Estate Planning Insights

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PROBLEM SOLVING: A SECOND MARRIAGE SITUATION

We are going to review a particular estate planning problem that frequently arises and see how we might try to solve the problem. This situation involves a second marriage but, unlike some cases, the married couple either did not execute a Pre-Marital Agreement prior to their marriage or a Post-Marital Agreement, or, if they did, the Marital Agreement defines only certain assets as the separate property of one spouse and, thus, the couple has substantial community property as well. Both spouses have children from their prior marriages and the couple wants to treat all of their children equally on the death of the second spouse.

The Facts of Our Situation. Tom and Sue have been married to each other for 20 years. Both were married previously. They did not execute a Pre-Marital Agreement prior to their marriage and all of their accumulated assets, including their separately titled bank accounts, investment accounts, IRAs, etc., are now community property due to application of Texas law.

Tom has two adult children from his prior marriage, Jim and Lucy, and Sue has two adult children from her prior marriage, Ben and Amy. Although it is a second marriage situation, involving a "blended family", everyone gets along well with each other.

Tom and Sue have approximately $6 million in combined assets at this time. Again, even though some assets are titled only in one spouse's name, all of the assets are (or have become) community property (we have explained how this happens in prior newsletters).

The Desired Estate Plan. Tom and Sue want to use all of their assets to take care of the surviving spouse (the "Surviving Spouse") after the death of the first spouse to die (the "Deceased Spouse"), but they also want to treat all four of their children equally on the death of the Surviving Spouse. We suggest that, instead of using traditional Wills as their primary dispositive estate planning vehicle, they use a joint revocable trust (or "Joint Living Trust") as their dispositive vehicle. Using a Joint Living Trust for their combined plan solidifies the joint nature of their estate plan. (For other advantages of Living Trusts as estate planning vehicles, *see* our April 30, 2005 newsletter, "Revisiting Living Trusts", which can be found on the firm's website, www.gerstnerlaw.com).

A "standard" tax plan, involving the creation of a Bypass Trust and Marital Trust for the benefit of the surviving spouse on the death of the first spouse to die and "lifetime, protective trusts" for children and other descendants (called "Descendant's Trusts") on the death of the second spouse, can be included in the Joint Living Trust. (A Joint Living Trust, like a Will, is merely a *vehicle* for transporting assets upon death. Further, like a Will, as long as the creator of the trust, called the "Trustor", is still alive and not mentally incapacitated, the estate plan in the Trust can be changed and the Trust itself can be revoked).

Tom and Sue want their Joint Living Trust instrument to be drafted to provide that all of their assets remaining on the death of the Surviving Spouse, meaning all of the assets remaining in the Bypass Trust and the Marital Trust (if created) plus all of the assets belonging to the Surviving Spouse, will be distributed in equal shares to separate Descendant's Trusts for their four children on the death of the Surviving Spouse. (If a child fails to survive the Surviving Spouse but leaves any child or other descendant who survives the Surviving Spouse, that child's share will be distributed to Descendant's Trusts for his/her descendants--this is the *per stirpes* distribution that everyone uses.)

The Problem and the Feared Result. The spouses are concerned that, after the death of the Deceased Spouse, the Surviving Spouse will change the couple's joint estate plan by changing her part of the plan. When couples express this concern (and sometimes it is an unexpressed concern that filters through during a planning meeting), the most usual meaning in a case like this is that the Surviving Spouse will "cut out" the children of the Deceased Spouse after the Deceased Spouse's death. (Of course, another concern some people have is that the Surviving Spouse will remarry and change the estate plan to leave some or all of the assets to his new spouse, another complicating factor which we are not specifically

going to address in this newsletter). A mentally competent living Trustor can always change his estate plan, including his part of the plan contained in a Joint Living Trust; however, once a Trustor dies, his part of the plan is "locked in". In a case like this, the Deceased Spouse would not usually give the Surviving Spouse a "power of appointment" over the Bypass Trust or the Marital Trust because that power can be exercised by the Surviving Spouse to change the distribution of those trust assets on the death of the Surviving Spouse. But, merely excising the power of appointment over the Bypass Trust and Marital Trust is not enough to protect the joint plan after the death of the Deceased Spouse. The Surviving Spouse always possesses the ability to change the distribution of her own assets held in the Joint Living Trust (this is called a "retained general power of appointment"). If you try to eliminate this right completely and/or try to make the plan *irrevocable* on the death of the first spouse, you can cause some adverse tax consequences (such as reduction in the marital deduction for estate tax purposes, potential unintended taxable gifts and income tax problems).

