PacificCPE

COURSE
40655A

Blended Families and Estate Tax Considerations

Estate planning gets more complex when blended families are involved—and more so when tax implications enter the picture. This course tackles the unique challenges of planning for spouses, stepchildren, and former partners, then shifts to a practical overview of income, gift, and estate taxes. For CPAs and tax professionals, this combination is especially relevant: understanding both the family dynamics and the tax landscape is essential to crafting plans that hold up and minimize unnecessary tax burdens.

CREDIT HOURS 2 | FIELD OF STUDY BUSINESS | EXAM QUESTIONS 10

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LEARNING ASSIGNMENTS AND OBJECTIVES

Assignment

- Study the full course materials included here.
- Complete the review questions after each chapter.
- Answer 10 final exam questions.
- Final exam is scored immediately, 70% or better passes.
- Certificate of completion is available in your account.
- Failed exams can be retaken free of charge.

Course Objectives

- Recall the characteristics of the laws that govern how property is owned.
- Identify the maximum federal estate tax rate.

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Chapter 1: YOURS, MINE, AND OURS: ESTATE PLANNING FOR BLENDED FAMILIES

Chapter Objective

After completing this chapter, you should be able to:

- Recall the characteristics of the laws that govern how property is owned.

It is hard enough to take the time to think through an estate plan when you are single or in a first marriage with mutual children. But it gets more complicated when you are in a second (or third) marriage, or are living with someone (but not married), and have children from prior relationships. If this describes your family, what's traditionally called a "blended family," this chapter is for you. I use the term blended family broadly, to include couples, married or not, who bring not only children but possibly assets as well to their relationship. These couples need an estate plan that can address the issues that come with blending prior lives together.

While blended families don't always have estate plans that are more complicated than other couples, they often do, for these reasons:

- Couples with children from prior marriages often want their assets to go to their respective children at their deaths. A husband and wife who married in their sixties, for example, each with adult children from a prior marriage, often want to take care of each other for their lifetimes, but want their respective children to inherit what's left of their estate after the death of the surviving spouse.
- Couples with mutual children who are many years younger than children from their prior marriages might want the younger kids to get the bulk of their estate. But the couples also want to make gifts to the older children.
- Couples who come to a marriage with separate property and live in community property states might want to keep that property separate. For example, one partner might own the house that the couple lives in, but does not want the new partner to acquire any community property rights in that house.
- Unmarried couples do not get certain tax benefits that married couples do, and need to plan for that.

None of the estate planning issues affecting blended families are insurmountable, but all of them require attention, focus, and, sometimes, a willingness to have uncomfortable conversations about topics that many people would prefer to avoid. Here's a roadmap for the rest of this chapter.

Estate planning for married couples in a blended marriage often focuses on two key issues:

- *Defining* clearly how your property is owned, and
- *Controlling* where assets go after a person dies.

These issues are completely related to each other, because you can't give away what you don't own.

Estate planning for unmarried couples often centers on:

- Understanding what will happen upon the death of the first partner with respect to taxes and the transfer of property
- How to take care of minor children, and
- When each partner has children from prior marriages, how to balance the children's needs against those of a surviving partner.

Unmarried couples also need to plan for incapacity, by putting durable powers of attorney and advance health care directives in place (see Chapter 1 of course 40657B). While it is, of course, true that married couples also need to do this, for unmarried partners this kind of planning is especially important, because married couples sometimes get access to finances and medical information by virtue of the marriage, while unmarried couples often are required to show legal proof of their authority to act for one another.

If you are in a blended family and want to balance the needs of your partner with the needs of children from prior marriages, or if each spouse brings significant property to your marriage, please see a good estate planning attorney after you've read the rest of this chapter. While thinking through the issues that I raise here is critical to your success in estate planning, you are out of DIY territory here—you are going to need professional help to write the documents required.

WHO OWNS WHAT?

Blended families often come together after one or both partners have already acquired property independently. How a couple chooses to manage their financial lives together can run the gamut from keeping everything separate to putting everything into one joint family bucket and everything in between. While there's no one right answer for all families, what is true is that, in order to get your estate planning done properly, you'll need to understand how your major assets are owned.

In Chapter 2 of course 40651B, I discussed the default rules for property ownership and how couples can own property together. These rules differ depending on where you live. There are nine community property states. If you live in one of them, property acquired during a marriage is owned equally by both spouses unless you both agree otherwise in a written agreement. What that means is that when one spouse dies, the default rules say that the surviving spouse owns one-half of

the community property; what happens to the other half of it depends upon the decedent's will or trust.

	Community Property States	
Arizona	Louisiana*	Texas
California	Nevada	Washington
Idaho	New Mexico	Wisconsin**

*This book doesn't cover Louisiana law.

