ESTATE PLANNING TODAY

A Quarterly Publication of

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Vol. 3, No. 3 October 31, 2003

Harder Than Tax Planning–Estate Planning for Blended Families

Estate planning for traditional families presents a variety of challenges to estate planning attorneys. These challenges can be compounded, however, when the family structure includes a second marriage and children from former marriages. Fearing the adage that "you never really know someone until you share an inheritance with them," clients struggle to treat loved ones fairly, and to avoid a situation in which a surviving second spouse attracts resentment (or litigation) from children of a prior marriage, or vice versa. Texas community property rules can compound the problem by blurring the distinction between which assets are "yours," "mine" or "ours." Careful estate planning can minimize a host of problems that might otherwise arise at the death of a member of a blended family.

The Blended Family

Many people are in, or are about to enter into, a second (or later) marriage, after either the death of or divorce from a spouse. One or both partners may have a child or children from a prior marriage. In addition, some of these new couples plan to have children together. Sometimes a child from a spouse's prior marriage is adopted by the new spouse (the child's other parent, if still living, must agree to terminate his or her parental rights in order for the child to be adopted by the step-parent). Sometimes a spouse desires to treat the new spouse's children as his or her own when it comes to passing on assets at death. Parents may have current and future contractual and other legal obligations to their minor (and sometimes to their adult) children, arising from a divorce decree or applicable state law.

Because Texas is a community property state, the marital property characterization of the assets each spouse believes that he or she owns individually, as well as the assets that they acquire together, can be complex. Some couples, recognizing the legal and other problems that can arise from a new marriage, choose instead to cohabitate, without being formally married. This arrangement, without proper planning, can often create more problems than it solves. For a variety of reasons, estate planning for people in new relationships can be extremely complicated.

Estate Planning Challenges

One of the biggest challenges in estate planning for blended families is to coordinate provisions made for a new spouse with those for children from a prior marriage. For example, imagine a married couple who has already raised and educated their children. Suppose that the husband dies first, and the surviving wife remarries. In her new estate plan (created after her marriage to her new husband), she wants to leave virtually all of her assets to her children when she dies. On the other hand, the new husband wants to leave virtually his all of his assets to his new wife upon his death. This frequently encountered scenario may arise from social or cultural mores (i.e., the wife may feel that the husband can and should care for himself; the husband may feel that his children are now adults, capable of taking care of themselves, while the new wife may need long term maintenance and support, and should be remembered for the care and happiness she provides to him). One of the "inequities" of this situation that is often overlooked, however, is that, while the husband is clearly taking care of his new wife by leaving her everything he owns on his death, he has failed to look beyond her death. If she inherits his assets and then dies leaving all of "her" property to her children, all of the

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assets from the husband's original marriage (and his assets from his second marriage) will pass to the wife's children; none will pass to his children from his first marriage. This result can be avoided through proper estate planning.

Use of Trusts and Other "Split" Gifts

Is there a way to take care of one's new spouse without disinheriting one's children? Several estate planning tools address this concern.

One of the most common estate planning solutions, and often the best option if the value of the estate is relatively small, is to use a trust. A trust is merely a device in which ownership of assets is split into two parts: legal ownership of the assets, held by a "Trustee," and "real" or "true" ownership of the assets, held by a "beneficiary." The Trustee holds and manages the assets for the benefit of the beneficiary. The Trustee also makes the distributions of income or principal to or for the benefit of the beneficiary, as called for in the instrument creating the trust. Most trusts are created either in a lifetime document (called an inter vivos or "living" trust), or in a Will, which becomes effective only upon the person's death (called a "testamentary" trust). The same person may be both the Trustee and the beneficiary of the trust, but he or she must carefully follow the terms of the trust, which are the written instructions regarding how the trust is to be handled, or administered, during its term. Using a trust is also a way to split the enjoyment of the assets into two different time periods: now and later. The current beneficiary of the trust may be entitled to some or all of the income produced by the assets in the trust and may also be allowed to enjoy the assets of the trust themselves (i.e., the "principal" or "corpus" of the trust) currently– usually receiving distributions from the trust on a regular basis, such as monthly or quarterly. The "remainder" beneficiaries are entitled to receive the assets that remain in the trust upon its termination (which often occurs upon the death of the current beneficiary). Thus, for example, a husband could provide that, upon his death, his assets pass into a trust created in his Will for the sole or primary benefit of his wife during her lifetime and, upon her death, the assets remaining in the trust are to be delivered by the Trustee to his children from his prior marriage. In this way, he has taken care of his new wife, without disinheriting his children (or allowing his wife to pass his assets on to her children or even to a new husband). Naturally, the wife could make similar provisions in her Will if she so desires.

