Yours, Mine, and Ours: Estate Planning for Today's Blended Family

Take steps to ensure that your estate planning reflects your current intentions. A thoughtful approach can help you avoid future conflicts and misunderstandings. By Richard Krim ChFC, Krim Associates and Scott Krim CPA, Krim Associates.

In a "traditional" estate plan, each spouse provides for his or her assets (or most of the assets) to pass to the surviving spouse, with the understanding that those assets will go to their children at the surviving spouse's death. This planning approach may work well when the spouses have only been married once — to each other — and the only children involved are the ones they have together.

But it can spell disaster if your family is one of the many today that doesn't fit this traditional definition. For couples with children from prior marriages, a better approach is to sort out what's "yours, mine, and ours" and plan accordingly so neither your spouse nor your children are unintentionally disinherited. Think carefully and objectively about potential conflicts, future needs, and human nature. The following strategies may help in your planning.

Preliminaries

Most estate plans have two goals:

(1) To spell out whom should receive assets and

(2) To reduce or minimize taxes on the estate.

The first goal generally can be accomplished through:

- A will (if you don't have one, you should contact your legal advisor and have one written),
- Premarital agreements (a will alone may be insufficient if your spouse challenges it),
- Proper titling of any property you and your spouse acquire during marriage, and
- Beneficiary designations for life insurance policies, annuities, employer-sponsored retirement plan benefits, and IRAs.

The second goal is more difficult to achieve. Reducing or minimizing estate taxes — which in 2006 can be as high as 46% at the federal level — without cheating any family members usually calls for more sophisticated strategies. These planning strategies often rely on trust arrangements to make optimal use of the federal credit and the unlimited marital deduction. The credit lets you pass a certain amount of assets to anyone you choose, free of estate and gift tax. This amount – the credit equivalent – is $2 million in 2006. Under the Economic Growth and Tax Relief Reconciliation Act of 2001, the estate tax credit equivalent is scheduled to increase gradually, reaching $3.5 million in 2009. The estate tax is repealed in 2010, but returns in 2011, with a credit equivalent of $1 million. Unlike the estate tax credit equivalent, the gift tax credit equivalent is not scheduled to increase above $1 million.

With the marital deduction, you can give your spouse an unlimited amount of assets transfer tax-free during your lifetime or at death. So, if you leave your entire estate outright to your surviving spouse, no federal estate tax will be due on your estate at your death. By doing so, though, you relinquish any control over who will receive the assets at your spouse's death. Moreover, when your spouse dies, the assets that remain will be included in his or her federal estate for estate-tax purposes. Other strategies might better accomplish your objectives.

QTIP Trusts

One way to make use of the marital deduction and control who will receive your assets after your spouse's death is to create a Qualified Terminable Interest Property QTIP) trust in your will. With a QTIP trust, the assets are held in trust for the use of your spouse, but pass to whomever you have chosen when your spouse dies — your children, for example. As long as the trust meets these requirements, it will qualify for the marital deduction:

- Your surviving spouse must be entitled to all trust income, payable annually or more frequently, for life.
- No person can have a power to appoint trust property to anyone other than your spouse while your spouse is alive.
- Your executor (or personal representative) must elect to treat the trust as QTIP property.

Your spouse's estate may have to pay federal estate tax on the assets, but the assets themselves must be distributed as you have directed in your QTIP trust agreement.

A Two-Part Estate Plan

A QTIP trust isn't the answer for everyone, though. In cases where a person with adult children from a previous marriage has a considerably younger second spouse, the children may have to wait a long time before they can benefit from the QTIP assets. A better way may be to divide your estate into two parts. You give the first part to your children, either outright or in a trust that takes advantage of your federal credit. The credit will offset some or all of the tax on these assets, depending on the amount you leave to your children.

The second part of your estate is placed in a trust that qualifies for the marital deduction, such as a QTIP trust. Your estate pays no federal tax on this transfer because of the marital deduction. When your spouse subsequently dies, the assets that remain will be included in his or her gross estate. However, your spouse's credit may be available to shelter all or part of those assets from tax.

Life Insurance Trusts

An irrevocable life insurance trust is another strategy you might use to pass wealth to select family members. With a life insurance trust, you transfer money to the trust and the trustee buys a life insurance policy on your life. The trust is the owner and beneficiary of the policy. At your death, your trustee collects the insurance proceeds and either manages them for your children or other trust beneficiaries or distributes them as you have directed in your trust agreement. As long as the trust is properly structured, the life insurance proceeds won't be subject to federal estate tax.

Lifetime Gifts

Making gifts to children or others now gives you complete control over who will receive your assets and lets you share in the enjoyment of your generosity. Thanks to the gift-tax annual exclusion, for 2006, you can give any number of people up to $12,000 each in assets ($24,000, if your spouse joins in the gift) free of federal gift tax. The amount of these gifts also will be removed from your federal estate for estate-tax purposes. Many people use the annual exclusion to give assets that are appreciating in value. Then, both the current value of the gift and any future appreciation escape federal gift and estate taxes.

When a Business Is Involved

Transferring a business interest requires additional planning. You can pass your business to children or other family members by:

- Bringing in a child or other relative as a co-owner who will buy your share of the business at your retirement or death,
- Selling the business to family members now in installments,
- Making lifetime gifts of company stock to them, or
- Leaving stock to the family members who will continue the business.

Each of these possibilities has different tax consequences that you should discuss with your legal advisor and tax consultant.

If you plan to sell your business to a family member, a buy-sell agreement may be the answer to your succession planning needs. A buy-sell agreement:

- Provides for an orderly transfer of the business,
- Permits family members and other present owners to continue in their business roles after
- your disability, retirement or death,
- Allows a fair market price for the business to be agreed upon today,
- Provides a plan to fund the purchase, and
- Lets you plan your estate and taxes ahead of time.

Life insurance is a popular way to provide the cash needed to complete the buyout. You also can use life insurance to provide your family with the funds needed to pay estate taxes or to provide for your spouse if your business is your major asset and you transfer it to you children.

Everyone’s situation is different. The strategies discussed here may or may not fit your situation. Please consult a professional advisor before implementing any of the approaches we have discussed. Even the smallest of mistakes can undo your estate planning efforts and jeopardize your family’s future financial security.

For more information on this and other wealth management strategies, please contact Richard Krim, ChFC or Scott Krim, CPA.

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