A Step Toward Equality in Estate Planning

Delaware Adds to its Jurisdictional Advantages for Asset Protection and Estate Planning Opportunities for Same-Sex Couples

by Mark V. Purpura, Esq.,
F. Peter Conaty, Jr., Esq.,
and Ginger L. Ward

On May 11, 2011, Governor Jack Markell signed into law the Civil Union and Equality Act of 2011 (the "Act").[1] When this landmark legislation becomes effective on January 1, 2012, same-sex couples who either enter into civil unions in Delaware, or who were married or entered into civil unions or domestic partnerships granting marriage-equivalent rights in other jurisdictions, will be entitled to all the same rights, benefits and protections, and will be subject to the same responsibilities and obligations, as married spouses under Delaware law. From an asset protection and estate planning perspective, the Act will significantly alter the landscape for same-sex couples in Delaware, and will make Delaware an even more attractive asset protection and estate planning option for same-sex couples from other jurisdictions who wish to take advantage of Delaware law for planning opportunities that may not be available in other jurisdictions. The state level relationship recognition provided by the Act ensures that Delaware is the preeminent jurisdictional choice in the United States for asset protection and estate planning opportunities for same-sex couples.

In the United States, sixteen jurisdictions either currently permit or have enacted legislation that will permit same-sex couples to enter into marriages, civil unions or domestic partnerships that provide all or substantially all of the rights, benefits, protections and obligations of marriage for state law purposes.[2] Of the jurisdictions which are typically considered the most trust and asset protection "friendly" (Alaska, Delaware, Nevada and South Dakota) only Delaware and Nevada provide for state law recognition of same-sex relationships. However, unlike Nevada, Delaware will automatically recognize and treat same-sex marriages, civil unions and domestic partnerships performed outside the state as civil unions for all purposes of state law without requiring further registration and recharacterization of the relationship. Alaska and South Dakota do not recognize any form of same-sex relationships, and both have provisions in their state constitutions prohibiting same-sex marriage.

Overview of the Act

As a result of the Act, parties to a civil union (or a relationship recognized as a civil union for purposes of Delaware law) will be treated in the same manner as married spouses are treated for purposes of Delaware law. Specifically, parties to a civil union are included in any reference in Delaware law to "husband and wife" or other terms denoting a spousal, familial or dependent relationship. Further, the Act specifically provides that parties to a civil union can hold property as tenants by the entirety.

The Act not only recognizes civil unions performed in Delaware, but also automatically recognizes or "converts" same-sex marriages, civil unions and domestic partnerships lawfully performed in other jurisdictions into civil unions for all purposes of Delaware law, so long as the that relationship is "substantially similar" to a Delaware civil union. Thus, for instance, same-sex marriages entered into

in California, Canada, Connecticut, the District of Columbia, Iowa, Massachusetts, New Hampshire, New York, and Vermont, civil unions entered into in Hawaii, Rhode Island, Illinois and New Jersey, and domestic partnerships entered into in California, Nevada, Oregon and Washington, will all be recognized, automatically and without any registration, as civil unions for purposes of Delaware law.[3]

Importantly, for tax and estate planning purposes, where Delaware law is based in full or in part on federal law, unless prohibited by federal law, the application of such Delaware law must treat the parties to a civil union as though they have a legal marriage under federal law. This has implications in both the income tax and estate tax context, for instance, where Delaware tax laws rely in part on federal tax laws.

Civil unions are not recognized under federal law, including for purposes of the Internal Revenue Code. Although there are many rights and benefits of marriage under federal law, including significant tax and estate planning spousal benefits, none of these rights and benefits are currently available to same-sex couples. Under the federal Defense of Marriage Act ("DOMA"), for purposes of federal law, "marriage" is defined as only between a man and a woman, and a "spouse" is defined as only a person of the opposite sex. Federal court cases (including in the tax context) challenging the constitutionality of Section 3 of DOMA are currently pending, and the United States Attorney General has announced that in at least those federal circuit courts that have not specifically determined that the most deferential standard of review applies to laws that discriminate based on sexual orientation, the United States Department of Justice will no longer defend Section 3 of DOMA. The United States Court of Appeals for the Third Circuit, which covers Delaware, has not yet ruled on the applicable standard of review for such laws.

The Act will present same-sex couples and their advisors, both within and without Delaware, with new planning opportunities. While a full discussion of the impact the Act will have on planning for same-sex couples is beyond the scope of this article, several areas for consideration will be addressed.

Cohabitation/Antenuptial Agreements

As with traditional married couples, it is advisable for individuals who are entering into a civil union to enter into a written cohabitation, prenuptial or antenuptial agreement to delineate their respective rights and responsibilities regarding ownership of property, payment of expenses, and management of financial resources. Such an agreement should also spell out what will happen in the event of the dissolution of the relationship. Delaware law now provides that a civil union may be dissolved in the same manner as a marriage, which includes the ability to request that the court equitably divide the marital property.[4] It is always a better practice, however, for the parties to determine how their assets will be divided on their own terms, rather than relying on the court. Furthermore, having a written cohabitation or antenuptial agreement is particularly important for same-sex couples who may relocate to a state other than Delaware, where their relationship may not be recognized and the local law may not provide a mechanism for dividing property.

