

# DEALING WITH SPECIAL ISSUES IN ARIZONA PROBATES

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## A. Intestate Succession.

### 1. *Surviving Spouse.*

Where there is a surviving spouse, the spouse receives all the decedent's estate except where there are children of the decedent who were not children of the surviving spouse. Thus, where there is a surviving spouse and no children, or children all of whom are also children of the survivor, the surviving spouse receives the entire estate and the children receive nothing. Where there is at least one child of the decedent who was not issue of the surviving spouse, the spouse takes one-half of the decedent's separate property and none of the decedent's interest in community property; the decedent's issue take the other half of separate property and the decedent's share of community property.

Example 1. John dies after a twenty-year marriage to Joan, during which they had five children, all of whom survived John by 120 days. John does not leave a will. At the time of death, John owned Blackacre, worth \$200,000, which he recently inherited from his uncle; and other property, all acquired during marriage, worth \$1,000,000. Unknown to Joan, John had fathered an out-of-wedlock child before their marriage. Under Arizona law, the out-of-wedlock child is an heir on equal footing with John's other children. § 14-2114. The result is that Joan inherits one-half of Blackacre, worth \$100,000 and none of John's community interest in the other property. Joan of course retains her half of the community interest in the property, or \$500,000. The six children will each receive \$100,000, one-sixth of John's community property interest combined with half of Blackacre.

Example 2. The facts are the same except that the other property consists of a life insurance policy payable to Joan as beneficiary. Because the life insurance is a non-probate asset, Joan will receive all of the insurance

proceeds and half of Blackacre. The children each receive one-twelfth of Blackacre.

2. *No Surviving Spouse.*

If there is no surviving spouse, the descendants of the deceased receive all of the property, taking by representation.

Example 3. Decedent dies leaving three living children and no spouse. In addition, decedent had a fourth child, now deceased, who is survived by three children. Decedent's living children each receive one-fourth of the estate. The children of the deceased child each receive one-twelfth of the estate.

If the decedent left no spouse and no issue, the parents of the decedent are next in line (if only one parent survives, the one parent takes all), followed by brothers and sisters and nieces and nephews, all on the principal of representation. If there are none of these, paternal and maternal grandparents take equally by representation.

Example 4. Decedent dies leaving no spouse, issue, siblings or descendants of siblings. Decedent is survived by his paternal grandmother, the other three grandparents being deceased. He also is survived by two uncles on his father's side and six cousins who are descendants of his maternal grandparents. The result is that the surviving grandmother receives one-half the estate. The other half is divided equally among the six cousins. The uncles take nothing.

Example 5. Decedent's closest relatives are nine first cousins, eight on his mother's side of the family and one on his father's side. The single cousin on the father's side inherits one-half of the estate. The other eight cousins each receive one-sixteenth.

**B. Adopted Children.**

Adopted children are, unless a testamentary instrument specifically provides otherwise, considered on the same footing as other children. § 14-2114. Such children are, however, cut off as heirs of their birth parents. Consequently, if the natural parents of a

child adopted by others wants that child to inherit, the child must be specifically mentioned in a will.

### **C. Various Doctrines Concerning Wills.**

1. *Pour-Over Wills.* Wills which leave some or all property to a trust are specifically sanctioned. § 14-2511. The trust does not have to be in existence at the time the will is executed, provided that it is established during the testator's lifetime and the will adequately identifies the trust.

2. *Revival.* Where a will is executed revoking all previous wills and that later will is then revoked, the common law held that, absent a showing of the decedent's intent to the contrary, the previous will was revived. Under § 14-2509, revival will only occur if the previous will is still in existence, the second will is revoked by physical act (i.e., tearing or marking) and the decedent's intention was to revive the previous will. The decedent's intent may be shown by testimony as to the statements of the decedent.

3. *Anti-Lapse.* § 14-2603 sets forth Arizona's anti-lapse rule. If testator leaves a specific devise to A and A fails to survive the testator by 120 hours, the devise will pass to A's issue. If A leaves no issue, the devise lapses into the residuary. The result is also true of the residuary. However, if a residuary beneficiary predeceases the testator leaving no issue, that portion does not pass intestate but instead passes to the other residuary devisees. § 14-2604.

4. *Securities.* Specifically devised securities carry with them stock splits and stock dividends. § 14-2605.

5. *Ademption.* A specific devise of property which is sold before death but as to which proceeds have not been received. In this case, the specific devisee receives the proceeds. If the proceeds had been received by the testator prior to death, they will not pass to the devisee, even if specifically identifiable. If the decedent sells property taking back a promissory note, the note will pass to the devisee.

6. *Exoneration.* Specifically devised property passes without exoneration. Thus, testator leaves Blackacre to A and his will contains a directive for his PR to pay all his just debts. If Blackacre is encumbered by a mortgage, it will pass to A subject to the

mortgage and the general language about paying debts will not cause the mortgage to be extinguished from other estate assets.

