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ESTATE PLANNING FOR BLENDED FAMILIES
August 21, 2008

I. INTRODUCTION

Most estate planning for married couples is done for both spouses on a coordinated basis. The couple usually has a single investment advisor, a single insurance professional, a single CPA, a single banker, and a single attorney advising them. However, spouses often do not share a single goal in structuring their estate plans, especially when one spouse has significantly more money than the other and/or children from a prior marriage. For purposes of this outline, a marriage facing either challenge will be referred to as a "blended family."

Estate planning for "blended families" often requires a balance of the spouses' often divergent interests. Consequently, their advisors must be aware of the potential sources of this divergence in their goals and be prepared to offer solutions for achieving an overall plan that will fulfill both spouses' objectives. Often, the CPA is the first professional called upon to advise spouses on tax planning. The CPA will also often be in the best position to assess whether an attorney should be consulted to prepare foundational estate planning documents/a marital property agreement to accommodate the clients' objectives. Consequently, the CPA must be aware of issues particularly unique to planning for blended families. This outline summarizes some of the more common issues the CPA should expect to encounter during the course of representing a blended family and offers solutions the CPA might propose for addressing those issues. **Note, this presentation does not address the complex ethical issues involved in representing spouses in a blended family.**

This outline begins with a brief overview of basic estate and gift tax principles, followed by an overview of Texas marital property law. This outline will then address the various ways in which a"conventional" estate plan will often fail to address issues commonly encountered with a blended family and will offer solutions whereby spouses can accommodate those unique issues through an estate plan specifically tailored for their situation. This outline also includes a discussion of the issues to be considered in lifetime gift planning for spouses in a blended family and concludes with a discussion of a few additional issues a CPA should be aware of in planning for a blended family.

This outline assumes the following:

- The engagement of a tax advisor's services will not occur until after a blended family has been established. However, many of the concerns addressed in this outline should ideally be considered and addressed prior to marriage. Generally, most of what can be accomplished in a "marital property agreement" between spouses can be accomplished in a prenuptial agreement between prospective spouses (although certain applicable Texas statutes refer to "spouses," indicating exceptions to this rule). Consequently, any reference in this outline to a "marital property agreement" should be read as an agreement between spouses, although the objective of the agreement may be accomplishable through a prenuptial agreement (counsel should be engaged to confirm that result).

- The Husband will be the first spouse to die.

For ease of reference, the following applies:

- References in this Outline to "IRC" are to the Internal Revenue Code of 1986, as amended.

- References to "TFC" are to the Texas Family Code.

- References to "TPC" are to the Texas Probate Code.

- A reference to a "Will" should also be interpreted as a reference to an estate plan in which a "pour over Will" is used and the main dispositive vehicle in the plan is a revocable management trust.

II. <u>SHORT COURSE IN ESTATE AND GIFT TAX PRINCIPLES</u>

The following is a brief overview of several concepts integral to the estate and gift tax system impacting planning for blended families.

A. <u>General Nature of Estate and Gift Tax System</u>. The federal tax laws impose a tax on the lifetime and testamentary transfer of assets.

To the extent an individual makes taxable gifts (described below) over the course of his/her lifetime collectively in excess of his/her $1,000,000 lifetime gift tax exemption amount, gift tax will be due. The donor is responsible for paying any gift tax due.

At death, the executor of an estate is required to (i) aggregate and value all assets owned by the decedent as of the date of death (or otherwise included in the decedent's estate under the IRC pursuant to Sections 2031-2044), (ii) subtract all debts and expenses, (iii) deduct amounts passing to the decedent's spouse, a qualified charity, or to a qualifying trust for either (for a qualifying charitable trust, limited to the charitable interest in the trust), (iv) combine that net amount with all taxable gifts made by the decedent during life (even if collectively within the gift tax exemption amount), and (v) pay estate taxes on the balance to the extent it exceeds the applicable estate tax exemption amount (described below).

B. Applicable Exemptions For Gift And Estate Taxes.

1. Gift Tax Exemption Amount. The IRC provides each individual with a lifetime exemption against gift taxes equal to $1,000,000. As a result, each individual may make up to $1,000,000 in "taxable gifts" (discussed below) during the course of his/her lifetime without having to pay any gift tax. In the event a person makes in excess of $1,000,000 in taxable gifts during life, the excess will be subject to gift taxes. A "taxable gift" is a gift (or a portion of a gift) that does not qualify for any of the following:

a. Unlimited marital deduction for gifts made either directly to a spouse or to a qualify trust for the spouse's benefit (discussed below);

b.* Unlimited charitable deduction for a gift made to a qualifying charity, either directly or via a qualifying trust, such as a charitable remainder trust or charitable lead trust (as discussed below, only the charitable portion is eligible for the charitable deduction);

c.* Gift tax annual exclusion amount (currently $12,000 per donee, or $24,000 per donee if the election to "gift-split" is made by spouses pursuant to IRC 2513); or

d. Gift tax exclusion for gifts made to the provider of qualifying educational or medical care services pursuant to IRC 2503(e).

*Note, a gift to a charitable remainder trust or a charitable lead trust may qualify in part for the charitable deduction but also result in a taxable gift with regard to the portion of the gift representing the noncharitable beneficiary's interest. Similarly, a gift to an individual may qualify in part for the gift tax annual exclusion amount, leaving the excess amount of the gift to be considered a taxable gift.

2. Estate Tax Exemption Amount.

The IRC also provides each individual with an exemption against estate taxes in an amount currently equal to $2,000,000 but scheduled to adjust in the manner described below. However, the aggregation of an individual's lifetime taxable gifts with his/her gross estate at death effectively causes his/her estate tax exemption amount to be reduced by his/her use of his/her $1,000,000 lifetime gift tax exemption amount. In the event a decedent transfers at death property in excess of his or her estate tax exemption amount (taking into account any lifetime taxable gifts), such excess will be subject to the estate tax except to the extent the charitable or martial deduction applies.

As a result of the 2001 Tax Act, the estate tax exemption amount will gradually increase to $3,500,000 and subsequently fluctuate as follows (however, again, the gift tax exemption amount is frozen at $1,000,000):

YEAR OF DEATH	AVAILABLE EXEMPTION
2008	$2,000,000
2009	$3,500,00
2010	ESTATE TAX REPEAL
2011	$1,000,000 (under current law, although this is likely to change through future legislation)

C. Unlimited Marital Deduction. Congress passed the Economic Tax Recovery Act in 1981, which provided married individuals with the opportunity to transfer an unlimited amount of property to and between each other (or to a qualifying marital trust for the other spouse described in IRC 2056) without paying any gift or estate taxes on the transfer. The rationale behind the enactment of the unlimited marital deduction was to treat married individuals as one economic unit and therefore exempt transfers between them for federal wealth transfer tax purposes. For example, if one spouse dies and leaves property to the other spouse under his or her Will in excess of the $2,000,000 estate tax exemption amount, the deceased spouse's estate would otherwise be required to pay a federal estate tax on the excess in the absence of the marital deduction. However, the unlimited marital deduction provides that to the extent property is left to the surviving spouse, outright or in a qualifying marital trust, such property will not be exposed to potential federal estate taxes until the death of the surviving spouse. Thus, with a properly designed estate plan, spouses can together exempt an amount of property equal to the combination of their respective estate tax exemptions, or currently $4,000,000 (assuming each death occurs in 2008).

D. Unlimited Charitable Deduction. Each individual has the opportunity to transfer property to a qualified charity described in IRC 2522 and 2055 (either directly or via a qualifying trust, such as a charitable remainder trust or charitable lead trust) and receive at least a partial charitable deduction in return. If the gift is made free of trust to a qualifying charity or to a "zeroed-out" charitable lead trust, an offsetting charitable estate or gift (as applicable) deduction will be secured and no estate/gift tax exemption will be used in the process. If a gift is made to a charitable remainder trust or to a charitable lead trust that is not "zeroed-out," the donor/decedent will receive an offsetting charitable estate or gift (as applicable) deduction equal to the actuarial value of the charitable interest and will be required to use gift/estate tax exemption on the noncharitable portion of the gift (and possibly pay gift/estate tax depending upon the size of the noncharitable portion of the gift and the amount of exemption remaining at the time of the gift).

E. Generation-Skipping Transfer Tax ("GST"). Congress was concerned that wealthy individuals might seek to circumvent additional gift or estate taxes by transferring their assets in such a way so as to bypass their children for federal wealth transfer tax purposes. For example, one can transfer assets to a trust for the lifetime benefit of a child, with any remaining assets passing at the child's death to grandchildren (or trusts for them). Even though the child receives benefits from the trust during his or her lifetime, the remaining assets passing at the child's death to grandchildren (or trusts for them) will not be subject to inclusion in the child's estate for federal estate tax purposes (i.e., it will “skip”) if the trust is properly structured because the remaining assets will be owned by the child's <u>trust</u> (and not the child) at death.

