to be "adequate and full consideration in money or money's worth" for purposes of the Section 2053 deduction. Attempts to recharacterize relinquished marital rights as support rights have generally been unsuccessful. Because the payment of life insurance proceeds is certain to begin only after the death of the insured spouse, the rights relinquished in exchange for such payments will likely be characterized as "marital rights," regardless of how they're described under the pre-nuptial agreement.[18]

Despite these restrictions, in the event of divorce, there are two means to secure a deduction under Section 2053. The first arises if the obligation to provide life insurance is established in a divorce decree or an agreement that's approved by or incorporated into a divorce decree issued by a court that has the power to decree a settlement or to vary the terms of a prior settlement agreement.[19] In that case, the obligation won't be considered to be "founded on a promise or agreement," the requirement for adequate and full consideration under Section 2053(c) will be irrelevant and the obligation will be deductible.[20] The second involves the IRC Section 2043(b)(2) exception to the rule under IRC Section 2043(b)(1), which provides that for purposes of Section 2053, a transfer that satisfies the requirements of IRC Section 2516(1) is considered to be made for an adequate and full consideration in money or money's worth. Section 2516(1) states that if a husband and wife enter into a written agreement relative to their marital and property rights and divorce within the 3-year period beginning on the date that's one year before the date of the agreement, a transfer of property made pursuant to such agreement to either spouse in satisfaction of such spouse's marital or property rights will be considered a transfer made for a full and adequate consideration in money or money's worth (note that it's not necessary for the transfer to occur within the 3-year time period). One disadvantage of relying on this provision to substantiate the deduction is the 3-year limitation, which isn't applicable when the obligation is established in or approved by a qualifying divorce decree. It's noteworthy that Section 2516(1) refers to any "written agreement," which, in addition to separation agreements, could include a pre-nuptial or post-nuptial agreement, if divorce occurs within the relevant period and the agreement settles marital or property rights. Otherwise, if a provision for life insurance is initially contemplated in a pre-nuptial agreement and the insured continues to be obligated to provide life insurance after a divorce, incorporation of the life insurance obligation into a timely separation agreement or divorce decree is necessary to secure a deduction under Section 2053.[21]

Avoiding Taxation

The most effective way to prevent taxation of life insurance proceeds paid pursuant to a pre-nuptial agreement is to avoid inclusion altogether by ensuring that the insured spouse doesn't have a legally binding obligation that's satisfied with life insurance proceeds at his death. If the pre-nuptial agreement requires the insured spouse to fund a life insurance trust with a life insurance policy currently and to fund or pay the premiums with a lump sum payment or on an annual basis until the insured's death (or for such shorter period as may be determined),[22] there will be no "legally binding obligation" extant at death so long as the insured spouse's obligation is deemed satisfied during life under the relevant state law.[23] If, on the other hand, the agreement provides that the insured's spouse is entitled to the payment of life insurance proceeds in a certain amount at the death of the

insured, there's a risk that the payment of proceeds will be deemed to be the satisfaction of an obligation and the proceeds will, therefore, be includible in the decedent's gross estate. In that case, if the couple is married, the proceeds will likely be deductible under Section 2056. In the case of divorce, however, there's a second opportunity to secure additional protection against estate tax; by incorporating the life insurance obligation into a separation agreement or, preferably, into a qualifying divorce decree, the insured will ensure that any includible obligation will be deductible as a debt or a claim against the estate under Section 2053.[24]

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Endnotes

1.This article focuses on pre-nuptial agreements; a similar analysis applies to post-nuptial agreements.

2.The parties to the pre-nuptial agreement are referred to herein as "spouses," on the assumption that the parties to the agreement actually marry and the obligations, therefore, mature.

3. Internal Revenue Code Section 1041 treats transfers of property between spouses as acquired by gift (not by sale), thereby making the "transfer-for-value" rules under IRC Section 101 inapplicable to this type of transfer.

4.A similar issue arose in *Estate of Kahanic*, T.C.M. 2012-81, a recent Tax Court Memorandum decision, wherein a husband purchased insurance during marriage and named his wife and children as beneficiaries, and the insurance was maintained after the couple divorced. The insurance proceeds were includible in the husband's estate at his death because he held a reversionary interest in the policy. Ultimately, because maintenance of the policy was incorporated into a court order that modified the couple's marital settlement, it was deductible as a debt of the estate under IRC Section 2053.

5.If the insured spouse owns an insurance policy, and the spouse is designated as the outright beneficiary, such designation may be automatically revoked by divorce under state law; designating a trust for the spouse's benefit can be structured to avoid this revocation, which may be preferable if the proceeds are to be paid if the couple is divorced.

6.Treasury Regulations Section 20.2042-1(b).

7. Treas. Regs. Section 20.2036-1(b)(2).

8. An insurance policy will also be includible under IRC Section 2035 if the insured owns a policy, which he transfers to a trust and then dies within three years after the transfer. Note, however, that any transfers of cash made by the insured to a life insurance trust within three years of the insured's death won't trigger inclusion under IRC Section 2035. *See Estate of Headrick v. Commissioner*, 918 F.2d 1263, 1266 (6th Cir. 1990), action on decision, 1991-012 (July 3, 1991); *Estate of Perry v. Comm'r,* T.C.M. 1990-123, aff'd, 927 F.2d 209 (5th Cir. 1991).

