Reckoning With New York's Marital Right of Election

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Throughout history, many cultures have imposed restrictions on the right of an individual to freely bequeath assets. The concept of "forced heirship" has been entrenched in the laws of many jurisdictions for centuries. The historical basis of forced heirship was to require land to pass down to one's issue—frequently giving priority in distributions to the eldest son. Today, most U.S. jurisdictions permit one to freely disinherit their descendents.[1]

Forced heirship laws did not always provide protection for a surviving spouse against disinheritance. Modern society, at least in the United States, has taken a decidedly different tack. While children generally may be freely disinherited, a surviving spouse is generally afforded considerable protection under statutory law. New York's EPTL §5-1.1-A "right of election by surviving spouse" is one of the more robust elective share statutes in the United States. When you combine these rights under state law with the federal estate tax, which currently allows an unlimited marital deduction, there tends to be an overwhelming bias in the law in favor of spousal inheritance.

However, there are times when the right of election can be too generous to the surviving spouse. Its exercise can disrupt important estate planning considerations. It can also be inequitable. However, the mere existence of this statutory right usually ensures that the needs of the surviving spouse will not be ignored and will be protected. It is not, however, a perfect solution. While the right of election is designed to provide equitable relief, it represents a compromise of a sort—a sort of rough justice.

Although protecting the rights of a surviving spouse is usually a desirable societal objective, there are many situations where there are conflicting considerations. The most obvious is to protect the interests of children of a first marriage from those of a second spouse. Other important objectives could include: protecting the marital estate against the claims of creditors, protecting the interests of descendents where a surviving spouse may be a spendthrift, or may remarry a louse, have a short-lived second or third marriage, may be estranged from the decedent, or may have less need than the minor or adult children and grandchildren of the decedent. Moreover, a bequest to a surviving spouse may leave that spouse ineligible for governmental assistance that would otherwise pay for elder care.

Lastly, where ownership interests in a business are involved, there may be contractual restrictions and/or compelling business reasons to prevent the surviving spouse from inheriting. If adult children are involved, there may be compelling equities to leave those assets to the children, who may have become the central figures in the business, while the contribution of the founding parent may have been long since eclipsed. Non-family members who own interests in the business may object to having a surviving spouse who does not participate in the business to become a partner or co-owner.

These and other considerations make planning for the elective share essential for the married client. An otherwise carefully crafted estate plan can be fatally flawed if planning for the elective share is given short shrift.

Planning for the elective share usually means seeking to minimize what a surviving spouse may take should he or she make an election under EPTL §5-1.1-A. There is no legal prohibition against overindulging the surviving spouse. It is when there is an effort to limit the inheritance of the surviving spouse that the possibility of a spousal election must be carefully considered.

Proper planning for the possibility of an election under EPTL §5-1.1-A commences prior to marriage. A waiver of the right of election is a necessary component of every pre-nuptial agreement. A waiver can be integrated with the pre-nuptial agreement or may be standalone. In either case, the spouses must have separate counsel.

It is also possible to enter into a waiver of the right of election after marriage. If it does not exist, when doing wills and other estate planning for a married couple, entering into a waiver of the right of election should at least be considered. For obvious reasons, this can be a disturbing topic for a married couple. It should also be an occasion for the planner to recommend that the spouses retain separate counsel—or at a minimum, a properly crafted conflict waiver—which would necessarily include a waiver of the attorney-client privilege between the spouses as to this topic.[2]

Defining the Elective Share

§5-1.1-A(a)(2) defines the "elective share" as "the pecuniary amount equal to the greater of (i) $50,000, or, if the capital value of the net estate is less than $50,000, the entire capital value, or (ii) one third of the net estate," reduced by the capital value of any interest which "passed absolutely" from the decedent to the decedent's spouse.

The "passed absolutely" requirement presents a significant hurdle in New York. In many states, the elective share can be satisfied with variations of a trust that meets the requirements of §2056 of the Internal Revenue Code (IRC) a/k/a the "QTIP" trust. A QTIP trust must provide, inter alia, for the payment of all of the income to the spouse for life and enable the spouse to require the assets of the trust to be invested in productive property.

In those states, planning for the elective share may dovetail with federal tax planning. The QTIP trust has been permitted to qualify for the unlimited marital deduction since its enactment in 1981. The enactment of the QTIP trust represented a major departure from prior tax law. Since the beneficiary of the QTIP trust may be limited to a life estate, prior to 1981, a bequest in the form of a QTIP trust would not have qualified for the unlimited marital deduction. Its use would thus have resulted in the imposition of an estate tax upon the death of the first spouse to die.