To curb these perceived tax "abuses," Congress enacted the GST provisions as part of the 1986 Tax Reform Act. In addition to applicable gift or estate taxes, the GST provisions impose a flat tax on transfers which "skip" generations for federal gift and/or estate taxes equal to the highest marginal estate tax rate in effect at the time of the "skip." Fortunately, however, Congress likewise provided each person with a GST exemption wherein assets can still be "skipped" through successive generations without being subject to such additional GST taxes. The GST exemption matches the estate tax exemption amount described in the table on the preceding page and can be allocated to gifts made directly to grandchildren (or individuals deemed to occupy the grandchildren’s generational level pursuant to IRC 2613), or to trusts for which a grandchild (or a member of a grandchild’s generational assignment) is either currently a beneficiary or will ultimately become a beneficiary (subject to the inability to allocate GST exemption during an “ETIP” period, described in IRC 2642(f)).

III. SHORT COURSE ON MARITAL PROPERTY LAW

Generally, the law of the state where spouses reside at the time either of them acquires title to an asset will control the nature of the ownership of that asset. Generally, the character of property follows spouses as they move from state to state (see an exception to this rule discussed below referred to as “quasi-community property”). Texas is one of ten states (including New Mexico and Louisiana) which follow the "community property" system. The community property system manifests the social and legal belief that property acquired by spouses during marriage should be construed as one total "community" of property. Regardless of how title to community property is taken, it belongs to the marital partnership in the absence of a written agreement to the contrary. In the non-community property states ("common law" states), for most purposes, property acquired during marriage is deemed to be the separate property of the spouse who acquired it.

In Texas, all property owned by spouses is either "community property" or the "separate property" of one of the spouses. A spouse's separate property is his or her own, but community property is owned one-half by the husband and one-half by the wife during the marriage and divided accordingly at death (but not necessarily upon divorce, as discussed below). The character of property is important in the estate planning context because of the many legal consequences that derive from property being either community or separate. For instance, the character of property determines (i) how it is managed and controlled by the respective spouses during marriage and following the death of a spouse; (ii) what liabilities it is subject to; (iii) various tax aspects of the property; and (iv) how it is divided and distributed at the termination of the marriage by death or divorce.

A. <u>Definition of Separate Property</u>. The Texas Constitution, the Texas Family Code, and the Texas Courts define a spouse's "separate property" as (although spouses can agree otherwise in writing):

1. Property owned or claimed by the spouse before marriage.

2. Property acquired during the marriage by gift, devise or inheritance.

3. Amounts recovered for personal injuries sustained by the spouse (except for money paid for loss of earning capacity, which is community property).

4. All income or property arising from a gift of property from one spouse to the other.

5. Assets acquired during marriage with separate funds, or with the proceeds of the sale of separate assets. An increase in the value of separate property is still separate property.

6. Bonuses and royalties from separate property minerals.

7. A gift of property from a third party to both spouses. In this case, one-half of the property would be held by each spouse as tenants in common (i.e., a gift cannot be made to the community).

The owner-spouse retains full ownership of his/her separate property in the event of a divorce and retains full discretion to dispose of such property in any manner he/she deems fit upon death, unless a different distribution of the separate property is otherwise required under a marital property agreement.

As a caveat, the surviving spouse has an absolute right in Texas (the “homestead right”) to continue residing rent-free in the property the spouses shared during their joint lifetime as their primary residence. The homestead right applies even if the residence was the deceased spouse’s separate property and ownership of the residence passed at his/her death to his/her children. In that event, the deceased spouse’s children will not be able to sell the residence so long as the surviving spouse wishes to continue living there. The surviving spouse will even retain this right to reside rent-free in the residence if he/she remarries.

If the surviving spouse exercises his/her homestead right, he/she will be responsible for paying upkeep costs, property taxes, and mortgage interest (but not principal). The actual owner of the residence will be responsible for paying the mortgage principal payments and casualty insurance premiums. If the spouses owned the residence as community property but the deceased spouse’s children from a prior marriage receive his/her interest in the residence at death, the surviving spouse will bear ½ of these expenses, and the children will bear the rest.

Other “spousal” rights exist under state law, but exclude the scope of this presentation.

B. Definition of Community Property. The Texas Family Code negatively defines "community property" to be all property acquired during marriage that is not "separate property." TFC § 3.002. Some examples of community property include (although spouses can agree otherwise in writing):

1. Income of either spouse's separate property and income from community property.

2. Income acquired by either spouse as compensation for services.

3. Offspring from separate property animals.

Community property is owned equally by spouses during the marriage (e.g., a gift of community property is deemed a gift of ½ of the property by each spouse). Upon the death of the first spouse to die, the deceased spouse may dispose of his/her ½ of the community estate in whatever manner he/she chooses, and the surviving spouse takes his/her ½ of the community.

Although each spouse technically owns ½ of each community asset, typically a non pro rata settling of the community estate upon the death of the first spouse to die should be authorized in the deceased spouse's Will. As a result, the executor of the deceased spouse's estate and the surviving spouse <u>should arguably</u> be able to divide up the community other than on a strictly pro rata basis (i.e., ½ of each community asset for each) without having to worry about incurring capital gains on any post-death appreciation. (If a non pro rata funding is not authorized, pursuing it will likely result in the recognition of capital gains as a result of each of the estate and the surviving spouse being deemed to have received an equal ½ in each community asset followed by an exchange of assets resulting in the actual desired division of the community estate.) As a caveat, the speaker is not aware of any binding authority issued by the IRS "blessing" this type of authorized non pro rata setting of the community estate in the deceased spouse's Will, although theoretically it should be permitted. Query whether this approach would be more supportable if a non pro rata division of the community property were authorized in a fully funded revocable management trust created by both spouses that becomes irrevocable upon the death of the first spouse to die.

However, community property is subject to a "just and right" division in the event of a divorce, with the court giving "due regard for the rights of each party and any children of the marriage." In other words, community property is not automatically divided equally between the spouses in the event of a divorce.

Note, the spouses can choose to override these results in a marital property agreement.

C. <u>Presumption of Community Property</u>. In Texas, all assets possessed by either spouse during or at dissolution of the marriage (i.e., upon divorce or the death of the first of the spouses to die) are presumed to be community property.

The evidence needed to overcome the presumption must be "clear and convincing" evidence. The community presumption is especially strong in cases where there has been commingling or mixing of separate and community property, as in a bank account. It is thus possible that if adequate records are not kept, separate property may lose its identity and become community property. The burden is on the spouse contending that the property is not community property to prove the separate property character of the property. This is often difficult to do.

Commingled separate property will not be community if it can be traced to its separate property origin. However, there is no reimbursement for separate property that has become community property by commingling.

D. Inception of Title Rule. The separate or community character of an asset is determined at the time the asset is acquired. If title to an asset is acquired before marriage, it is the acquiring spouse's separate property. If, thereafter, improvements are made on the property by the expenditure of community funds or labor, this does not change the property's character or classification as separate property, but raises only the possibility (usually in the event of divorce but sometimes at death) of a claim by the other spouse for reimbursement for the community funds expended.

A spouse's interest in an asset is determined according to the laws of the state in which the couple was domiciled at the time the asset was acquired. That original character is not altered when the couple thereafter moves to a community property state. For example, in a common law state, property acquired from a husband's efforts during marriage is "his" property, and if the couple thereafter moves to Texas, it remains his "separate property." However, see the discussion below regarding “quasi-community property” for an exception to this rule.

E. Quasi-Community Property. A natural extension of the inception of title rule applies when spouses migrate from a non-community property state to a community property state like Texas. The general rule is that property acquired in a non-community property state will maintain its character as determined under the laws of the state in which the property was acquired. Accordingly, when a property is owned by one spouse and the couple moves to Texas, the property will be considered the separate property of the owner spouse. Since this rule of law could result in a severe injustice to a couple which has recently moved to Texas and then obtains a divorce, the concept of quasi-community property was developed to protect such spouses. Quasi-community property is generally determined to be property which would have been community property if acquired in Texas. Quasi-community property is capable of division upon divorce as if it were community property. *See, Cameron v. Cameron,* 641 S.W.2d 210 (Tex. 1982).

THE QUASI-COMMUNITY PROPERTY RULE IS APPLICABLE ONLY UPON DIVORCE. IT IS NOT APPLICABLE UPON THE DISTRIBUTION OF ASSETS UPON THE DEATH OF A SPOUSE. TFC § 7.002(1).

