TIPS OF THE TRADE: PITFALLS OF SPLIT-INTEREST TRUSTS FOR BLENDED FAMILIES

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Estate planning clients with blended families often think they need a "split-interest" trust to provide benefits for a surviving spouse for life, with any remainder going to issue from a prior marriage. Although this reflects a natural wish, the administration of a split-interest trust is fraught with risks of conflict for the blended family.

This column outlines common split-interest trust structures and the reasons for them, examines the pitfalls they present in blended families, and suggests alternatives that can reduce family conflict. It suggests planning approaches to minimize the risks involved when drafting and administering split-interest trusts. It concludes with a separate discussion of split interests in a family residence.

I. COMMON SPLIT-INTEREST TRUSTS

The most common split-interest trust is the so-called "A-B" (or "A-B-C") married couple's joint revocable trust that requires division on the first death, so the deceased settlor's share of the marital property and separate property is allocated to one or more irrevocable trusts. The irrevocable trusts typically have a split-interest structure, with a lifetime interest for the surviving spouse and a remainder interest for other beneficiaries.

Another familiar split-interest structure is a married person's separate trust, which can have similar provisions to a couple's A-B or A-B-C trust. Married or not, trustors can also provide split interests for a non-spouse initial beneficiary (e.g., a "significant other" or child) and some other remainder beneficiary (e.g., child, grandchild, or charity).

II. RATIONALES FOR SPLIT-INTEREST TRUSTS

For years, adoption of the A-B or A-B-C structure was dictated by the desire to avoid or minimize the federal estate tax. Now, except for all but the very largest estates, adoption of a split-interest structure is a matter of personal choice. Continuing reasons for an individual to adopt a split-interest structure include:

- Balancing the benefits for the surviving spouse and other beneficiaries;
- Preventing the surviving spouse from giving all of the assets to a new spouse or partner;
- Shielding the deceased spouse's assets from creditors with the protection of an irrevocable trust;
- Preserving the deceased spouse's assets with stewardship by an independent trustee; and
- Maintaining "dead hand control" to accomplish these and other objectives.

III. PITFALLS FOR BLENDED FAMILIES

Split-interest trusts often disappoint both the surviving spouse and the deceased spouse's family members. A surviving spouse consulting with the attorney is often disappointed to learn that he or she has lost control, and that the trust terms must be disclosed to the deceased spouse's family members who have significant rights and who must be kept informed of the trust administration. The deceased spouse's children are disappointed that they will have to wait to receive the inheritance they expected, and that a stepparent they may not like has an ongoing interest in the trust and rights as a current beneficiary.

Inter-family conflicts are magnified by the zero-sum financial relationship typical in the A-B or A-B-C structure. In this structure, the greater the duration of the stepparent's life the more the stepparent gains, and the stepchildren correspondingly lose. Given this inherent conflict, the trustee's various duties and the beneficiary's corresponding rights that ensure fair trust administration (e.g., loyalty,[1] impartiality,[2] making property productive,[3] separating property,[4] prudent investing,[5] informing, accounting, and reporting to beneficiaries, etc.[6]) become flashpoints between the stepparent and the deceased spouse's children, often ending in litigation.

IV. PLANNING OPTIONS TO PROVIDE FOR ALL BENEFICIARIES

Planning alternatives which avoid leaving an entire estate to a spouse, without a split-interest trust and the resulting friction, may include providing outright gifts to the surviving spouse or to the children on the first death. Such gifts can be from the deceased spouse's property in the trust or can be made through beneficiary designations including pay-on-death accounts, IRAs and pension plans, or life insurance.

While this subtraction from the couple's combined wealth can cause a perceived immediate hardship, the elimination of blended family friction can be well worth it.

The problem, as always, is money. The surviving spouse may want or need access to the deceased spouse's property to continue the lifestyle the couple enjoyed together. The children may want or need a parent's funds for support, or even for retirement. To properly advise the clients counsel needs to explore the family finances and may need input from the client's financial advisor. It is a disservice to the clients to discuss or create a plan that leaves a surviving spouse in a financial vacuum. While split-interest trusts are traditional they are not required, and the estate planning attorney should encourage the clients to consider other plans. It is not unusual for clients to have unrealistic or unexamined ideas about how their property can be shared when they are gone.

If the assets available to the surviving spouse are expected to be sufficiently large, the clients may come to see that a split-interest structure is simply unnecessary or that the split-interest trust does not need to cover all of the deceased spouse's assets. In these cases, there is "enough to go around" without imposing unnecessary restrictions on a spouse's inheritance, and without making one's children or grandchildren wait on their inheritance or most of it.

If the clients' estate is modest, they may come to see that the split-interest structure is not financially realistic and not sufficiently generous to the surviving spouse. It may be financially unrealistic because there is not enough wealth to provide for the surviving spouse confidently and comfortably. In a modest estate, a split-interest trust may create an expectation there will be something left for the remainder beneficiaries, when there is no reasonable assurance the trust property will not be expended in providing for the surviving spouse's foreseeable needs.