The QTIP trust allows the monied spouse to leave a right to the income from the trust to the surviving spouse but still retain control over who would be the remainder beneficiaries. There may or may not be powers of invasion in the QTIP trust. However, no power of invasion is required to attain QTIP treatment. Thus, the decedent can, in effect, rule from the grave by determining who will get the corpus of the estate and who will be the ultimate beneficiaries, leaving the surviving spouse with little or no control over that outcome.

Prior to Sept. 1, 1994, a bequest to a surviving spouse in the form of a QTIP trust would have satisfied the elective share in New York, as long as the surviving spouse also had a right to withdraw $50,000. Since Sept. 1, 1994, a bequest in trust no longer satisfies the elective share. Such a bequest would violate the requirement under the elective share statute that property must "pass absolutely."

Section 5-1.1-A defines the types of property that will be taken into account in determining "net estate" against which the surviving spouse can elect. It also contains certain definitions that can draw in assets that are not in the "testamentary" estate into the rights of election—these items are referred to as "testamentary substitutes."

EPTL §5-1.1-A(a)(3) provides that the estate against which the right of election is exercised consists of the capital value of all of the following:

(1) all property passing under decedent's will;

(2) all property qualifying as a testamentary substitute; and

(3) all property of decedent passing to distributees under the laws of intestacy as codified by EPTL §4-1.1.

After determining the pecuniary value of the surviving spouse's elective share, the amount payable to the spouse under the elective share will be reduced by the capital value of any testamentary disposition, testamentary substitute, or intestate share received by the spouse outright (i.e., not in trust).

To arrive at the "net estate," the debts of decedent, the administration expenses of the estate, and the cost of reasonable funeral expenses are deducted from the total capital value of the testamentary dispositions, testamentary substitutes, and intestate property.

In arriving at the "net estate," no reduction in the value of the estate is made for estate taxes that may be owed on any of the property. Rather, each recipient of property included in the estate, including the surviving spouse, must contribute his or her proportional share of the estate taxes, pursuant to the terms of EPTL §2-1.8. The surviving spouse will not, however, as a general rule, have to pay an estate tax on any property qualifying for the marital deduction.

After determining the pecuniary value of the elective share and deducting the capital value of any testamentary disposition, distributive share, and testamentary substitute passing to the surviving spouse absolutely, the remaining amount owing as an elective share must be satisfied on a pro rata basis by those persons, other than the surviving spouse, who have received or who are entitled to receive property interests, the value of which were included in the net estate against which the right of election was exercised. Thus, any beneficiary of a testamentary disposition, a testamentary substitute, or a distributive share under the laws of intestacy must make a pro rata contribution.

Under EPTL §5-1.1-A, certain non-testamentary transfers are added to the testamentary estate to determine the "net estate" against which the spouse can elect. These items are referred to in the statute as "testamentary substitutes." Notable examples include gifts causa mortis and certain other gifts made within one year of death, Totten trusts ("in trust for accounts," i.e., accounts with a designated beneficiary other than the surviving spouse), joint bank accounts, personal or real property held jointly with a right of survivorship or by tenancy by the entirety, etc.

EPTL §5-1.1-A also includes as testamentary substitutes similar types of non-testamentary dispositions that would be treated as part of a decedent's taxable estate under the federal estate tax laws. Thus, certain types of self-settled trusts settled on or after Sept.1, 1992 are considered to be testamentary substitutes. This includes transfers by decedent in trust or otherwise to the extent that the decedent retained for his or her life, or for any period not ascertainable without reference to his or her death, or for any period that does not in fact end before his or her death, the possession or enjoyment of, or the right to income from, the property. Likewise, certain types of dispositions in trust over which the decedent maintained control will be treated as testamentary substitutes. This includes a disposition of property or a contractual arrangement made by decedent in trust or otherwise to the extent that the decedent, at the date of death, retained a general power of appointment, a right to revoke or a power to consume, invade, or dispose of the principal.

Similarly, certain types of deferred compensation, including pensions, profit sharing plans, non-qualified deferred compensation plans (including those subject to §409A of the Code), will also be treated as testamentary substitutes if the decedent had the power to designate the beneficiaries.

Annual exclusion gifts and gifts to fund educational and medical expenses are generally not considered to be testamentary substitutes.

Minimizing Techniques

There is a close parallel between planning to minimize the elective share and the advanced estate and asset protection planning that a wealthy person would normally consider. The key is to do the planning during lifetime—usually, the earlier the better. Thus, techniques that leverage inter vivos gifting exemptions may also serve as powerful vehicles to minimize the elective share. Typically, these estate planning techniques involve the use of valuation opportunities and freezing asset values. Some of these techniques include the following:

1) Outright gifts or gifts in trust that are not gifts causa mortis or made within one year of the decedent's death to any person or person or trusts for the benefit for such persons other than the surviving spouse.