F. Planning For Texas Residents. The laws of the State of Texas regarding community and separate property apply to married persons while domiciled in the State of Texas. Accordingly, when spouses move to Texas from a non-community property jurisdiction, all of their assets become subject to the rules regarding marital property characterization. As indicated previously, the general rule is that property acquired in a non-community property state will maintain its character as determined by laws of the state in which the property was acquired (subject to the quasi-community property rule). However, once the spouses become domiciled in Texas, all income and earnings on all property is the community property of the spouses. Most people moving into a community property jurisdiction are unfamiliar with the property characterization laws. Accordingly, at a minimum, all couples should be advised as to the community property system (as discussed above) and also be advised to take one of the following actions:

1. **<u>Do Nothing</u>.** If the clients do nothing with respect to their financial affairs, all of the income generated by the separate property of either spouse will be community property. In many cases, the community property income will become co-mingled with the original separate property corpus, and at some point, the separate property may become untraceable. As a result of the presumption that all property is community property, unless it can be shown by clear and convincing evidence that it is the separate property of one spouse, the co-mingling may unintentionally convert separate property into community property by default.

2. **<u>Do Nothing But Keep Very Good Records</u>.** A second alternative is for the clients to simply keep very accurate records as to the initial corpus of the separate property and allow the accumulation of community property income. This method would preserve the separate property character of the initial corpus and provide the clear and convincing evidence as to its separate property character.

3. **<u>Keep The Income And Corpus Separate</u>.** In order to facilitate the record keeping, the clients may wish to arrange their financial affairs so that each spouse's separate property is held in a separate revocable management trust created solely for that spouse' s benefit and then provide for any community property income earned by those assets (e.g., interest and dividends) to be segregated (or "swept out") into a separate community property account or joint revocable management trust.

4. **<u>Marital Property Agreement</u>.** The final alternative (and often the recommended alternative) for the clients is to enter into a marital agreement prepared which clarifies the character of the property and the income generated by the property. A marital property agreement can accomplish the following:

    - Provide for specific assets (e.g., a bank account) to be considered one spouse's separate property (even if it would not be so classified in the absence of the agreement) and provide that all income generated by that asset will be separate property. This avoids any need to "sweep out" what would otherwise be community property income earned by a separate property asset to avoid the commingling that could otherwise occur. To be effective, such agreements must meet all the requirements of TFC § 4.101, et. seq.

    - Alternatively, provide for either spouse's separate property (or specific separate property assets) to be considered community property, thus avoiding a need to trace the origin of assets at the time of death and qualifying the asset for a full "step up" in basis at the death of the first spouse to die (regardless of whether that spouse was the original owner). As a caveat, converting separate property into community property will subject the converted asset to a 'just and right" division in the event of a divorce and will give each spouse the right to dispose of ½ of the asset at death (and generally the entire asset during life if it is a spouse's sole management community property), whereas the asset would have been unconditionally retained by the original owner-spouse in either event had he/she retained the asset as his/her separate property. Converting a spouse' s separate property into community property may also alter the original owner-spouse's management rights with regard to the property (unless otherwise retained in the marital property agreement) and may subject the converted property to the other spouse's creditors when the property would have been exempt from those claims if it had retained its separate property character. To be effective, such agreements must meet all the requirements of TFC § 4.201, et. seq.

- Provide for the manner in which property is to be divided in the event of death or divorce. To be effective, such agreements must meet all the requirements of TFC § 4.101, et. seq.

5. **Summary Of Planning.** Regardless of which action the clients decide to take, it is important that they (i) understand the basics of the community property regime and (ii) understand the consequences of the characterization of property as it relates to distribution upon death, division upon divorce, management during the marriage, creditor claims, and the issues related to taxation of such assets. Note that the marital property characterization of interests in trusts, partnerships, life insurance, and retirement benefits involve many complicated factors, the discussion of which is beyond the scope of this presentation.

IV. THE ROLE OF PROPERTY CHARACTERIZATION IN ESTATE PLANNING

The characterization of marital property plays an important role in the estate planning process. How property is distributed upon death of a spouse, the management of the assets during marriage, the rights of creditors both during the marriage and following the death of a spouse, and the taxation of such property are all affected by the character of the property held by the spouses.

A. Distribution Of Marital Property Upon Death. Upon the death of a spouse, his or her interest in probate property may pass by a Will (or via a Pour Over Will directing the probate estate into a revocable management trust becoming irrevocable at death). In the absence of such an arrangement, the laws of descent and distribution (i.e., intestate distribution) will apply with regard to the distribution of the probate estate. As an exception to these rules, certain assets pass in accordance with a beneficiary designation (e.g., an insurance policy or retirement account) or in accordance with the titling on an account (e.g., an account or other asset held in a joint tenancy with rights of survivorship format or in a "P.O.D." format).

1. **<u>Intestate Distribution</u>.** The laws of descent and distribution in the Texas Probate Code determine the distribution of the decedent's probate property in the absence of a Will (or a revocable management trust providing for that result). Specifically, § 38 of the Texas Probate Code deals with the distribution of separate property and § 45 of the Texas Probate Code deals with the distribution of the community property assets. It is important to note that the concept of quasi-community property is not applicable to the distribution of assets upon the death of a spouse.

   a. **<u>Separate Property Intestate Distribution</u>.** Section 38(b) of the Texas Probate Code provides that if a person dies leaving a spouse, then the surviving spouse will take ⅓ of the personal estate and the balance of the personal estate shall go to the children and the descendants of the deceased. In addition, the surviving spouse will be entitled to an estate for life in ⅓ of the land, with remainder to the children and descendants of the deceased spouse. If there are no children, then the surviving spouse shall be entitled to all of the personal estate and to ½ of the land, and the other half of the land will pass to the decedent's heirs at law (unless the deceased spouse has no living parent, sibling, or issue of a sibling, in which event the surviving spouse will receive the entire estate).

   b. **<u>Community Property Intestate Distribution</u>.** Section 45 of the Texas Probate Code provides that upon the death of a spouse, ½ of the community estate is owned by the surviving spouse. In other words, the laws of intestate distribution do not affect the surviving spouse's interest in the community property. The decedent's interest in the community property, will pass to the surviving spouse if the deceased has no children or descendants, or all surviving children and descendants of the deceased spouse are also children and descendants of the surviving spouse. If there are children or descendants of the deceased spouse who are <u>not</u> children of the surviving spouse, then the deceased's ½ interest in the community property will pass to all children and descendants of the deceased spouse.

2. **<u>Testate Distribution</u>.** Under the laws of Texas, a decedent has the right to dispose of his or her interest in all property. Therefore, a decedent's Will typically disposes of 100% of his or her separate property and his or her ½ interest in the community property (or a Pour Over Will directing the probate estate into a revocable management trust becoming irrevocable at death will provide for that result). If the Will of the decedent attempts to distribute the surviving spouse's interest in the community property, the surviving spouse may be put to a "widow's election."

From an estate planning perspective, it is therefore very important to not only know the client's assets, but also to know the separate or community property character of the property.

B. Management Of Assets During Marriage.

1. **Separate Property.** A spouse has the authority to manage and dispose of his/her separate property without the joinder or consent of the other spouse.

2. **Sole Management Community Property.** Each spouse has the sole right to control, manage and dispose of the community property that he or she would have owned if single, including but not limited to personal earnings, separate property income, recoveries for personal injuries and income from sole management community property (which is generally referred to as a spouse's "special community" property). The Texas Family Code also allows a measure of protection to third parties dealing with a spouse by providing that property held in a spouse's name or in his or her possession and not subject to written evidence of ownership is presumed to be subject to the sole management and control of that spouse. Also, a third person dealing with a spouse is entitled to rely on the spouse' s authority to deal with the property if the property in question is presumed to be subject to the sole control of the spouse and the person dealing with the spouse is not a party to fraud on the other spouse or another person and does not have actual or constructive notice of the spouse's lack of authority.

3. **Joint Management Community Property.** Joint management community property is all other community property other than the sole management community property. Such property is subject to the joint management and disposition decisions of the spouses.

C. Rules of Marital Property Liability.

1. The Texas Family Code provides that each spouse has a duty to support his or her minor children and the other spouse when the other spouse is unable to support himself or herself. A spouse who fails to discharge this obligation is liable to any person who provides such support.

2. The Texas Family Code also provides specific rules for marital property liability:

   (a) A spouse's separate property is not subject to liabilities of the other spouse unless both spouses are liable by other rules of law.

   (b) Community property subject to a spouse's sole management (special) is not subject to non-tortious liabilities of the other spouse (i.e., bank debt) incurred during the marriage or any liabilities of the other spouse incurred before marriage unless both spouses are liable by other rules of law.

(c) All community property is subject to tortious liabilities of either spouse incurred during marriage.

(d) Different rules may apply with respect to federal tax liabilities, even if the tax liabilities were incurred prior to marriage.