In summary, after the death of the Deceased Spouse, the Surviving Spouse (i) can remove all of her assets from the Joint Living Trust and execute a new Will or Trust, or (ii) can amend the terms of the Joint Living Trust that apply to the Surviving Spouse's assets *to eliminate the gifts in favor of the Deceased Spouse's children* on her death. In other words, after the Deceased Spouse has died, his plan of leaving 1/4 to each child when the Surviving Spouse dies will be "fixed" while the Surviving Spouse may change the plan and leave all of her assets to her own children only. If this is done, the children of the Deceased Spouse will be splitting the assets remaining in the Bypass Trust and the Marital Trust with the children of the Surviving Spouse but they will not be receiving any amount from the assets belonging to the Surviving Spouse on his/her death. This is unfortunate, especially since the assets that originally belonged to the Deceased Spouse were placed in the Bypass Trust and Marital Trust for the benefit of the Surviving Spouse rather than given to the Deceased Spouse's children immediately on the Deceased Spouse's death (which is another option to consider in some cases, although such a plan may negatively impact the Surviving Spouse's lifestyle). In other words, the Deceased Spouse took care of the Surviving Spouse but the Surviving Spouse "reneged" on their joint plan and took care of her own children only on her death.

Assumptions and Example: For purposes of our example, assume all four children survive the Surviving Spouse (so that we are working with 1/4 shares). Assume that the applicable estate tax exclusion amount in the year when each spouse dies is at least $3.5 million, so that estate taxes can be ignored in our example (the estate tax exemption is scheduled to reach $3.5 million on January 1, 2009, and it is hoped that Congress will not allow the exemption to drop below that level thereafter). Thus, as a result of the death of the first spouse, the $3 million owned by the Deceased Spouse (i.e., his ½ of the community property) will pass into the Bypass Trust (the Marital Trust will not be funded under our assumptions) and the Surviving Spouse's $3 million will remain in the Living Trust portion of the Joint Living Trust (some trust instruments label the Surviving Spouse's interest in the Living Trust after the death of the Deceased Spouse the "Survivor's Trust"). If the Surviving Spouse does *not* "renege" on the joint plan, assuming the assets are frozen in value so that we are working with the $6 million total estate, each child should receive $1.5 million on the death of the Surviving Spouse ($6 million ÷ 4 = $1.5 million). Of course, it is not really likely that *exactly* $6 million will remain on the death of the Surviving Spouse due to changes in the values of assets between now and when each spouse dies; however, it is possible that the Surviving Spouse can live off the income from the $6 million after the death of the Deceased Spouse and not "touch the principal" so that it is not unrealistic to assume that the principal will still remain (more or less) on the second spouse's death. At the very least, we must indulge in these somewhat artificial assumptions to understand the problem and the proposed solution. Thus, the *desired distribution* on the death of the Surviving Spouse looks like this:

Desired Plan

Jim	$1,500,000	25%
Lucy	$1,500,000	25%
Ben	$1,500,000	25%
Amy	$1,500,000	25%
Total	$6,000,000	100%

If the Surviving Spouse "reneges" on the joint plan after the death of the Deceased Spouse by changing her plan to leave her assets to her children only, the split of assets on the death of the Surviving Spouse would be: (A) 1/4 (25%) to each child from the assets remaining in the Bypass Trust (and also in the Marital Trust, if one had been created) on the death of the Surviving Spouse, and (B) ½ (50%) of the Surviving Spouse's assets to each child of the Surviving Spouse, with no amount (zero [0]) out of the Surviving Spouse's assets to the children of the Deceased Spouse, resulting in fractions of the whole (i.e., of both spouses' combined estate)of 37.5% to each child of the Surviving Spouse and 12.5% to each child of the Deceased Spouse, instead of 1/4 (25%) of all assets remaining on the death of the Surviving Spouse to each of the four children. Here is the *feared result* in this case, assuming Tom dies first in our example:

Feared Result

Jim	$750,000	12.5%
Lucy	$750,000	12.5%
Ben	$2,250,000	37.5%
Amy	$2,250,000	37.5%
Total	$6,000,000	100.0%

Discussion of Some Options. As previously noted, there are disadvantages to some other possible solutions. If the Deceased Spouse leaves all of his assets directly to his children on his death, rather than placing them in a Bypass Trust (or Marital Trust) for the benefit of the Surviving Spouse, while his children will be protected, the Surviving Spouse will suddenly have only half of the assets the couple was utilizing up to that time for her support after the Deceased Spouse's death. Or, if the spouses make their estate plan contractual or irrevocable, either upon creation or on the death of the first spouse, then there could be some negative tax consequences, as well as an increased chance of litigation (due to a breach of contract). There will also be a lot less flexibility. Another option would be to provide from the beginning that the Bypass Trust and Marital Trust assets will pass to the Deceased Spouse's children (only) on the second spouse's death while the Surviving Spouse's assets will pass to the Surviving Spouse's children (only) on the second spouse's death. The only downside of this plan compared to the renege plan is that if the renege plan *works*, the children will receive truly equal shares on the second spouse's death while the former plan often does not work out that way (because the two spouses' respective "pots" may not be divided evenly on the first spouse's death, especially if the couple owns significant pre-tax, non probate assets [such as qualified plans and IRAs], and/or may not remain proportionate in value during the life of the Surviving Spouse, either as a result of disproportionate spending from the various pots by the Surviving Spouse and/or different investment results).