Confronting clients with the hard reality that they do not have enough family wealth to provide for everyone on their wish list can be an awkward conversation. That conversation can bring home to the clients possible inadequacies in their saving and planning for retirement and the human frailties of their children, and open an unwelcome discussion of whether and how to prioritize providing for the surviving spouse as opposed to their children, given limited resources.

As difficult as that discussion may be, the most difficult cases fall between the two extremes, where there are not enough resources to provide for all beneficiaries easily and amply without a split-interest structure, but those resources are not so obviously limited that the split-interest structure is financially unrealistic and unduly restrictive on the surviving spouse. In that middle ground, the clients may feel that they have to adopt a split-interest trust, even though it may cause future conflict.

V. DRAFTING SPLIT-INTEREST TRUSTS TO MINIMIZE PITFALLS

Assuming the clients are intent on a plan with a split-interest trust, some drafting options to reduce family friction include:

1. Designating a neutral trustee, who has no stake in favoring either lifetime or remainder beneficiaries;
2. Providing the surviving spouse with only an income interest;
3. Providing a formula for distribution of principal that differs from the traditional health, education, maintenance, and support standard;
4. Providing fixed formulas for distributions to a surviving spouse, to minimize trustee discretion over spending;
5. Using unitrusts instead of "net income" trusts to avoid conflicts over investing for income versus growth and issues in principal and income accounting;
6. Requiring exhaustion of the survivor's trust before the surviving spouse may withdraw principal, and perhaps income, from the decedent's irrevocable trust;
7. Distributing the principal residence to the surviving spouse or to a survivor's trust;
8. Providing possible distributions to the deceased spouse's children during the surviving spouse's lifetime; and
9. Giving the trust a term shorter than the surviving spouse's lifetime, maybe long enough to permit the surviving spouse to recover from the death of the deceased spouse, with termination of the trust at the end of that term with distribution to the remainder beneficiaries.

VI. ADMINISTERING SPLIT-INTEREST TRUSTS TO REDUCE PITFALLS

Most of the above options may be available to some extent during the trust administration after the deceased spouse's

death, even if not clearly provided for in the trust instrument. The surviving spouse/trustee may be authorized to appoint a neutral trustee of the deceased spouse's trust. A trustee with distribution discretion may exercise it by following a fixed formula for distributions, so that distributions are less subject to recurring debate. A "net income" trust can be converted to a unitrust (without court approval if all beneficiaries agree).[7] And non-pro rata sub-trust funding can allocate a principal residence to a survivor's trust.

However, given that restrictive options are often unappealing to a surviving spouse who wants unfettered access to the deceased spouse's share of the trust assets, drafting the trust instrument initially to minimize friction is advisable, if at all possible.

VII. PLANNING FOR THE FAMILY RESIDENCE

Giving a surviving spouse a life interest in a residence is a common recipe for strife in the blended family, especially if it is the house where the deceased spouse's children grew up. If the residence cannot be left outright to the surviving spouse, and if the clients insist on giving the survivor of them the right to occupy the residence, a thorough discussion is needed to address devilish drafting details, including:

- Providing liquid funds in the trust to cover housing expenses including taxes, insurance, maintenance, and short-term and long-term repairs;
- Outlining responsibility for all of these categories of expenses, clarifying specifically what the trust will or will not cover;
- Defining the consequences if either the surviving spouse or the trustee defaults on an expense payment obligation;
- Providing whether and how remarriage or cohabitation affects the surviving spouse's right of occupancy;
- Giving the surviving spouse the right to lease the residence with defined rights that are readily understood by, for example, courts enforcing landlord-tenant laws including unlawful detainer;
- Addressing possible changes of residence by the surviving spouse, including due to incapacity, and defining when and how such changes may terminate the surviving spouse's right of occupancy; and
- Addressing possible sales or encumbrances, including whether and how the surviving spouse or trustee can purchase a substitute residence with trust funds, whether a substitute residence must be for equal or lesser value than the current one, and if for a lesser value, whether and how use of excess proceeds of sale from the first residence is restricted.

VIII. CONCLUSION

Estate planning attorneys do their clients a service when they make their clients aware of the choices available to them, and do not simply draft traditional split-interest trusts because they happen to have the form available to them. Working with clients with blended families requires investigation and imagination to give the clients a clear plan to maximize their ability to meet all family needs while minimizing the risks of blended family friction.

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1 Prob. Code, section 16002.

2 Prob. Code, section 16003.

3 Prob. Code, section 16007.

4 Prob. Code, section 16009.

5 Prob. Code, sections 16045-54

6 Prob. Code, section 16061 et seq.

7 Prob. Code, sections 16336.4-6.