The chart on the following page illustrates the application of these rules.

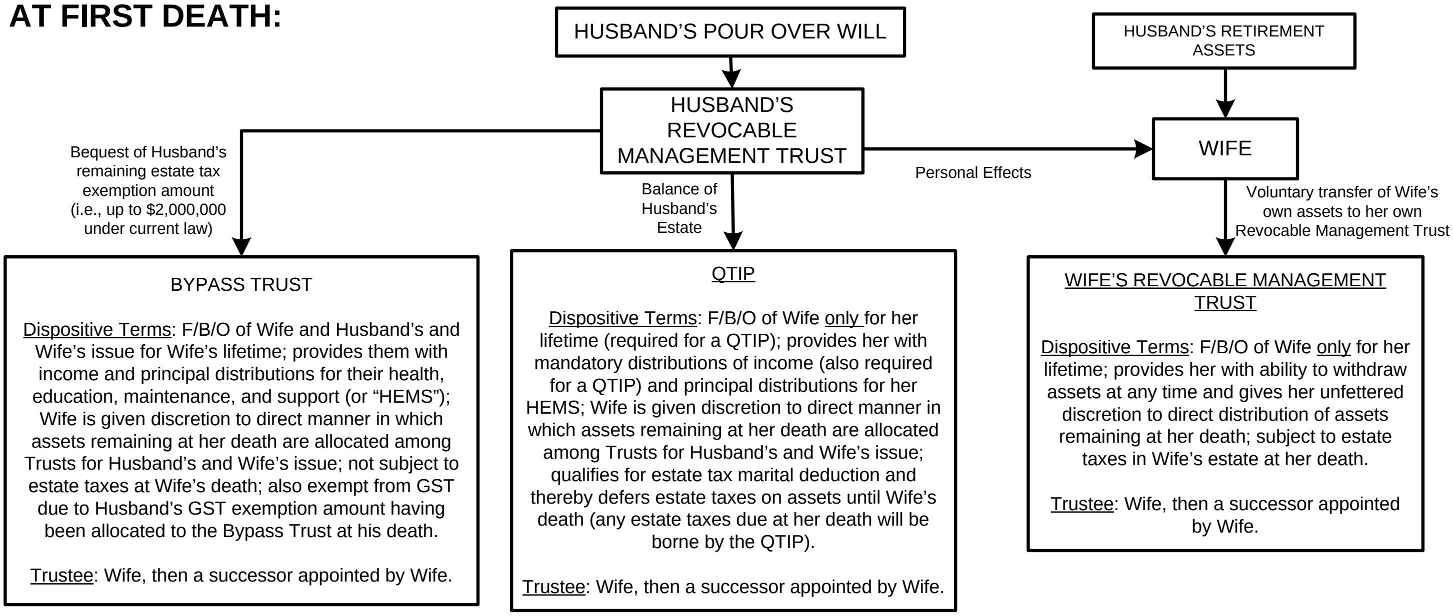
PROPERTY SUBJECT TO LIABILITY
(UNLESS BOTH SPOUSES ARE LIABLE BY OTHER RULES OF LAW)

	TYPE OF LIABILITY	Joint Management Community Property	Sole Management Community Property	Separate Property
1.	Contracts of Other Spouse Before Marriage	X		
2.	Contracts of Other Spouse During Marriage	X		
3.	Torts of Other Spouse Before Marriage	X		
4.	Torts of Other Spouse During Marriage	X	X	
5.	Debts Incurred by Other Spouse for Necessities	X	X	X
6.	Own Contracts (Before or During Marriage)	X	X	X
7.	Own Torts (Before or During Marriage)	X	X	X

V. TESTAMENTARY PLANNING FOR BLENDED FAMILIES

A. **<u>Typical Estate Planning for Married Couple</u>**. The following reflects a typical estate plan for a married couple with (i) no children from a prior marriage, (ii) relative equality in wealth, and (iii) a reasonable probability of a need to take advantage of both spouses' estate tax exemption amounts (i.e., the collective value of their combined estate is expected (allowing for reasonable growth) to exceed the estate tax exemption amount applicable at the second spouse's death, making a simple "all to the survivor" approach inadvisable for tax purposes):

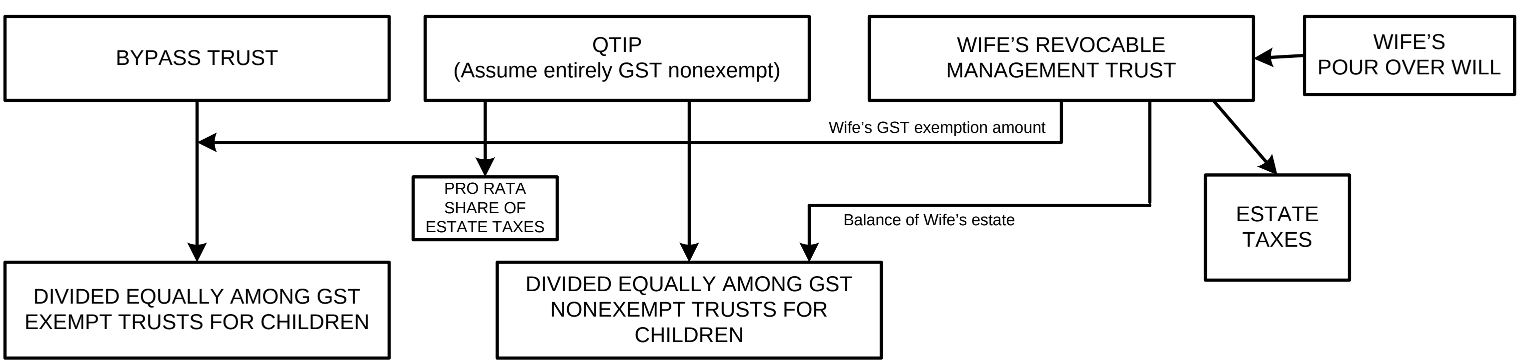
AT FIRST DEATH:



NOTE: The portion of Husband's estate in excess of his estate tax exemption amount could alternatively pass to Wife free of trust and still qualify for the marital deduction. While obviously giving Wife outright ownership of that portion of Husband's estate would not be recommended for a blended family (unless the Family Trust were itself considered to provide satisfactorily for Husband's children from a prior marriage), many estate planners favor the use of a QTIP even for first marriages due to the protection the trust format provides against creditor claims and distributions of Husband's estate to non-family members (e.g, Wife's new husband).

The QTIP approach also enables Husband to obtain full use of his GST exemption amount in the event it exceeds the amount necessary to allocate to the Bypass Trust at Husband's death to cause it to be GST exempt. This situation might occur if Husband had made taxable gifts directly to children during his lifetime (i.e., requiring use of his lifetime gift tax exemption amount and thereby reducing the available estate tax exemption amount at his death but without a corresponding use of his GST exemption amount). However, for purposes of this chart, it is assumed that Husband's estate tax exemption amount and GST exemption amount will be equal at his death.

AT SECOND DEATH:



NOTE: If spouses' combined estate is sufficiently large enough to make it likely that estate taxes will be due at the second death, lifetime gifting to children/grandchildren/charity may also be advisable, depending upon the clients' situation and goals.

B. **Reasons Why the "Typical Estate Plan" May Not Work for a BlendedFamily.**

The above-described plan may not be an advisable plan for a blended family for one or more of the following reasons:

- **Potential Problem #1**: A situation is created whereby children from the Husband's first marriage are required to survive their stepmother in order to obtain any of their inheritance. This is particularly problematic if Wife is in the same (or lower) generation as Husband's children.

- **Potential Problem #2**: As the remainder beneficiaries, the children from Husband's first marriage may constantly challenge Wife's entitlement to discretionary distributions under a HEMS standard (income distributions are mandatory for a QTIP).

- **Potential Problem #3**: If Wife is the trustee (a conventional approach), the children from Husband's first marriage may take issue with Wife's investment and management of the trust assets (e.g., given that Wife is entitled to mandatory distributions of income from the QTIP, the children may be inclined to view her choice of investments for the QTIP as being unnecessarily weighted to income producing assets).

- **Potential Problem #4**: If Husband has adult children from his first marriage and young children from his second marriage, providing for all of his children to share equally at Wife's death in his estate may not be "fair" if the adult children from his first marriage have already received significant financial support from Husband. For example, if Husband has already paid (or set aside money in a 529 Plan) for his children from his first marriage to attend college/grad school, it may make sense for his younger children from the second marriage to receive a larger share of his estate in recognition of this fact.

- **Potential Problem #5**: Although passing Husband's retirement assets directly to Wife may make the most sense for income tax purposes (i.e., Wife can roll over the accounts into her own IRA and use her own life expectancy (calculated based upon the advantageous Uniform Lifetime Table) for "stretch out" purposes), this arrangement gives Wife the ability to name the designated beneficiary for the account and thus provide for the account to ultimately pass other than to Husband's children from his prior marriage.