A cohabitation or antenuptial agreement can also address custody and child support issues if the couple has minor children. The couple must ensure, however, that they retain an experienced family law attorney to advise them as to custody issues, which can be extremely complex.[5]

Holding Property

There are three ways that property can be held concurrently by more than one party: as a tenancy in common, joint tenancy, or tenancy by the entirety. If the property is held as a tenancy in common, each tenant will have a distinct, undivided interest in the property, held in proportionate shares with their ownership interest. A tenancy in common does not have a right of survivorship. If the property is held as a joint tenancy, each joint tenant holds a right of survivorship. In the event one joint tenant dies, the property interest held by that joint tenant automatically extinguishes. As a result, the surviving joint tenants then hold the property in larger equal shares. To the extent a joint tenant conveys her interest, either voluntarily or involuntarily, the joint tenancy is destroyed as to that joint tenant and a tenancy in common results.

In Delaware, property can only be held in the form of a tenancy by the entirety by a husband and a wife and by parties in a relationship that qualifies as a civil union under the Act. As with a joint tenancy, a tenancy by the entirety has a right of survivorship. Unlike a joint tenancy, the tenancy by the entirety cannot be terminated by involuntary partition. Rather, it can only be terminated by mutual agreement by the parties, by divorce, by death, or by execution of a joint creditor. Accordingly, there are substantial asset protection benefits of holding property as a tenancy by the entirety.

At common law, only real property was able to be held as a tenancy by the entirety. However, the Delaware Court of Chancery has recognized that personal property can also be held as a tenancy by the entirety. This includes, among others: household goods, automobiles, equity interests and joint bank accounts. This may provide additional asset protection planning opportunities not only to same-sex couples in Delaware, but also same-sex couples from other jurisdictions whose relationship is recognized in Delaware as a civil union. Such out-of-state couples may contribute property not held as tenants by the entirety to a Delaware entity and hold the interests in that entity as tenants by the entirety for purposes of Delaware law.

In Delaware, when property is acquired by a husband and wife,[6] there exists a presumption that the property is held as a tenancy by the entirety; however, since courts will look to the original intent of the parties, it is highly recommended that the intent of the parties be clear.

As one of the spouses cannot unilaterally convey property without the consent of the other, it follows that the creditors of one spouse cannot reach the property while it is held in the entirety. In the unpublished opinion, Dryden v. Estate of Joseph Gallucio, Jr., the Court of Chancery summarizes the applicable Delaware law by stating:

> In Delaware, a husband and wife may hold personal property as tenants by the entireties and, thereby, protect the property from the claims of the creditor of one of them. In addition, the

(continued on p. 20)

(continued from p. 19)

> assets held by husband and wife as tenants by the entireties will not be part of the estate of the first spouse to die and, thus will not be available for that spouse's creditors even in death.

Upon divorce, property held by a husband and wife as a tenancy by the entirety will convert, as a matter of law, to a tenancy in common. The same should be true for parties to a civil union.

Delaware law also recognizes that when title is taken by husband and wife as tenants by the entirety, and one spouse alone has provided the consideration, a rebuttable presumption arises that such spouse intended to make the tenancy by the entirety a gift to his wife. The same should be true for spouses in a civil union. This may present an issue for same-sex couples for federal gift tax purposes, however, that does not exist for opposite sex couples.

Ordinarily, when a married couple opens a joint bank account, or purchases real property and titles the property jointly, no taxable gift occurs, regardless of which spouse is actually contributing the funds, due to the unlimited marital deduction for gift tax purposes.[7] As discussed above, however, DOMA excludes parties to a civil union from the definition of "spouse" under the Internal Revenue Code, and therefore the unlimited marital deduction for gift tax purposes is not available to parties to a civil union. Thus, if property is held by two parties to a civil union as tenants by the entirety, and one party provided most of the consideration, there may be a taxable gift from the party contributing a greater share to the party contributing the lesser share.[8] The same result will occur if a joint bank account is opened and funded with only assets of one party, and the non-contributing spouse makes withdrawals from the account.[9] With careful planning, civil union couples can minimize the impact of the gift tax on joint ownership of property, such as through tracking contributions, making use of the gift tax annual exclusion, and making use of the lifetime gift tax exemption.