9. *See* Revenue Ruling 84-130, 1984-2 C.B. 194 (holding that a decedent's right to convert a group-term life insurance policy to an individual policy upon ceasing employment didn't render the policy includible in the decedent's estate under IRC Section 2042, as the power to convert was exercisable only as a collateral consequence of a voluntary termination of employment); *Estate of Tully v. United States*, 528 F.2d 1401, 1406 (Ct. Cl. 1976) (stating that "[i]n reality, a man might divorce his wife, but to assume that he would fight through an entire divorce process merely to alter employee death benefits approaches the absurd"); Private Letter Ruling 8819001 (Jan. 6, 1988) (holding that "[t]he act of divorcing one's spouse is an act of independent significance, the incidental and collateral consequences of which is to terminate the spouse's interest in the trust").

10.In which case the marital deduction is available under IRC Sections 2056(b)(7) or 2056(d)(2), respectively.

11. *See also* IRC Section 2056(b)(6) regarding the proceeds on life insurance payable in installments.

12. *See* S. Rep. No. 80-1013 (1948), 1948-1 C.B. 335.

13. *See* Rev. Rul 57-368, 1957-2 C.B. 896; *Eccles v. Comm'r*, 19 T.C. 1049 (1953).

14. Treas. Regs. Section 20.2056(b)-4(b)(2), Example 2.

15.Section 2053(c)(1) provides that the deduction for claims or indebtedness founded on a promise or IRC agreement are limited to the extent such claim or indebtedness was contracted bona fide and for an adequate and full consideration in money or money's worth.

16.Treas. Regs. Section 20.2053-4. See, e.g., Rev. Rul. 76-113, 1976-1 C.B. 276 (holding that includible insurance proceeds paid pursuant to a divorce decree weren't deductible as a claim against the estate under IRC Section 2053(a)(3), because the decree imposed an obligation on the insured to keep the life insurance policy in full force and effect and to pay premiums until death, which obligations were satisfied during life. The proceeds were, however, held deductible as indebtedness of the estate under IRC Section 2053(a)(4), because the liability was created in settlement of the insured's marital and property rights). *See also* Rev. Rul. 78-379, 1978-2 C.B. 238 (holding that when state law provides that a parent's obligation to support his child ceases at death, life insurance proceeds paid to a decedent's child aren't deductible as a debt or a claim against the decedent's estate, even if paid pursuant to a divorce decree). In these rulings, the insurance wasn't includible as an obligation under IRC Sections 2036 or 2042, but rather because the insured retained incidents of ownership under Section 2042. Note, if, as contemplated above, insurance proceeds are includible in the insured's estate as an obligation, this additional requirement that a claim be considered a personal obligation will be satisfied. Accordingly, only the requirement that the obligation be contracted for at arm's length for an adequate and full consideration in money or money's worth is relevant for this discussion.

17.*See Estate of Robert Rodger Glen*, 45 T.C. 323, 339 (1966)(describing marital rights as a "backstop, or a catchall" designed to include any interest not otherwise considered to be a dower, curtesy, or a statutory estate created in lieu of a dower or curtesy). *See also Estate of Carli v. Comm'r*, 84 T.C. 649 (1985); *Estate of Isadore Rubin*, 57 T.C. 817 (1972); *Estate of Michael Ellman*59 T.C. 367 (1972); E.T. 19, 1946-2, C.B. 166; Rev. Rul. 60, 160 1960-1 C.B. 374; Rev. Rul. 68-379, 1968-2 C.B. 414.

18.*See, e.g., Estate of Robert Rodger Glen*, 45 T.C. 323; *Estate of Isadore Rubin*, 57 T.C. 817; *Estate of Michael Ellman*, 59 T.C. 367; E.T. 19, 1946-2, C.B. 166.

19.Rev. Rul 60-160, 1960-1 C.B. 374 (holding that transfers pursuant to a marital agreement are only deemed transferred by decree if the agreement is approved by a court that has the power to decree a settlement or to vary the terms of a prior settlement agreement).

20.*Harris v. Comm'r*, 340 U.S. 106 (1950).

21.*See, e.g., Estate of Kahanic*, T.C.M. 2012-81 (holding that includible insurance proceeds were deductible because the insurance was maintained pursuant to a court order that was incorporated into a couple's marital settlement).

22.Funding on an annual basis shouldn't result in inclusion under IRC Section 2035 as discussed above. *See supra* note 8.

23.*See, e.g.*, Rev. Rul. 78-271, 1978-2 C.B. 239 (stating that "a deductible claim within the meaning of [Code] [S]ection 2053(a) must represent a debt of the decedent that is recognized by state law … a claim may be deducted from the decedent's gross estate only if the claimant had a valid right under state law to enforce the claim against the estate").

24.*See, e.g., Estate of Hermann v. Comm'r*, 85 F.3d 1032 (2d Cir. 1996).