- **Potential Problem #6**: If Husband is the "poorer" spouse (i.e., he has little or no separate property of his own in addition to his ½ of the community property), there is a potential that the Bypass Trust created at Husband's death under his estate plan will be underfunded. This is becoming more and more important as the estate tax exemption amount rises.

EXAMPLE: Assume that Mr. and Mrs. Peal have a $2,000,000 community property estate and Mrs. Peal has inherited $2,000,000 worth of property, which she holds as her separate property. If Mr. Peal dies first, his entire estate will consist of his $1,000,000 interest in the community property estate. If such property passes to a Bypass Trust for the benefit of Mrs. Peal, such assets will not be included in Mrs. Peal's estate, however, she will have a gross estate of $3,000,000 (i.e., $1,000,000 in community property and $2,000,000 in separate property). Had Mr. and Mrs. Peal's combined estate been split evenly for <u>estate tax purposes</u> at each death, no estate tax would have been owed.

- **<u>Potential Problem #7</u>**: Husband's children from a prior marriage may have a sentimental attachment to certain personal effects/household furnishings (particularly if Husband remarried after their mother's death). This may be addressed simply by providing for those items to pass directly to those children at death. However, Wife may wish to have continued use of those items, and Husband may be reluctant to deny her that use.

- **<u>Potential Problem #8</u>**: If each of Husband and Wife have children from prior marriages and those children have all essentially grown up together, Husband and Wife may wish to treat all children as being the children of both spouses. If so, Husband and Wife may believe a conventional plan will work for them. However, there is a great potential for Wife to change her estate plan after Husband's death, even though at that point her children will have become irrevocably entitled to share equally in Husband's estate along with his children as remainder beneficiaries of the Bypass Trust and QTIP.

C. **<u>Potential Solutions</u>.**

- **<u>Potential Solution to Potential Problems #1, #2, and #3</u>:** Consider "carving out" a portion of Husband's estate for Wife sufficient to ensure she will be able to maintain her lifestyle (or appropriately supplement a lifestyle afforded by her own estate). Provide for Wife to receive this amount either outright or in a QTIP over which she has complete dispositive discretion at her death (i.e., Husband's children are not the remainder beneficiaries) and for which the default takers are her own children or other beneficiaries of her choosing. Provide for the balance of Husband's estate to pass in trust to his children from his prior marriage. As a caveat, diving the estate between Wife and the children based upon a "community property" or "separate property" characterization of assets will likely create challenges to classifications and make tracing of assets key and burdensome. Consider instead dividing the estate based on dollar amounts or percentages. Also, keep in mind that fluctuations in the amount of the estate tax exemption amount may cause a bequest to the children's trust tied to the exemption amount to create a situation in which the children's trusts receive a greater (or smaller, if 2011 ushers in a permanent reduction in the exemption amount) portion of the estate than envisioned by the parent.

Alternatively, create an ILIT for the benefit of Husband’s children so that they have the insurance proceeds available for their use at Husband’s death. Provide for the probate estate to pass to Wife (either outright or in trust, as appropriate). Note, an exception to this approach would likely need to be made if specific planning for a family business, farm, or ranch is required. If Husband is set on providing for any of those assets to be held for Wife’s benefit during her lifetime, consider seriously providing for the affected assets to be held in a Trust over which Wife has no dispositive authority at her death (with the children or trusts for their benefit as the remainder beneficiaries).

- **<u>Potential Solutions to Potential Problems #2 and #3 (If a “carve out” is not feasible or desired)</u>:** If Wife wants to serve as Trustee, consider giving her a testamentary power of appointment whereby she can rearrange the manner in which Husband's children/grandchildren are to share in any assets remaining at her death in the Bypass Trust and the QTIP. In doing so, Wife is given the ability to "cut out" an otherwise meddlesome child from sharing in the assets remaining at her death, the threat of which is often sufficient to cause a "change of heart." Of course, the possibility of Husband's children uniting to challenge Wife's management of the Trusts prevents this approach from being a fail safe alternative.

  Alternatively (or in conjunction with giving Wife a testamentary power of appointment), appoint a third party trustee (e.g., a bank) so Wife will not have to endure accusations of having managed the Trusts in a self interested manner. Consider giving a third party trustee the ability to make distributions in addition to those under a HEMS standard in order to avoid having to demonstrate a "need" each time a distribution is made. As a result, Wife will still be entitled to distributions under a HEMS standard (i.e., she can challenge a non-cooperative bank’s refusal to distribute assets for her support), but the third party trustee will not have to justify "close call" distributions since it will have discretion to make distributions for any reason, rather than be limited to a HEMS standard. Query: Could this absolute discretion also work to the detriment of a corporate trustee which does not want to be caught in the middle?

- **<u>Potential Solutions to Potential Problem #4</u>:** Husband might provide for the children from his second marriage to receive a larger share of his estate than his adult children from a prior marriage (e.g., a "make up" amount actuarially calculated to defray college/grad school expenses and provide other financial support previously given to adult children from prior marriage). Note, it is often advisable for Husband to include language in his Will explaining the reasons for the disparity in the treatment of the different sets of children.

- **<u>Potential Solutions to Potential Problem #5</u>:** If Husband is agreeable to splitting up his estate between his children from a prior marriage and Wife at his death, consider providing for Wife to receive the retirement accounts in satisfaction (either full or partial, as appropriate) of her share.

  Alternatively, consider providing for Husband's retirement account to be payable to a QTIP, which can also be structured (provided the requisite requirements are met) as a "see-through trust" so that Wife's life expectancy (if she is the oldest identifiable beneficiary) can be used in calculating minimum required distributions (or “MRDs”), or in other words the QTIP can qualify for the “stretch out.” Under this arrangement, MRDs will be calculated based upon Wife’s expectancy (if she is the oldest identifiable beneficiary) as determined using the Single Life Table rather than the more advantageous (i.e., providing a greater "stretch out") Uniform Lifetime Table, which would apply if Wife were to receive Husband's retirement account directly and then roll it over into her own IRA. All of the requirements of Revenue Ruling 2002-2, 2001-C.B. 305 and Revenue Ruling 2006-26, 2006-22 I.R.B. 939 must be met to qualify <u>each of</u> Husband's retirement account and the recipient QTIP Trust itself for QTIP treatment and thus secure the resulting estate tax deferral (i.e., the IRS requires that the QTIP election be made for each of the retirement account and the Trust).

  Note, providing for Husband's retirement account to be payable to a “QTIP<u>able</u>” Trust also gives the executor of Husband's estate the ability to refine Husband's estate plan as necessary after his death if circumstances warrant. Specifically, if Husband's estate excluding his retirement account is insufficient to take full advantage of Husband's estate tax exemption amount (otherwise used to fund the Bypass Trust), then his executor can do so by making a partial QTIP election with regard to the QTIPable Trust and the retirement account so that a portion of each equal to Husband’s remaining estate tax exemption amount will not be subject to the QTIP election. As a result, that portion of the underlying retirement account and the QTIPable Trust not subject to a QTIP election will be carved out and held in a separate Trust designed to pass at Wife's death free of estate taxes to the remainder beneficiaries. Alternatively, if the Will provides appropriately, the absence of a QTIP election for the portion of the retirement account and Trust equal to the remaining estate tax exemption amount could pass to a Trust with terms similar to the Bypass Trust so that the mandatory income distributions required of a QTIPable Trust can be avoided (i.e., a "Clayton election" could be made).

  As a caveat, again, providing for a retirement account to be payable to a Trust will accelerate MRD from the account because Wife’s life expectancy (if she is the oldest identifiable beneficiary) will be calculated for purposes of MRDs under the Single Life Table and not the more advantageous Uniform Lifetime Table. Providing for a retirement account to be payable to a Trust may also result in higher income taxes on distributions from the account due to a trust's compressed rate bracket applicable for MRDs retained in trust.

Also keep in mind that under certain circumstances, Wife's consent must be secured before Husband can designate a Trust as the beneficiary of a retirement account. This is the case with regard to plans subject to ERISA and often is the case for IRAs due to restrictions self imposed by the administrator (of course, spouses can provide otherwise by a marital property agreement).

