

PROFESSIONAL TAX & ESTATE PLANNING NOTES

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Spousal Right of Election in New York

New York law protects a surviving spouse against being disinherited by giving him or her a personal right of election against the capital value of the decedent spouse's estate. This issue of *Professional Notes* discusses the right of election as well as how to ensure that charitable gifts are protected. Under New York law, the surviving spouse has the choice of receiving that part of the estate passing to him or her by will and non-testamentary dispositions or renouncing these interests and claiming his or her elective share. The elective share is the greater of \$50,000 or one-third of the net estate. Only an outright interest in property will satisfy the elective share.

The value of the net estate is not simply the value of the property passing under the decedent's will.

The value of certain *inter vivos* dispositions or gifts is recaptured and included in the decedent's estate for purposes of determining the elective share of the surviving spouse. These recaptured *inter vivos* dispositions, or "testamentary substitutes," include property transferred by the decedent in which he or she retained some interest, including jointly held property, trusts for the benefit of the decedent, certain retirement accounts, property over which the decedent had a general power of appointment, and gifts over the annual exclusion amount (\$12,000 in 2006) made within the one-year period before death. A transfer to a charitable remainder trust (CRT) in which the decedent retained a lifetime income interest or an outright gift to charity in the year before death is a testamentary substitute.

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Effect on Charitable Gifts

It is possible that a gift to charity—either outright within one year of death, or through a charitable remainder trust in which the decedent retained an interest—will be reduced to contribute to the one-third elective share. For example, if a donor dies within a year of making a gift of art to a museum, the museum may be compelled to return up to one-third of the value of the gift, in cash or in the specific property, or both, as contribution to the elective share.

Example: Mr. Jones contributes low basis, highly appreciated stock to a charitable remainder trust in January 2005. He and his wife, or the survivor of them, will receive 6 percent each year and at their deaths, the remainder is to go to a fund at The New York Community Trust for a particular passion of theirs, parks and open spaces. Unfortunately, following Mr. Jones's death later that year, Mrs. Jones exercises her right of election. The gift to The New York Community Trust is included in the computation of the elective share and one-third of the gift must be returned to the estate and to Mrs. Jones. As a result, no charitable deduction is permitted, because the trust is no longer a qualified split interest trust. The trust is taxed on the capital gains realized when the stock is sold, and on future income and gains from investments. In addition, the gift will not qualify for the estate tax charitable deduction. In such event, the value of the transfer to charity, if worth more than \$12,000, would be subject to gift tax.

Because a charity may be required to retain one-third

of a gift, there is a risk that the Internal Revenue Service will disallow part of the charitable deduction, particularly if the likelihood of the charitable interest being reduced is “not so remote as to be negligible.” Remoteness constituting negligibility has been defined as having a less than 5 percent probability.

Commentators have recognized for some time the risk that a charitable remainder trust, because of the spousal right of election, would fail to qualify because the trust is not exclusively for a charitable remainder from its inception. As a result, the charitable income tax deduction would be denied and the remainder trust would not be tax exempt and would not qualify for estate and gift tax benefits.

In Rev. Proc. 2005-24, the IRS reached just this conclusion, advising that the mere existence of a spousal right of election, whether or not exercised, would cause a CRT created during the donor's lifetime to fail to qualify under IRC Section 664(d). The ruling set out a safe harbor under which the IRS would disregard a right of election with respect to an *inter vivos* CRT. CRTs created before June 28, 2005 were “grandfathered.”

In that ruling, which has since been suspended pending further guidance, the IRS advised that the surviving spouse must irrevocably waive the right of election in writing, and that the waiver must be executed not later than six months after the due date for Form 5227 for the CRT (without extensions) in the later of the year (i) in which the CRT is created, (ii) of the marriage of the grantor to the non-grantor spouse, (iii) in which the grantor becomes domiciled or resident in a state with a right of election that could be satisfied with CRT assets, or (iv) of the effective date of applicable state law creating a right of election.

A number of concerns were raised about the undue burden of the revenue procedure, and on February 3, 2006, the IRS issued Notice 2006-15 confirming that it is rethinking the approach taken in the earlier revenue procedure, and extending indefinitely the June 28, 2005 grandfather date. For now, as long as the spouse does not in fact exercise the right of election as to CRT assets, the mere possibility of such an exercise will not cause the CRT to fail to qualify.

Gifts to pooled income funds, charitable gift annuities, and retained life use gifts of personal residences similarly may be challenged where the donor has retained an interest and a surviving spouse might exercise the right of election. Theoretically, the entire pooled income fund could be disqualified. However, it seems unlikely the IRS would disallow charitable deductions for these types of partial gifts, or disqualify a pooled income fund, without warning.

Waiver of Right of Election

To avoid unintended consequences to estate plans, a spouse should waive a right of election with respect to a particular testamentary substitute. The New York statute allows the surviving spouse to waive or release his or her right of election with respect to testamentary substitutes, so long as the waiver is in writing and is made during the lifetime of the other spouse. Such waivers must be carefully drawn in order to be effective; otherwise, it is possible that, for example, a charitable remainder beneficiary could lose a gift that was clearly intended. Many attorneys now routinely obtain an acknowledged waiver by the non-contributing spouse of the elective share at the time the trust is created.

Where the grantor retains an interest in a CRT and subsequently marries, the new spouse (should she or he

survive) would have a right of election. Consequently, a waiver of the right of election as to an existing CRT should be sought as part of a prenuptial agreement.

Conclusion

The spousal election rules may have unintended consequences, and underscore the need for careful estate planning. Many practitioners routinely obtain waivers of the right of election with respect to CRTs. Careful prenuptial planning is called for as well, particularly before a second marriage where there may be a need or desire to provide for children from the first marriage and for philanthropic objectives. Previously established CRTs will be considered testamentary substitutes, and as part of a prenuptial agreement, a waiver should be obtained from the new spouse.

For further reference, please see:

EPTL Section 5-1.1-A: Right of Election by Surviving Spouse

IRC Section 170(f)(7): Gifts of Split Interests

IRC Section 2055(e)(3): Gift Tax Deduction for Transfers to Charitable Remainder Trusts

Treasury Regulation Section 1.170A-1(e): Transfers subject to a condition or power

Revenue Ruling 70-452, 1970-2 CB 199

Revenue Procedure 2005-24, 2005-16 I.R.B. 909

Notice 2006-15, 2006-8 I.R.B. 501

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