Another Solution: Use a Joint Living Trust estate plan (because the Joint Living Trust plan "feels" more "contractual" in nature compared to mirror image Wills, and requires more effort to change compared to revoking a Will and executing a new Will), consider having the Trustors *fully fund* the Joint Living Trust upon its creation (which also helps to strengthen the "feeling" that the plan is a joint plan and makes it harder to change the plan due to the need to re-title assets), and include "renege" provisions in the Joint Living Trust.

Renege Provisions. Renege provisions work best when both spouses have the same number of children, but even if they do not, they often work better than doing nothing. Many people say that they will just "trust" the Surviving Spouse to abide by their joint plan if they die first. That is all well and good and a nice sentiment; however, as people age, they sometimes become forgetful and sometimes become subject to the influence of others, either or both of which could cause the Surviving Spouse to change the plan later. Further, sometimes the Surviving Spouse just does not remain close to the children of the Deceased Spouse (or conflict could develop between them). These are always tough situations and, of course, no one has a crystal ball to predict the future.

In essence, a renege provision states that if the Surviving Spouse reneges on the joint estate plan and leaves all of her assets to her own children only, then, upon her death, her children do not share in the distribution of the assets held in the Bypass Trust and Marital Trust (if created) and those assets are distributed to the children of the Deceased Spouse only. In this way, the children of the Deceased Spouse are somewhat protected from the truly inequitable result shown in the *Feared Result* case. Assuming, in our example, the Bypass Trust is still worth $3 million at the time of the Surviving Spouse's death, the following shows the result upon the death of the Surviving Spouse in the case where the Surviving Spouse reneges on the joint estate plan, but renege provisions are included in the Joint Living Trust:

Distribution of Bypass Trust assets ($3 million):
Jim $1,500,000
Lucy $1,500,000

Distribution of Surviving Spouse's assets ($3 million):
Ben $1,500,000
Amy $1,500,000

As you will note, this looks exactly like the desired distribution on page 3, although the shares are composed a different way (i.e., from different sources). As noted, however, the best result for the children in all cases will be obtained when the Surviving Spouse abides by the joint plan because no matter how much the assets remaining in the various "pots" are worth on the second spouse's death, all children will receive equal shares. This is especially true in cases where the spouses do not have the same number of children, because the renege provisions cannot always produce the right result in that case.

The Joint Living Trust would have to be custom-drafted to contain other special provisions in addition to the renege provisions, such as making it clear that it is the spouses' mutual intention to treat each other's children as their own children and to treat all of their children equally on the death of the Surviving Spouse. The boilerplate definitions of children and descendants that are included in the spouses' estate planning documents have to be changed as well. The drafting part is our job, of course.

Summary. Second marriages are common these days. In second marriages of long duration, where the children of one spouse have grown to know and love their parent's spouse and that spouse is truly a second mother or father to them, it is not unusual for clients to say that this is the plan they want to have: to take care of the surviving spouse and then treat all of the children equally upon the death of that spouse. The plan discussed in this newsletter--in which all of the children of both spouses are treated equally on the death of the second spouse--is

more popular in cases where most or all of the couple's assets are community property (as opposed to second marriage situations where the spouses have executed either a Pre-Marital Agreement or a Post-Marital Agreement to preserve separate property treatment for some or all of their assets). As noted, there are various ways to deal with these situations and this is certainly not a planning scenario where "one size fits all". In some of these situations, however, using a funded Joint Living Trust containing renege provisions might be helpful. It is one possible solution to an estate planning "problem" that is becoming fairly common.

New Staff. We have two new people at the firm: Jill Gary Hughes, an attorney, and Mary Ann Bandy, a legal secretary/office administrator. You may view their photos and information on the firm's website.

Holiday Greetings and Firm Holidays. It has been our pleasure to assist many clients this year and we thank you for your business and referrals. We also want to wish all of our clients and friends very **Happy Holidays**.

Please note that the firm will be closed on the following dates: Thursday, November 22 and Friday, November 23 for Thanksgiving; Monday, December 24 and Tuesday, December 25 for Christmas; and Tuesday, January 1 for New Year's Day. If you did not come in this year for an estate planning check up and you are "due" for one, we will see you next year!

Contact Us:

If you have any questions about the material in this publication, or if we can be of assistance to you or someone you know regarding estate planning or probate matters, feel free to contact us by phone, fax or traditional mail at the address and phone number shown below.

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