- **Potential Solutions to Potential Problem #6:**

a. First Solution: Lifetime Gift By Wife to Husband of Amount Designed to Enable Husband to Fully Utilize His Estate Tax Exemption Amount in the Event Husband Dies First. Wife (the "wealthy spouse") could consider making a lifetime gift under the marital deduction in an amount reasonably expected to bring Husband's estate up to his estate tax exemption amount (IRC § 2523(a)). In making this gift, Wife can provide for this gift in a QTIP trust (thus avoiding the obvious "risk" of making an outright gift to a spouse in a time of high divorce rates), so that the marital deduction will be available. Assets remaining in the QTIP at Husband's death will be included in his estate but will be offset by his estate tax exemption amount (ideally, in full). The obvious disadvantage to this approach is Wife's loss of use of the assets gifted and the requirement that Husband be given an absolute entitlement (required by IRC 2056 for a QTIP) to the income from the gifted asset even if Husband and Wife ultimately end up divorcing.

It is worth noting that there appears to be a supportable argument for structuring the QTIP so that the gifted property remaining at Husband's death will in turn be used to fund a Bypass Trust for which Wife is a beneficiary that will be excluded from her estate pursuant to IRC 2036 or IRC 2038. As a caveat, this result is contingent upon the QTIP election having been made so that Husband becomes the "transferor" of the property for estate tax purposes when it is included in his estate at death pursuant to IRC 2044 (see PLR 9731009, relying on Treas. Reg. 25.2523(f)-1(f), Example 11 in support of the exclusion of the property from Wife's estate at her subsequent death). Note that while the Regulations are binding upon the IRS, this result is somewhat troubling in that it is at odds with IRC 2523(f)(5)(B), which indicates that Wife's retained interest in the property after Husband's death (at which point IRC 2044 applies) will result in the inclusion of the affected property in her estate under IRC 2036/2038. See a more detailed discussion of this issue presented by Jeff Pennell in BNA Estates, Gifts and Trusts Portfolio 843-2nd: Estate Tax Marital Deduction.

b. Second Solution: Converting Separate Property into Community Property. Wife could convert a portion of her separate property to community property with the amount of separate property selected designed to provide Husband with an amount (as his ½ community property interest) equal to his (projected) otherwise unused estate tax exemption amount. This result would be achieved in a marital property agreement drafted in accordance with Section 4.201 et. seq. of the Texas Family Code.

The advantages of this approach include:

[1] Step-Up In Basis. Under IRC Section 1014, property received from a decedent gets a new basis for federal income tax purposes equal to the fair market value of the asset as of the appropriate valuation date (either date of date or the alternate valuation date, if elected). It is clear under IRC Section 1014 that both halves of the community property receive the new basis. Accordingly, owning appreciated property as community property will ensure that the surviving spouse (regardless of which spouse that may be) receives a new basis in the property. As a caveat, note the step up in basis will not apply for property acquired by gift (i.e., presumably including the surviving spouse's separate property converted into community property) within one year of the deceased individual's death to the extent the acquired property is returned to the donor (see IRC 1014(e)).

[2] Avoidance of Tracing on First Death. It is fundamental that a person's Will only affects his or her interest in community property and his or her separate property. On the death of a spouse owing separate property, it is necessary for the surviving spouse to trace all separate property in order to reach the proper disposition of assets, to determine the proper funding of trusts, and determine the proper taxation of the assets. If the separate property has been commingled, this may become a very difficult (and expensive chore). Converting the property into community property will ease the administration of the estate in many respects.

[3] Management of Converted Assets. It is possible under the marital property agreement to provide that the donor spouse (in our situation, Wife) may retain the management rights over the converted property.

There are at least two disadvantages to converting separate property to community property (in addition to the obvious loss of the entire ownership of the property by the spouse previously owning it as his/her separate property). One, the entire assets become subject to a "just and right division" in the event of a divorce. Two, by converting separate property into joint management community property, a spouse exposes such property to all contractual liabilities of both spouses and all tortious liabilities of both spouses when previously it had not been subject to the tortious or contractual liabilities of the other spouse (excluding contractual liabilities incurred for necessaries). If, however, the property is converted into sole management community property, the additional exposure is limited to only tortious liabilities of the other spouse arising during the marriage. Consequently, if Wife were to convert a portion of her separate property into community property, the converted property will become unavoidably subject to Husband's tortious liabilities incurred during marriage.

c. <u>Third Solution: Make Each Spouse's Estate Tax Exemption "Transferable"</u>: The IRS has approved of the following technique in several private letter rulings (PLR 200403094, PLR 200604028, PLR 200210051, PLR 200101021). As a caveat, it is important to keep in mind that the IRS has only approved of the use of this technique in <u>PLRs</u>, which provide no precedential authority – i.e., there is no guarantee that the IRS will approve of this technique if implemented by a taxpayer other than the taxpayer who sought one of the PLRs. So, the speaker strongly suggests that this technique only be pursued if your clients are willing to obtain their own private letter ruling.

Here's how this technique apparently works. Wife creates a revocable management trust giving Husband <u>if he predeceases Wife</u> a testamentary (i.e., exercisable at his death only) general power of appointment ("GPOA") over assets equal to the unused portion of Husband's estate tax exemption amount at his death (after allowing for allocation to Husband's own estate). Note, for this technique to work, Wife's management trust must be funded <u>during</u> Wife and Husband's joint lifetime with sufficient assets to accomplish this result. Since Wife's management trust is entirely revocable during Husband's and Wife's joint lifetime, she can revoke Husband's GPOA at any time until his death and therefore no gift occurs during their joint lifetime.

Note, the GPOA granted Husband could be narrowly drafted to enable Husband to exercise it only to (i) direct that the affected assets be used to fund a Bypass Trust for the benefit of Wife (the manner in which the GPOA <u>should</u> be exercised, if at all) or (ii) direct that the affected assets be distributed to a single creditor of Husband's estate (theoretically, the <u>minimum</u> additional discretion the Husband must be given under the GPOA to cause the desired inclusion in his estate). As a caveat, while this approach seems to be the "safest" way of minimizing the risk of Husband exercising the GPOA to send assets outside the family (e.g., to a girlfriend) in contradiction to Wife's wishes, conventional wisdom suggests Husband could easily "follow the rules" but circumvent Wife's wishes by simply creating a debtor relationship with his girlfriend. However, query whether his girlfriend would remain a "debtor" if the underlying debt were forgiven by Husband at death? As with a gift from Wife to Husband via an inter vivos QTIP, it appears the trust instrument can provide for the property subject to the GPOA (to the extent Husband does not provide otherwise) to pass by default to a Bypass Trust for which Wife is a beneficiary that will be excluded from her estate pursuant to IRC 2036 or IRC 2038 (while Treas. Reg. 25.2523(f)-1(f), Example 11 bases the exclusion of the affected QTIP property from Wife's estate upon Husband becoming the "transferor" of the affected property at his death under IRC 2044, the same reasoning should apply with this technique even though Husband acquires his "transferor" status at his death under IRC 2041). Of course, the same concerns with the apparent inconsistency between Treas. Reg. 25.2523(f)-1(f), Example 11 and IRC 2523(f)(5)(B) apply with this approach as well.

The PLRs contain several additional questionable rulings, which, again, the speaker feels makes any reliance on them unwise. First, the IRS makes the questionable (albeit taxpayer-friendly) ruling that when Wife's gift of the GPOA to Husband becomes complete at his death, it qualifies for the marital deduction despite the fact Husband is deceased at the time. Second, certain of the cited PLRs also conclude IRC 1014(e) prevents the assets subject to Husband's GPOA from receiving a full step up in basis to the extent Wife will in turn receive enjoyment from the affected assets. PLR 9321050 suggests that if Wife's interest in the Bypass Trust could be assigned an actuarial value, then a corresponding portion of the Bypass Trust's assets actuarially severable from Wife's interest should be eligible for a step up in basis. This raises several questions, not the least of which is how to assign an actuarial value to Wife's interest in the Bypass Trust if she is entitled to distributions only under a HEMS standard or only in the absolute discretion of a third party.

- **<u>Potential Solution to Problem #7</u>:** Husband could provide for the personal effects/household furnishings with particular sentimental importance to Husband's children to pass to a Trust for the benefit of Wife granting her continued use of those items but without any ownership of them or dispositive discretion over them at her death. If Husband wishes to avoid the formality of a Trust, he can provide Wife with a life estate in those items to effect approximately the same result.

- **<u>Potential Solution to Problem #8</u>:** Add language to each spouse's Will so that if Wife changes her estate plan to cut out Husband's children from her estate plan after Husband's death, her children will correspondingly be prevented from sharing in any assets remaining in the Bypass Trust and QTIP at her death.

  Alternatively, Husband and Wife could established an irrevocable life insurance trust (or an "ILIT") for the benefit of all of their children and provide for the ILIT to purchase a joint and survivor policy. The children could be given crummey withdrawal rights exercisable with regard to Husband's and Wife's contributions to the ILIT (to facilitate premium payments) to minimize the use of Husband's and Wife's gift tax exemptions on contributions. The insurance proceeds payable at the surviving spouse's death would be divided equally among separate dynasty trusts for the children (i.e., each child's trust could be designed to last for his/her lifetime). To the extent Husband and Wife allocate their GST exemption amounts to their contributions, a child's Trust (and subsequent Trusts created for his/her own children) would be forever exempt from transfer taxes. Each of Husband and Wife could then plan his/her own estate to ultimately pass (at the surviving spouse's death) solely to his/her own children.