7. *Joint or mutual wills.* Where there are children from a prior marriage, the following scenario has given rise to much litigation. H and W are married, both having been married before and each having children from a former marriage. H and W agree on an estate plan leaving all property to the surviving spouse; at the death of the surviving spouse, half of the estate is to go to H's children and half to W's. H dies and his estate passes to W. W lives another 20 years and late in life changes her will to make her children sole beneficiaries. Upon W's death, H's children present claims against her estate on the theory that W breached her contract with H when she changed her will. In Arizona, § 14-2511 provides that a contract to make a will is not to be inferred by the mere execution of joint or reciprocal wills. All contracts to make a will must be in writing. Therefore, the joint wills would need to contain language indicating that the parties intended to bind themselves by not altering their wills; alternatively, there would need to be a separate written agreement to that effect.

In this situation, a living trust certainly seems like the best solution to carry out the parties' intentions. The trust would have a QTIP provision under which the decedent's estate would pass to an irrevocable trust to benefit the spouse for life and, upon the survivor's death, to pass to the first decedent's children. This has the added protection that the survivor cannot alter the trust after the first death. The trust must provide that all income is to be paid to the survivor for life in order to qualify for the estate tax marital deduction. In addition, the spouse could be granted other withdrawal rights. However, unlimited withdrawal rights would, although preserving the marital deduction, allow the trust to be defeated by the simple expedient of withdrawing the entire principal, which would then pass by will. Consequently, such a couple seeking estate planning advice should be counseled on this point and advised that prudent limitations on the withdrawal rights of the spouse should be included.

8. *Pretermitted spouse or children.* If a person executes a will and subsequently marries, Arizona law provides that the spouse may elect an intestate share against the

will. § 12-2301. If there are no children of the decedent from a prior marriage, since the intestate share of the spouse is the entire estate, none of the devisees would take under the will. If, however, the decedent had children born prior to his marriage, the new wife's election will not reduce the children's share. Thus, if decedent executed a will leaving his entire estate equally to his two children and later married, the wife would receive nothing under the will. The wife would still be entitled to a homestead and exempt property allowance. Afterborn children are similarly allowed an intestate share.

9. *Advances and gifts.* If testator provides by will that A and B are to take equal shares of his estate and, during life, gives B a large monetary gift, thus reducing the estate, is the gift treated as an advance of the bequest? § 14-2109 provides that a gift is to be treated as an advance only if the decedent declared to in a writing contemporaneous with the gift, or if the recipient acknowledges the nature of the gift as an advancement. Thus, if the testator specifically told A and B that the gift was to be taken into account in calculating B's share, this would be ineffective and B's share of the remaining estate would be one half. Where the gift is treated as an advancement, the value of the gift is determined as of the date of the gift.

#### **D. Non-Probate Transfers.**

The Arizona law on non-probate transfers contains important rules on asset protection and creditors rights which should not be overlooked. A non-probate transfer is a valid transfer effective at death by a decedent who was domiciled in Arizona at the time of death and who, prior to death and acting alone, had the power of revocation or withdrawal with respect to the transfer and who could have used the property for his own benefit or to satisfy creditors. Transfers of real estate by right of survivorship is specifically excluded from the definition. A.R.S. § 14-6102(I).

This definition is broad enough to cover most common forms of property transferred by beneficiary designation, such as insurance proceeds, retirement accounts, pay-on-death designated bank accounts and securities with transfer-on-death designations. It appears it would not cover stock or accounts held as JTWRROS because the decedent would not ordinarily have the power to terminate the joint tenant's interest

unilaterally. The definition clearly includes transfers at a settlor's death by garden-type revocable trusts.

The recipients of non-probate transfers are liable to the decedent's probate estate for claims of creditors and statutory allowances to the decedent's spouse and children to the extent the probate estate is insufficient. A.R.S. § 14-6102(B). Prior to the enactment of this statute, the establishment of a revocable trust might have defeated both the homestead allowance and claims of creditors. While Arizona courts have never ruled on this, other states have. See, e.g., *Johnson v. LaGrange State Bank*, 73 Ill.2d 342 (1978).

Trust beneficiaries who are liable to creditors of the decedent abate in the same manner as wills – that is, the residuary estate is the first to go. In a proceeding to enforce the liability a demand must be made upon the personal representative to present a claim to the trustee. If the PR refuses to do so, the creditors may, at their own expense, initiate a proceeding to require abatement. The action must commence within two years of the date of death, unless a claim has been submitted and disputed, in which case the limit is 60 days after final allowance. The PR may give notice to transferors of non-probate transfers, including insurance companies and trustees, that there is a deficiency in the probate estate. Upon such notice, the transferor may become liable if distribution is made without satisfaction of the claims of creditors. See A.R.S. § 14-6102(H).

#### **E. Creditors Rights Under the Uniform Trust Code**

Under the now-postponed UTC, the ability of creditors to obtain assets held in trust for a debtor is addressed. Although the UTC is under attack and may not be enacted, these provisions are also to be found in the Restatement Third of Trusts and it is thus arguable that they are already the law in Arizona, absent a statutory provision to the contrary.