**Wisconsin's system of property ownership is like that of community property states but is called "marital property."

A few other states allow married couples to create community property by transferring it to a community property trust. These states are Alaska, Tennessee, Kentucky, South Dakota, and Florida. Alaska allows couples to create community property in a marital property agreement. But unless the deceased person made the effort to intentionally create community property in this way, traditional "common law" (non–community property) rules apply to those who lived in these states.

If you live in any other state, called the common law states, the rules are different. In those states, the spouse who acquires the property owns it unless it is held jointly. So, technically, if the spouse who owned most of the property died and left that property to someone other than their surviving spouse, they could do so. But common law states also have rules that try to protect a surviving spouse from being left penniless in such a situation by providing that they are entitled to a certain share of the decedent's estate (usually one-third to one-half).

As you read through this chapter, if you find yourself unsure of how you and your partner have decided to own your major assets, now is an excellent time to sort this out. I realize that estate planning can prompt what might be uncomfortable conversations. But estate planning can also be a real opportunity to clarify a couple's understanding of who owns what now, while they are not in a health or other crisis situation. Untangling ownership and finances in the midst of a divorce or separation, or after one spouse has died, is inevitably stressful (and some necessary information might not be forthcoming or available).

Couples who live together but don't marry don't have to sort out the legal characterization of property— each of them owns their own property separately. In fact, that's why many couples that I worked with choose not to marry at all. Still, even unmarried couples face most of the other, thorny issues that come from trying to balance the needs of a partner with the needs of children from prior marriages or relationships.

What to Talk About

Here are some things that many couples that I worked with discussed.

If married, what assets are separate and which ones are considered to be community? You might discover that you have different ideas about what you own together and what you own separately. You might discover that you don't even know how to characterize the property that you do have. If so, see a family law lawyer and work that out.

If a couple has children from prior relationships, would they like to make gifts to those children after the first spouse (or partner) dies? Balancing the needs of children with the needs of a surviving partner can be difficult, especially if there's not a large age difference between children of a first marriage and a new, younger partner. Sometimes life insurance can be used to provide adult children with assets after a parent dies, which will help to ensure that a surviving spouse or partner has sufficient assets to live on.

What will happen to the house when one spouse or partner dies? Would the survivor continue to live there? As far as you can tell now, would that partner be able or want to do so after the other's death? When that's the case, I advised couples to take a look at whether the survivor would likely be able to afford to stay in the house—in terms of both maintenance and mortgages and property tax.

If stepchildren need to sell the house because it is their primary inheritance, where will the surviving partner then live? I advised couples to be realistic about the likelihood that stepchildren would permit a surviving partner to stay in a valuable house. Couples should plan for the eventuality of that partner's having to move elsewhere. This won't be an issue for all families, but if the assets of the first spouse to die are partially held in an irrevocable trust for the benefit of children of the first marriage, it could be. The reason is that if the surviving spouse is not the trustee, that spouse might not have control over whether they could continue to live there, or whether the property would be sold.

How do you want to handle the furniture, furnishings, and other items of a personal nature at the death of one partner? Would stepchildren want some of their parent's things? Would giving them these things be disruptive for the survivor? Would stepchildren and the surviving partner be able to sort out which items belonged to which partner? Couples sometimes leave lists of specific gifts of such tangible items to avoid fights about them. Couples also sometimes leave such tangible personal items in trust for the survivor, so it is clear to children that they can't just come over and take all the furniture or artwork after their parent dies.

Whom do you want to name as beneficiaries for retirement plans and life insurance policies? Naming beneficiaries for accounts and policies is one way to transfer assets directly to children, or to your spouse or partner, but this requires filling out beneficiary forms with each institution. Importantly, if you wish to name someone other than your spouse as a beneficiary, that spouse

needs to consent. For unmarried couples, it is especially important to name a partner as beneficiary for such accounts because they won't otherwise qualify as an heir.

Changing the Rules

While each state has specific rules about who owns what, you don't have to be governed by them. State laws permit couples to come to a different understanding about what they own and how they own it. To do this, a couple must clearly state how their property is owned. They must do so in writing; a handshake or an oral understanding won't do. Such a property agreement (called a premarital agreement if done before marriage, or a postmarital agreement if done after) must include crystal-clear language stating that the characterization of property is being changed by the agreement. States have different rules about exactly how these pre-or postnuptial agreements must be worded and how each spouse must work with an attorney (or waive that right). My advice is that each person should have a lawyer take a look at an agreement like this, even if not required by state law. After all, because you will be bound by whatever the two of you have agreed upon, it's best to make certain that you understand what you're getting or giving away.

Such agreements don't have to be complicated—they just need to be clear. As long as the pre- or postmarital agreement is in writing, and each party has complied with the relevant state's law, the agreement will be valid (enforceable by a court, if it comes to that), as long as each party has honestly and fully disclosed all of their assets.

Why Sign a Property Agreement?