2) Sale of Family Limited Partnership interests to an intentionally defective grantor trust for benefit of any persons other than the surviving spouse for a standard interest-only promissory note with a balloon payment of principal at end of the term, or for Self Canceling Installment Note, or for a Private Annuity.

3) Transfer property to a grantor retained annuity trust (GRAT). Grantor (spouse making transfer to the trust) must survive the trust term in order for this technique to work.

4) Transfer of residence to a qualified personal residence trust (QPRT). Grantor (spouse making transfer to the trust) must survive the trust term in order for this technique to work).

Planning to minimize the elective share does not always strictly parallel planning to minimize estate taxes. For example, life insurance that does not name the insured's estate as a beneficiary would not be considered to be a testamentary substitute even if the insurance proceeds are includable in the deceased spouse's estate for tax purposes. Obviously, there are many ways to avoid taxable inclusion, including having the insurance purchased in trust.

The benefit received by an electing spouse can be reduced by naming the spouse as the beneficiary of qualified plan or individual retirement account assets. This is because while these assets are valued at face for tax purpose, and for purposes of determining the assets that will be taken into consideration in determining assets inherited by the spouse that reduce the elective share, these assets carry with them an inherent income tax liability. Withdrawals and distributions of these assets are normally subject to income taxation.[3] Some might argue that the ability to grow these assets in a tax deferred environment is an offsetting benefit. Opinions can differ on the benefits of this technique to reduce the elective share.

Protecting Business Interests

Where the deceased spouse owned interests in a non-marketable or closely held business, the planning for the elective share is of particular significance. Whether there are related or unrelated partners or co-owners of the interest, the consequences of not anticipating the possibility of a spousal right of election against the owner's will can be severe. A well-drafted partnership agreement, shareholders agreement and/or buy sell agreement can go a long way towards mitigating these difficulties. It may be easier to request that a spouse enter into a waiver of the right of election if the requirement is imposed by business partners or the organizational documents.

It is essential to provide for a method to fund the marital bequest if the major asset of the deceased spouse's estate is comprised of a non-controlling interest in a business. Unless there is a clear right of the surviving partners to purchase the decedent's interest, a viable funding source for the buyout and an unambiguous methodology for determining purchase price, there is a potential for considerable conflict between the surviving spouse and the surviving partners.[4]

Issues as to the disposition of the deceased partner's interest can go unresolved for years. Advance planning for this type of interest is essential. The operative business entity agreements must be carefully crafted to be effective and enforceable. These documents should only be drafted by an attorney with an intimate knowledge and understanding of corporate, partnership or limited liability company law, as applicable.

Conclusion

Failure to plan for the possibility of a surviving spouse exercising a right of election pursuant to EPTL §5-1.1-A can be a fatal flaw to an otherwise well thought out estate plan. Planning for the right of election can begin prior to marriage by obtaining a written waiver. After the marriage, obtaining that waiver can pose considerable difficulties. Fortunately, planning for the right of election often parallels normal estate planning. One notable exception is that under New York law, a right of election will not be deemed satisfied by naming the surviving spouse as the beneficiary of a QTIP trust. Only an outright disposition will satisfy the spouse's elective share. Where the estate includes interests in a closely held business, there is a compelling need to address these concerns in a properly drafted partnership agreement, shareholders agreement, operating agreement and/or buy sell agreement. However, the partners in a closely held business are well advised to insist that each of the married partners obtain waivers of the spousal right of election at least insofar as the business is concerned.

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Endnotes:

1. One notable exception is the Louisiana Civil Code, which imposes limitations on one's ability to disinherit issue. Louisiana, Civil Code, art. 1493.

2. EPTL §5-1.1-A(e) specifically provides for the validity of waivers entered into either before or during the marriage. To be valid, the waiver must be in writing and duly acknowledged. Some commentators have questioned

whether a waiver would be proper in the absence of separate counsel.

3. See generally Silverberg, "Safeguarding Against Troubled Marriages," Trusts & Estates 18 (June 2005).

4. See, e.g., *In re Shalik*, 13 Misc.3d 1222(A), 831 N.Y.S.2d 350 (Nassau County Sur. 2006) (Surrogates court finding that construction of transfer restrictions in limited partnership agreement which can determine rights of estate to transfer partnership interest is governed by arbitration clause in partnership agreement); and *In re Kalikow*, 58 A.D.3d 849, 872 N.Y.S.2d 508, (2d Dept. 2009) (related proceeding upholding determination of surrogates court that there was no basis to disqualify arbitrator selected by the parties; attorney draftsman was named in partnership agreement as the arbitrator of disputes relating to the partnership agreement). See also Breitstone, Stephen M., "Tax Perils for Beneficiaries of QTIP Trusts," New York Law Journal, June 14, 2007.