There are additional creditor protection planning opportunities for same-sex couples under Delaware law relating to holding property as tenants by the entirety. Although parties to a civil union must take into consideration the federal gift tax implications of holding property as tenants by the entirety, such parties can transfer tenants by the entirety property to a trust created by one of the parties to the civil union but such property will continue to retain the asset protection benefits as tenancy by the entirety property.[10] Moreover, additional asset protection planning is available where one party to a civil union has creditor issues, both parties hold property as tenants by the entirety, and the wish to transfer the property to the party of the civil union that does not have creditor issues. Such a transfer is not considered a transfer under the Delaware Uniform Fraudulent Transfer Act.[11]

Probate

In addition to planning for financial matters during the lives of same-sex spouses, it is also important to consider how the estate

of such spouses will pass upon their deaths and to understand the probate process. The probate process consists of identifying, marshalling and valuing assets, payment of administration expenses, funeral expenses, debts and taxes and distribution of the balance of the assets to the beneficiaries pursuant to the Will, trust or in the event that the individual died intestate (without a Will), in accordance with the intestacy laws. There may be somewhat onerous probate fees. Individuals often utilize revocable trusts (often known as Living Trusts) to avoid the probate process and for other planning purposes. Benefits of utilizing revocable trusts include elimination of probate fees, planning for incompetency, privacy, expediency and reducing and eliminating contests of Wills and litigation concerning the administration of estates. This is particularly important for same-sex couples who have family members who may not approve of the relationship. Additionally, to address this issue, same-sex couples often use no contest provisions, which are expressly permitted under Delaware law, in their Will and revocable trusts.[12]

Estate Tax Planning

As mentioned previously, same-sex couples are not entitled to the benefits available to married spouses under the federal gift and estate tax laws. Under federal law, a spouse may, at death, pass an unlimited amount of assets to the surviving spouse without the imposition of federal estate taxes and may gift an unlimited amount of assets to their spouse during their lifetime. In addition, an individual may, under current federal law, gift during his or her lifetime or pass free of federal estate tax at his or her death, up to $5,000,000 of assets. As a general rule, the definition of "gross estate" is all inclusive for federal estate tax purposes and includes real property, stocks and bonds, notes receivable, cash, bank accounts, mutual funds, life insurance, annuities, 401K plans, individual retirement accounts, tangible personal property, and equity interests in entities. After reducing the gross estate for funeral expenses, administration expenses, debts, and amounts passing to charitable organizations, any amounts in excess of $5,000,000 are subject to a 35% tax. There are ways to minimize the imposition of the federal estate tax, however, at this time, a marital deduction is not available to parties to a civil union. Accordingly, more sophisticated methods of federal estate tax planning such as utilization of grantor retained annuity trusts, irrevocable life insurance trusts, qualified personal residence trusts, and family limited partnerships or limited liability companies are often utilized by same-sex couples in order to minimize the imposition of federal estate taxes at the death of the first spouse.

Conclusion

While there is still a great deal of uncertainty and difficulty in estate and asset protection planning for same-sex couples due to DOMA, the Act in Delaware will allow planners and their clients to feel more confident that they can create estate plans and protect property from creditors that take advantage of Delaware's advantageous laws while ensuring that the relationships of same-sex couples will be given full legal effect in Delaware.

Mark V. Purpura is a Director in the Limited Liability Company/Partnership Advisory and Banking practice groups of Richards, Layton & Finger, P.A., and was a principal drafter of the Civil Union and Equality Act of 2011.

Peter Conaty is a Director in the Tax and Trusts and Estates practice groups of Richards, Layton & Finger, P.A.

Ginger L. Ward is a Senior Vice President and Financial Advisor at MorganStanley SmithBarney in Wilmington.

Notes

[1]Senate Bill 30 (to be codified at 13 Del. C. § 201, et seq.).

[2]Connecticut, the District of Columbia, Iowa, Massachusetts, New Hampshire, New York and Vermont permit same-sex marriages. California, Delaware, Hawaii, Illinois, New Jersey, Oregon, Rhode Island, Nevada and Washington permit or will permit same-sex couples to enter into civil unions or domestic partnerships. California permitted same-sex marriage from June 16, 2008 to November 4, 2008, and any same-sex marriages that were performed in California between those dates continue to be recognized as valid marriages in California. In 2010, the Maryland Attorney General issued an advisory opinion analyzing Maryland's conflict of laws principles and determining that Maryland agencies can recognize same-sex marriages performed outside of Maryland.

[3]Some jurisdictions have adopted domestic partnership laws that provide some, but not all or substantially all, of the spousal benefits and obligations of marriage, such as Colorado, Maine, Maryland and Wisconsin. Those relationships will not be recognized as civil unions for purposes of Delaware law.

[4]13 Del. C. §216

[5] See, e.g., Smith v. Guest, 16 A.3d 920, 2011 Del. LEXIS 157, in which the Delaware Supreme Court upheld a decision of the Family Court granting a same-sex partner custody of her partner's adopted child based upon a de facto parent doctrine.

[6] The following discussion refers to "husband and wife" primarily as it refers to case law that predates the Act. Pursuant to the Act, the presumptions set forth above should equally apply to parties to a civil union. Joint property acquired prior to the effective time of the Act or a civil union will not automatically be deemed held as tenants by the entirety after the Act becomes effective or after the parties enter into a civil union.

[7] Internal Revenue Code §2523

[8] Treas. Reg. §25.2511-1(h)(5).

[9] Treas. Reg. §25.2511-1(h)(4).

[10] 12 Del. C. §§3334 and 3574.

[11] 6 Del. C. § 1301, et seq.

[12] 12 Del. C. § 3329