Under the UTC, The effectiveness of a trust against creditors depends on the inclusion of an effective spendthrift clause. Absent such a clause, creditors of a beneficiary can reach the beneficiary's interest by attachment. A.R.S. § 14-10501. § 14-10502 provides that a spendthrift provision is valid only if it restrains voluntary (e.g., pledging or assigning) and involuntary (e.g., bankruptcy) alienation. The provision

need not be lengthy; it must specify that the beneficiary's interest is subject to the spendthrift provision.

There are exceptions to the protection from creditors that a spendthrift trust provides. It is not effective against:

- A judgment or court order for support in favor of a spouse, child or former spouse;
- A judgment creditor who has provided services for the protection of a beneficiary's interest in the trust (e.g., attorney or trustee);
- A claim of the state or federal government (including tax claims) where a statute so provides.

Where the spendthrift clause is effective, it will prevent a creditor from attaching a beneficiary's interest or distributions (before receipt by the beneficiary), except where the beneficiary is entitled to mandatory distributions and the trustee has failed to make such distributions. § 14-10507.

Whether or not a trust has a spendthrift provision, a creditor (other than a spouse or child having a support order) may not compel a distribution where the distribution is discretionary with the trustee, *even if* a refusal of the trustee to make a distribution is an abuse of discretion or contrary to a standard expressed in the trust. § 14-10504.

The above protections generally do not apply to the settlor of a trust, to the extent of his proportionate interest in the trust based on his contribution. During the settlor's lifetime and after his death, a creditor may attach property of a trust which was revocable during the settlor's life (to the extent of any deficiency in the probate estate). After the settlor's death, or during life in the case of an irrevocable trust, the creditor may reach the maximum amount which could be distributed to the settlor. The holder of a power of withdrawal is treated as a settlor to the extent of the power. If the power lapses, the holder is treated as the settlor only to the extent the power exceeded a 5 by 5 power. In no event is the property of a trust subject to the claims of a creditor of a trustee who is not also a beneficiary.

## **F. Section 303 Redemptions**

Where a closely held business constitutes 35% or more of the gross estate, section 303 is available to allow redemptions of corporate stock to pay estate tax without being subject to ordinary income tax. A redemption is a purchase by the corporation of its own stock. Unless the rules of section 302 are met, a stock redemption is ordinarily taxed as a dividend to the redeeming shareholder. If the 35% test is met, section 303 permits the redemption to occur without dividend consequences. Because the stock is stepped up to market value at the date of death, there ordinarily would be no capital gain tax on a 303 redemption except for post-death appreciation. The amount of the redemption is limited to the federal and state estate and inheritance tax paid by the estate and funeral and administration expenses allowable as a deduction to the estate.

#### **G. Extensions of Time to Pay Estate Tax.**

1. *Extension for reasonable cause.* The personal representative may obtain an automatic six-month extension of time to file the form 706 estate tax return by filing form 4768 and requesting additional time to pay the tax. The IRS can grant a discretionary extension of time to pay the tax of up to twelve months upon a showing of reasonable cause. Code § 6161(a). Only a six month extension is available for any generation-skipping tax due. Reasonable cause for this purpose includes illiquidity of the estate and other circumstances specified in the IRS manual, but does not include reliance on the services or advice of an attorney or accountant. Granting of an extension will excuse the late-payment penalty but the estate will still have to pay interest on the tax paid late.

2. *Extensions for Undue Hardship.* The IRS may grant an extension up to ten years upon a demonstration of undue hardship (§ 6161(a)(2)) or an extension until six months after the termination of a reversion or remainder interest included in the estate (§ 6163). The first extension is usually available only where the estate includes farm land or business interests not large enough to qualify for the § 6166 extension. The extension for reversionary or remainder interests applies only to the extent of the value of the interest included in the gross estate.

3. *Extensions for Business or Farm Assets.* Section 6166 permits special installment payments of estate tax where over 35% of the adjusted gross estate consists of

closely held business interests (including farms operated as businesses). The election must be made on a timely filed estate tax return. The extension of time to pay can be for a period up to fifteen years, with no payments being made for the first five years and installments paid over the next ten. A special favorable interest rate of 2% applies to extensions under this section.

#### **H. Special Use Valuation.**

Section 2032A permits a special use valuation for real property used in a business or farming operation. The section is lengthy and complicated and no attempt will be made here to give a complete explanation. To qualify, the value of the business or farm must constitute 50% or more of the value of the gross estate (adjusted for taxes, debts and administration and funeral expenses) and the value of the real property must constitute at least 25% of the estate. The business must be passed to “qualified heirs” and such heirs must continue to use the property in the business and actively participate in the business for 10 years following the decedent’s death. Special dispensation from the active participation requirement is provided to spouses, students and minors who inherit the business or farm. A recapture tax is imposed if the farm or business is disposed of or active family participation ceases within the ten year period. If available, the section allows real estate to be valued in accordance with its actual use rather than its highest and best use. This can be especially valuable in the case of farm and timber land.