Sometimes an estate is large enough and contains a sufficient variety of assets so that the assets can be split immediately upon one spouse's death between the new spouse and the children from the prior marriage. Life insurance, annuities, retirement plans and other liquid assets are helpful to have in these situations. For example, if one spouse owns a closely held business or a valuable family ranch or farm, life insurance can be valuable in enabling that spouse's children to continue running the business or ranch, while ensuring that the second spouse is well taken care of. Again, assets can be placed in a trust to achieve professional or other qualified management of the assets for the benefit of the beneficiary, control over the ultimate disposition of the assets remaining in the trust upon termination, and creditor protection of the assets for the beneficiary. Trusts also often help achieve important tax planning objectives.

Excluding/Including Children and Stepchildren

Perhaps a spouse truly does not want the children from his or her first marriage to inherit any of the estate at any time (maybe the relationship with them is strained, or non-existent). Excluding children under your Will is legally allowable. There is no "forced heirship" in Texas. Because children would be legal heirs of a decedent in a second marriage who dies intestate (without a Will), the risk of a Will contest when children are excluded is greater than in many other cases. There are several planning techniques that can be used to discourage a Will contest or other litigation against an estate. One idea is to make a bequest to the potential Will contestants and then include a "No Contest" clause in the Will. This clause provides that if the person challenges the Will, then the gift to him is forfeited. Obviously, a gift of $1.00 is not significant enough to discourage anyone from contesting a Will. The bequest must be large enough to provide "teeth" to the No Contest clause. This technique is sometimes totally unpalatable to the client, but should be considered in appropriate situations, as a way to protect the favored beneficiaries of the estate.

Since the basis for a Will contest is often an alleged lack of testamentary capacity on the part of the Testator at the time when he or she wrote the Will, another idea is to give the potential contestant a small gift by check, delivered on the same day that the Will is signed. It will be hard for the contestant to later argue that the Testator lacked mental capacity on the date of the Will if the contestant cashed the gift check received from the Testator on that same date. There are other planning techniques that can be utilized to minimize the likelihood of lawsuits after death.

What if one of the partners in a second marriage wants to include his or her new spouse's children in the estate plan? This form of estate planning is easy to do.

Typically, the step-children are simply defined as the Testator's children for all purposes of the Will. Keep in mind, though, that while the estate plan of the first spouse to die will become irrevocable at his or her death, the surviving spouse can change his or her own estate plan. There is no guaranty that, after the first spouse dies treating both spouse's children equally, the second spouse won't cut out the deceased spouse's children, leaving everything to his or her own kids or a new spouse.

Impaired Judgment Documents

Estate planning for blended families often addresses other concerns as well. Most clients wish to designate someone to make financial and medical treatment decisions if the client becomes incapacitated. Similar appointments can be made to designate a legal guardian in the event of long term incapacity, or to give family members the authority to make funeral arrangements. *Absent a written designation, state law generally give a spouse legal priority in handling these matters.*

Pre-Nuptial Agreements

All couples who are about to marry, and especially those about to re-marry, should consider signing a pre-nuptial agreement before the wedding. Because we are estate planning attorneys, and not divorce attorneys, our recommendation is made to help avoid a myriad of problems that will arise on the death of one of the spouses. We don't focus on the possibility that the marriage will end in divorce (although the pre-nuptial agreement can prevent problems in that situation as well). Although it is true that assets owned by one spouse prior to marriage are that spouse's separate property, all income derived from those assets during the marriage will be community property, absent a specific, contrary provision in a valid written agreement. It is *not* sufficient to place the assets owned before marriage in a separate account, titled solely in the name of the spouse who owned them prior to marriage. If any income, such as interest, is paid into that same account during the marriage, the community property income will be commingled with the original separate property, thereby "tainting" the entire account and potentially causing it, at some point, to lose its character as that spouse's separate property. In addition, transfers into and out of the account during the marriage can be problematic for the same reason.

