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All in the “blended” family

Ensure your assets end up in the right hands

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If you have divorced and remarried and have children from two or more marriages, you’re part of the growing number of families known as blended families. If so, you may want to pass your wealth on to your biological children but also provide for your current spouse (and perhaps stepchildren). You also likely wish to minimize gift and estate taxes — and preserve the peace — in the process.

Sensitivity and tact can help ease any tension, but meticulous estate planning can be the best tool for ensuring your wishes for your blended family are carried out.

Provide balance with a QTIP trust

A qualified terminable interest property (QTIP) trust is a marital trust that can be an effective tool for balancing competing estate planning goals and preserving family harmony. A marital trust is designed to qualify for the estate tax marital deduction, so assets you transfer to the trust aren’t taxed when you die. (Be aware that, if your spouse isn’t a U.S. citizen, more restrictive rules apply.)

A QTIP trust is unlike an ordinary marital trust, however, because it provides your spouse with income for life but typically maintains the principal for your children (or other beneficiaries).

When your spouse dies, the trust assets will be subject to estate tax as part of his or her estate, even if the assets are to pass to your children as instructed in the trust. If the value of your spouse’s estate, including the QTIP trust assets, is greater than the \$2 million estate tax exemption under current law, the balance could be subject to hefty estate taxes. To minimize taxes, consider transferring some assets directly to your children (or another trust for their benefit) at your death. Typically, a credit shelter trust is used that can also provide income to the surviving spouse, but is taxable for estate tax purposes. This allows you to take advantage of your own \$2 million estate tax exemption.

Throw an ILIT into the mix

In a blended family where one spouse is considerably younger than the other, the children from a previous marriage — who may be much older than those from the second marriage and perhaps close to the age (or even older) than the second spouse — may have to wait years until the second spouse dies to receive their inheritance.

If you’re in such a situation, consider an irrevocable life insurance trust (ILIT). An ILIT purchases insurance on your life, and you make annual exclusion gifts to the trust to cover the premiums. Be sure the ILIT is properly designed so that the gifts will indeed

qualify for the annual exclusion and to ensure there won't be any estate tax on the insurance proceeds.

When you die, the ILIT collects the death benefit and pays it out to your children from your previous marriage. The older children receive their inheritance immediately, while the other assets remain available to provide for your spouse and younger children.

Consider other options

A QTIP trust and an ILIT are just two tax-minimizing tools for controlling the distribution of your wealth to your blended family. Other strategies to consider include a:

Long-term discretionary trust. This trust administers your children's inheritance through a trustee appointed by you. If one of your children dies before your ex-spouse, his or her inheritance would go to his or her children (your grandchildren) or your surviving children, not your ex. This trust also can protect your children's inheritance from divorce, bankruptcies, lawsuits and irresponsible spending.

Premarital agreement. Listing the assets you intend to keep separate after marriage can provide you with greater assurances that your wishes will be honored after you're gone — but only in states that recognize premarital agreements and only if the agreement is executed properly.

Second-to-die insurance policy. For couples that include one spouse who is significantly older than the other and who have young children, an insurance policy payout can allow the couple to amass financial wealth for their heirs. This may take the form of insurance on the older spouse to help provide for the surviving spouse, or it may be less expensive insurance on the younger spouse or a "second to die" policy to provide for the heirs. The policy may be owned by an ILIT to minimize estate taxes.

Weigh your options

Be sure to consult with an estate planning professional about these and other wealth transfer strategies to determine what's best for your blended family's needs. Whichever strategies you choose, discuss your plans with your loved ones. It can help them understand the logic behind your decisions and curtail disagreements and bad feelings later.

Factor in the ex factor

Although the best planning strategies to implement will depend on your family's circumstances, such as the children's ages and the age difference between you and your spouse, it's generally wise to disinherit your ex-spouse no matter what your family specifics are.

Unless you remove your ex-spouse as your beneficiary or joint owner with right of survivorship, he or she could legally inherit your home, retirement benefits, life insurance payout and bank account balances — even if you specified otherwise in your will or living trust. *Why?* Because a will covers only transfers that go through probate. Homes in joint tenancy, qualified retirement plans or IRAs, life insurance policies, and joint bank accounts are all considered non-probate transfers.

In addition, if you don't take the proper steps to disinherit your ex-spouse, a probate court potentially could name him or her to manage your children's inheritances, which you may not want.