  As a "bonus" under this approach, the insurance proceeds received by the ILIT at the surviving spouse's death could be used to provide the surviving spouse's estate with liquidity (via loans and/or purchase of estate assets) to the extent necessary to pay any estate taxes dues.

VI. <u>FACTORS UNIQUE TO A BLENDED FAMILY IMPACTING LIFETIME GIFTING</u>

A. <u>Gift Of Community Property</u>. A gift of community property is considered a gift of ½ of the property by each spouse. Accordingly, each spouse should file a separate Federal Gift Tax Return (IRS Form 709), reporting ½ of the gift. No gift-splitting election is required or should be made with respect to a gift of community property. In this regard, it is also irrelevant whether the community property gifted is the sole management community property of one of the spouses or joint management community property.

This can present problems in a situation in which one spouse wants to make gifts to his/her children from a prior marriage using community property (i.e., he/she does not have separate property to facilitate the gifts), but the non-donor spouse does not want to use any of his/her lifetime gift tax exemption or GST exemption amount in the process. This would be an issue if the gifts are other than annual exclusion gifts either made directly to children/grandchildren or to trusts for grandchildren described in IRC Section 2642(c) ("GST annual exclusion trusts"). As such, consider providing for the spouses to partition sufficient community property into equal shares of separate property so that the donor spouse will have enough resulting separate property to accommodate the gift (or provide for community property equal in amount to the proposed gift to be partitioned and then provide for the non-donor spouse to gift to the donor spouse his/her acquired separate property interest in the partitioned community property). The donor spouse will then have sufficient separate property to accommodate the gifts, and the non-donor spouse will not have to use any of his/her lifetime gift tax exemption or GST exemption amount in the process (assuming no election to gift-split will be made for the year of the gifts).

As a caveat, neither spouse is free to make unlimited gifts of community property without the consent of the other spouse. However, a discussion of the factors impacting the permissibility of a gift of community property by one spouse without the participation of the other spouse is beyond the scope of this presentation.

B. Gift Of Separate Property. A gift of separate property by a spouse will require the filing of a federal gift tax return by the donor spouse. The non-donor spouse, however, may make an election to gift-split the gift with the donor spouse pursuant to IRC § 2513(a)(2). Some important rules to keep in mind when gift-splitting are as follows: (i) if the election to gift-split is made, all gifts of separate property made by the spouses during the year must be split (i.e., you cannot elect to split only some of the gifts or just the annual exclusion portion); (ii) the election to split gifts will also cause the non-donor spouse to be treated as the transferor of such property for gift and GST tax purposes pursuant to IRC § 2652(a)(2) and Treas. Reg 26.2652-1(a) (4); (iii) once made, the election is irrevocable; and (iv) care must be taken when electing gift-splitting in the context of a spousal ILIT since it will only apply to the portion (if any) of the gift that is "severable" from any interest the noninsured spouse may have in the gift as a beneficiary of the ILIT. Treas. Reg. 25.2513-1(b)(4).

To illustrate, assume one spouse wants to make gifts of $24,000 of his/her own separate property to Crummey trusts for each of his/her children from a prior marriage and then make the election to gift-split with the non-donor spouse in order to avoiding using any of the donor spouse's lifetime gift tax exemption. If the election is made pursuant to IRC § 2513(a)(2), the non-donor spouse will not use any of his/her lifetime gift tax exemption on the gifts, but $12,000 per/child of his/her GST exemption amount will be used in the process unless the donee Trusts are "GST annual exclusion trusts" described in IRC Section 2642(c) or an election is made by the non-donor spouse pursuant to 2632(c) to block the automatic allocation of GST exemption amount to the Trusts (assuming the Trusts are "GST Trusts" pursuant to IRC 2632(c)(3)(B)).

VII. CHECKLIST OF MISCELLANEOUS ITEMS TO WATCH FOR IN A BLENDED FAMILY ESTATE PLAN

A. Ensure the Former Spouse and His/Her Relatives Are Removed From the Estate Plan. Ensure a former spouse and his/her relatives who are not also relatives of your client are removed from the client's estate plan to the extent (if any) the client desires. State law may accomplish the desired result but should not be relied upon to do so. Consequently, a new Will, trust amendment, retitling of an account, or revised beneficiary designation (for life insurance/retirement assets) may be necessary in order to achieve the desired result, unless a marital property agreement/divorce decree already provides for such.

For example, TPC Section 69 provides that a former spouse and "each relative of the former spouse who is not a relative of the testator" will be treated as having predeceased the testator (including for purposes of fiduciary appointments) unless the Will provides otherwise. In contrast, TPC Section 472 provides for a similar result with regard to the former spouse in the case of a revocable management trust, but it does not extend the same treatment to relatives of the former spouse who are not also relatives of the client (i.e., if a gift to a step child was provided for in a revocable management trust, a divorce will not invalidate that gift under state law).

Also consider whether state law may remove a former spouse from a role in the plan the client would prefer he/she instead retain (e.g., trustee of the Trusts to be created for the client's children from the prior marriage after the client's death).

B. **Ensure the Expenses and Tax Apportionment Provisions Are Consistent With the Plan.** Ensure any estate tax due on gifts made to children from a prior marriage will not be borne by any gifts made to the current spouse. For example, a typical estate plan will provide for any debts, expenses, and taxes due at the first spouse's death to be borne by the residuary estate (commonly, the QTIP). Since a typical estate plan will consist of a bequest by the deceased spouse of his/her estate tax exemption amount to the Bypass Trust and a bequest of the residuary estate to the QTIP, there will obviously be no estate tax due. However, if a sizeable bequest (i.e., in excess of the deceased spouse's estate tax exemption amount) is provided for children from a prior marriage (e.g., the deceased spouse's business), then the typical tax apportionment would cause the portion of the estate set aside for the surviving spouse (the QTIP) to bear the estate tax due on the children's gift of the decedent's business. Not only will this commonly be against the deceased spouse's wishes, but it will cause the overall estate tax ultimately due to be greater than would be the case if the estate tax were borne by the children's share of the estate due to the interrelation calculation required to account for the marital deduction's reduction by the estate tax.

A more in depth discussion of the potential hazards of a poorly drafted tax apportionment clause are beyond the scope of this presentation. However, the speaker cautions the reader to be advised that the lack of proper coordination between the dispositive provisions of an estate plan and the tax apportionment provisions can take many forms, making a careful review of the plan vital to ensure the client's objectives are served by it. Situations in which a problematic tax apportionment provision may be present may include (but are not limited to):

- a beneficiary/beneficiaries of a significant nonprobate asset is/are not the same as the residuary beneficiaries;
- a beneficiary/beneficiaries of a significant bequest is/are not the same as the residuary beneficiaries; and
- the beneficiaries under each spouse's estate plan are not the same.

C. **<u>Ensure Client Complies with Support Obligation Owed to Prior Spouse and/or Children From Prior Marriage and Marital Property Agreements</u>.** It is not uncommon for estate planning attorneys to neglect to incorporate a client's obligation to a former spouse and/or children under a settlement agreement or final divorce decree. Similarly, a client's plan should also incorporate any obligation assumed under a marital property agreement (e.g., a bequest to spouse of a specified amount or specific asset).

As a caveat, prospective spouses will commonly agree in a prenuptial agreement for one of them to waive his/her rights in the other's retirement plan. Federal law requires that a <u>spouse</u> waive such right, making the spouses' post-marriage ratification of a prenuptial agreement containing that waiver necessary. The post-marriage waiver should be filed with the plan administrator as well.

D. **<u>IRC 2207A</u>.** Consider whether the surviving spouse should waive the entitlement his/her estate has under IRC 2207A to be reimbursed for the estate tax due on a QTIP included in his/her estate at death.

CASE STUDY NO. 1: MAXIMIZING ANNUAL EXCLUSION GIFTING

Mr. and Mrs. Smith were married in 2002. It was the second marriage for each, and each had children and grandchildren from their first marriage. At the time of the marriage, both spouses were retired and had accumulated a sizeable enough estate to provide for themselves for the rest of their lives. After the marriage, Mr. and Mrs. Smith entered into a Marital Property Agreement in which they identified each spouse's separate property and agreed that income from a spouse's separate property would be that spouse's separate property. Since their marriage in 2002 until 2008, Mr. and Mrs. Smith had avoided commingling any of their separate property so that they each still had their separate estate intact. They did keep a small community property bank account that was used to pay household bills such as electricity, phone, lawn maintenance, etc. Mr. Smith's Will provided for the transfer of his separate property estate to his children and grandchildren upon his death, and Mrs. Smith's Will provided for the transfer of her property to her children and grandchildren upon her death. Neither spouse's Will left any property to the other spouse. Although each spouse's Will left their separate property half of the house to their descendants, it was understood that the surviving spouse would be able to live in the house for the remainder of their life under the Texas homestead laws.