When the spouse whose name is on the account dies, the Executor of his estate will have the responsibility of determining whether that account is community or separate property (or partly each). The Executor must begin with the state law presumption that the account is community property and see whether it is possible to show, by clear and convincing evidence, that all or part of the account was the deceased spouse's separate property. This determination has a direct impact on the size of the deceased spouse's estate and, therefore, affects the estate tax liability of the deceased spouse's estate and the distribution of assets to the deceased spouse's beneficiaries. Obviously, this task can be very difficult and potentially risky. This accounting nightmare, with its attendant extra work, additional expense to the estate, and high risk for the Executor, can be avoided by having a good pre-nuptial agreement. The pre-nuptial agreement doesn't have to do more than list and define what each spouse owns as his or her separate property, and what will be the spouse's community property during the marriage. The agreement can allow the spouses to do any type of estate planning they wish with the property they own, including leaving assets to the other spouse at death or giving assets to the other spouse during life. In other words, the agreement need not dictate the terms of any particular estate plan to be effective in alleviating the accounting/characterization problems described above that will arise on dissolution of the marriage, whether by death or divorce.

To ensure that a pre-nuptial agreement is legally binding, it is best for each party to be represented by separate counsel of his or her own choosing. It is sometimes possible for one attorney to represent both people with respect to agreements of this type, but the better practice is to have two attorneys, one for each party.

Post-Marital Agreements

What if a couple in a second marriage did not enter into a pre-nuptial agreement before their marriage and now realize how messy their asset holdings are? A couple can enter into a post-marital agreement that "cleans up" the confusion and prevents further commingling from occurring. In many cases, it is virtually a prerequisite for a post-marital agreement to be signed in order for the couple to do proper estate planning, unless they are willing to take the position that all of the assets held in liquid and/or investment-type accounts (including retirement plans and IRAs) have become community property due to the commingling of income. Again, while it is possible for one attorney to represent both spouses in preparing a post-nuptial agreement, the better practice in most cases is for each party to be represented by separate counsel.

Transmutation Agreements

Sometimes couples desire to treat otherwise separate property as the community property of their marriage. This arrangement requires a different type of post-marital agreement, one referred to as a "transmutation agreement." Again, the agreement is a legal document that should be prepared by an attorney and reviewed by each spouse with his or her attorney. The spouse who originally owned the transmuted property as separate property will be giving up

certain rights under the marital property laws, but is often willing to do so to achieve certain tax and other benefits. Simply re-titling assets into the spouses' joint names does *not* establish property as community property.

Non-Marital Agreements

What if a couple chooses merely to live together and not marry? Problematic issues can arise upon the death of one of these persons as well. When one of the cohabiting persons dies, his or her children may argue that the deceased co-habitant had a "common law" marriage with the surviving co-habitant. Alternatively, the surviving co-habitant may argue that he or she is in fact a surviving common law spouse. A common law marriage (i.e., a marriage entered into by a couple that is not ceremonial, but is based on their holding themselves out to be husband and wife) is a valid form of marriage in Texas (and in many other states). Because all assets acquired during a marriage in Texas are presumed to be community property, establishment of a common law marriage will impact the characterization of the assets belonging to the deceased person's estate. This characterization will affect the disposition of the assets upon the person's death. A couple who wants to live together but who wishes to negate the existence of a common law marriage should enter into a non-marital cohabitation agreement. In addition to negating the common law marriage, the agreement can also list and define the assets that each person owns, and provide for the sharing of certain expenses, such as insurance and property taxes for the home owned by one of them in which both parties reside.

Contact Us:

Naturally, each estate is unique, and this brief overview should not be treated as a substitute for legal advice. If you would like to discuss how the information outlined in this Newsletter applies to your specific situation, you can reach us at the address and phone number shown below, or by e-mail:

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