The value of signing a property agreement is that it helps make things clear after the death of one or both spouses (and, of course, in case of divorce). That's when the characterization of property or a spouse's right to inherit really matters. First, clear characterization of property can avoid challenges to an estate plan that claim that one person gave away property that the partner didn't, in fact, own. Second, a clear understanding of what a surviving spouse is entitled to under state law can help to avoid conflict. In a blended marriage, with children who are not mutual children, couples need to understand what they can, and can't, give away by will or trust.

As you can see from the examples below, the need for a written property agreement depends a lot on what state you live in and what your wishes are with respect to each other. Community property states say that married couples own one-half of the assets they acquire during marriage (except for inheritances and gifts), regardless of whose name is on an account or a deed. Common law states say that the spouse whose name is on an account or a deed is the owner, but they also say that a surviving spouse is entitled to a certain share of the estate at the death of a spouse regardless of what that spouse's will or trust says. In either kind of state, a written agreement can override state law. In a community property state, couples can agree that certain assets are owned by only one spouse; in a common law state, couples can agree that a spouse's inheritance rights are different from what the state law dictates.

Here's an easy way to think about it: Wherever you live, if you want to leave less than one-half of your property to your spouse, it's a good idea to see a lawyer and make sure your plan conforms to your state's rules.

Example 1

Daniel and Nora had been married for more than 20 years. Nora had a daughter (Karen) from her prior marriage. Daniel had no children. The couple lived in Daniel's house in California, a community property state, and he had also brought an investment account to the marriage. Daniel continued to add to the investment account during their marriage, and he and Nora paid off the mortgage on the home. Daniel wanted to leave his property to Nora at his death, but he was worried that Nora's adult daughter, Karen, might claim some of the property as her own if Nora died first.

Example 1 (continued)

Daniel and Nora worked with a mediator to write an agreement that stated that the house and investment accounts were Daniel's separate property. Both Daniel and Nora had that agreement reviewed by their own attorneys. Daniel's estate plan leaves all of his property to Nora, or, if Nora doesn't survive him, to his sister, Angela. If Nora dies first, her daughter, Karen, will have no claim on Daniel's property because it has been clearly designated as belonging only to Daniel. Karen can't argue that some of the house and some of the investment account should have belonged to her mother as community property (which she could have done, had Daniel and Nora not signed that agreement).

Example 2

If Daniel and Nora lived in a common law state, say, Massachusetts, then Daniel's house and investment account, which were held in his name alone, would have been considered his separate property. So, they wouldn't need to have a written agreement to make that clear and Nora's daughter from her first marriage, Angela, wouldn't have had a claim against Daniel's estate after he died. Because Daniel's intention was to leave all of his property to Nora at death, she wouldn't have contested his estate plan. But, if Daniel had decided to give her nothing in that estate plan, Nora could have gone to court to contest it. Under Massachusetts law, Nora would have been entitled to $25,000 plus one-half of Daniel's remaining estate—unless she and Daniel had signed a property agreement in which she had waived her inheritance rights.

A property agreement is also useful to reassure one partner that a particular piece of property that has been in their family for generations will stay in the family after they die. (It won't be distributed to the surviving partner's family.) A clear and written statement that the property is separate makes it simple to pass it directly to that person's heirs.

Example

Felicity and Lance had been married for 10 years. All of the property they acquired during the marriage was community property. Felicity's uncle died and left her a farm in Georgia that had been in the family for generations. The farm is Felicity's separate property because she received it as an inheritance. The farm is rented out and generates income that Felicity and Lance use to send their daughter, Camille, to school. Because Felicity wants to make absolutely sure that the farm will not have to be divided in a divorce, she and Lance sign a property agreement stating that the farm, and all income it generates, is Felicity's separate property, regardless of any work Lance might do in the management of the farm.

Example (continued)

In the family trust, Felicity leaves the farm to Camille directly, if Camille survives Felicity, or to Camille's children, if Camille does not survive Felicity. If Camille dies and has no children, the farm goes to Felicity's sister, Ginny. The community assets all go to Camille, too. If Camille does not survive Felicity and Lance, and leaves no children of her own, the trust's community property assets will be divided equally among Felicity's heirs (parents, siblings, nieces, and nephews) and Lance's heirs.

In the absence of a written agreement, heirs might have to sort out the nature of property at the death of one or both spouses. To do so, the survivor (or the ultimate beneficiaries) will look at the title to the property, the funds used to purchase that property, and any other evidence they have of gifts received. If a couple married when they had very little, and all the property was acquired during the marriage or held jointly, that's not such a hard task. But, as I hope this chapter makes clear, that's not true for all families, and failure to define the nature of property beforehand can make things complicated later on. That's why it's a good idea to discuss your understanding of how you own property together during life and create an agreement that makes this understanding explicit.

Unmarried couples don't need to create a property agreement, because their property is clearly separate, but they do need to discuss their intentions and plans with respect to how they will use that property to take care of each other (or not to) when one partner dies. For unmarried couples, estate planning can serve as a means to make these wishes binding and clear.