In 2007, Mrs. Smith's two grandchildren were ages 24 and 27, each had graduated from college and was pursuing a career, and she decided that she wanted to begin making annual exclusion gifts to a trust for those grandchildren each year. Given her age (mid-70's), the financial needs of her grandchildren, the size of her estate, and the projected federal estate tax that would be owed by that estate, it was important for her to maximize those annual exclusion gifts to her grandchildren each year, so the plan for the first round of gifts was to transfer $48,000 to a trust for the grandchildren on December 31, 2007 and another $48,000 to the trust on January 1, 2008.

It was explained to Mrs. Smith that the annual gift tax exclusion is unique to the individual, so that for 2007 the maximum amount that she could transfer under the annual exclusion for her two grandchildren would be $24,000 ($12,000 per grandchild). In order to make $48,000 a year in annual exclusion gifts to the grandchildren, it would be necessary for her husband to agree to allow his annual exclusion for those two grandchildren to be used each year. Even though the gifts were to come from Mrs. Smith's separate property, it is possible, if the spouses elect to split gifts on the federal gift tax return(s), to apply her husband's annual exclusion to those gifts and make a full $48,000 annual exclusion gift to a trust for those two grandchildren. Under the gift splitting rules, Mrs. Smith would make a $48,000 transfer to a trust for the grandchildren. $24,000 of that gift would be treated as from Mrs. Smith's property and the other $24,000 would be treated as from Mr. Smith's property. Thus, as those were the only gifts made by Mr. and Mrs. Smith to those grandchildren during the tax year, the full $48,000 gift could be excluded under the annual exclusion. Mr. Smith was willing to sign the gift tax return and elect gift splitting as he had no problem in using his annual exclusion for gifts to Mrs. Smith's grandchildren.

However, there was a flaw in this solution because, although it worked for gift tax purposes, there was another tax that was coming into play. As the gifts were made to a trust for the sole benefit of Mrs. Smith's grandchildren, the gifts constituted Direct Skips subject to the generation-skipping transfer tax ("GST"). Although Mr. Smith was comfortable treating the gifts made from Mrs. Smith's separate property as made one-half from his separate property for <u>gift tax purposes</u>, he was not comfortable treating them made as one-half from his separate property for <u>GST purposes</u>.

Specifically, the gift splitting rules require that all gifts be split for all purposes, including allocation of GST exemption. Thus, for GST purposes, by electing gift splitting, Mr. Smith would be treated as making $24,000 of the total gifts each year, and that would require him to allocate $24,000 of his GST exemption to those gifts or pay the GST.

With Mr. Smith not willing to consent to gift splitting because of the GST consequences, the answer fell back to Mrs. Smith limiting her annual gifts to the grandchildren to $24,000. Still, she was adamant about the desire to maximize those annual exclusion gifts and stretch it out to the $48,000 amount. A solution was found to allow her to meet that objective. The annual exclusion is a gift tax function and, generally, does not apply to the GST. However, there is a method to bring an annual exclusion type function into the GST planning area. Section 2642(c) provides that a Direct Skip transfer to a trust that is an annual exclusion transfer for gift tax purposes will be automatically exempted from the GST if the terms of the trust meet specific requirements. Specifically, an annual exclusion gift to a trust will be automatically exempted from the GST (without the allocation of GST exemption) if the trust has a single beneficiary and if the trust assets will be includible in the beneficiary's estate in the event that the trust terminates before the death of the beneficiary.

Thus, Mrs. Smith's plan was modified as follows: each year, she would make a $24,000 annual exclusion gift to a separate trust for each grandchild ($48,000 total). Each trust would be structured so that the grandchild was the sole beneficiary of the trust, the trust would last for the grandchild's lifetime, and the grandchild would become trustee at age 50. In addition, each trust provided that the grandchild would have a general power of appointment exercisable through his or her will at his or her death with the power to appoint the assets to his or her estate or any other recipient. Thus, the trust assets would be includible in the grandchild's taxable estate at death.

By structuring the trust in this manner, Mrs. Smith could make a full $24,000 gift to each grandchild's trust each year (for a total of $48,000 gifts in the year). On the gift tax return, Mr. and Mrs. Smith would elect gift splitting so that the $24,000 gift to each grandchild's trust would be fully eligible for the annual exclusion (one-half covered by Mrs. Smith's annual exclusion, one-half covered by Mr. Smith's annual exclusion). As the gifts to the trust would be automatically exempted from the GST under Section 2642(c) without allocating any GST exemption, the gifts would have no GST impact to Mr. Smith and he was willing to make the gift splitting election.

CASE STUDY NO. 2: COMBINING LARGE ESTATES

Mr. and Mrs. Henderson were married in 1990 and have one child. At the time of the marriage, Mr. Henderson owned a successful business that he had started in 1978 and Mrs. Henderson owned a minority interest in a successful business that was operated by her former husband (who owned a controlling interest in the business). Mr. Henderson had three children from a prior marriage and Mrs. Henderson also had three children from a prior marriage. Mr. H. sold his manufacturing business in 1996 for $36 million. Likewise, Mrs. H. and her former husband sold their business in 1998 and her share of the proceeds equaled $14 million. After both sales were consummated, Mr. and Mrs. H. entered in a Marital Property Agreement, after which their marital estate was owned as follows:

1. All of the sales proceeds received from the sale of Mr. H.'s business, including the investments that those proceeds had been converted into, were held as Mr. H.'s separate property;

2. All the sales proceeds that Mrs. H. received from the sale of her business, including all the investments that those proceeds had been converted into, were held as Mrs. H.'s separate property;

3. The house that they used as their principal residence and their vacation home retained their character as community property; and

4. It was agreed that all income from separate property would be the separate property of the owner spouse.

Mr. and Mrs. H. held the common agreement and understanding that upon each spouse's death that spouse's separate property would pass to his or her children and grandchildren (including their child from their marriage) and none of the estate would pass to the other spouse's children from that spouse's first marriage. Likewise, each of the seven children understood that agreement and had an expectation that the marital property estates would be distributed accordingly. Notwithstanding that understanding and expectation, Mr. and Mrs. H. had not been very diligent about protecting the separate property character of their substantial estates. Specifically, they had not been careful to trace the flow of separate property into common investments and acquisitions and, though in their minds they knew what was his and what was hers, the legal character of the assets that made up their respective estates had become cloudy.

With one exception, Mr. and Mrs. H. had not paid much attention to their estate tax situation following the passage of the 2001 Tax Act. That exception was that they had been making full annual exclusion gifts to each of their children and grandchildren for each year beginning shortly after their respective businesses had been sold. Given the size of their estates, the tax benefits of the annual exclusion gifts were obvious, but there were non-tax consequences from these gifts as the children and grandchildren had come to expect these gifts and relied upon them to maintain their lifestyle expenditures.

Mr. and Mrs. H. sought estate planning advice in 2008 with the primary stated objective of reducing the federal estate burden on their estates. An in-depth plan was put together to address both tax and non-tax concerns with respect to Mr. and Mrs. H.'s estates, with some aspects of that plan being affected by the fact that they are a Blended Family.

1. Both Mr. and Mrs. H. were confident that they knew which property was Mr. H.'s separate property and that property which was Mrs. H.'s separate property. Thus, the first step taken was the one that was most difficult to convince them that they needed. Due to their failure to diligently <u>segregate</u> their separate property <u>and maintain</u> its separate property character under Texas law, a viable question existed with respect to millions of dollars of their respective estates as to whether such property was separate property or community property. The mere existence of this issue would cause what would almost assuredly be a divisive <u>family</u> <u>problem</u> upon the death of the first spouse to die, as that spouse's executor would be obligated to identify and claim all of the separate property of the deceased spouse and transfer 100% of that property through the Will to that spouse's descendants, but would face the Texas property law presumption that all property owned by the marital estate upon the death of the first spouse to die is community property.

To address this problem and meet their common objective that all of each spouse's separate property (as they saw it) would pass to his or her heirs (to the exclusion of the other spouse's heirs), the first step taken was to prepare a <u>new</u> Marital Property Agreement. The body of that Agreement identified all of the property listed on Exhibit A to the Agreement as Mr. H.'s separate property and all the property listed on Exhibit B as Mrs. H.'s separate property. On those exhibits, each spouse made a detailed listing of their separate property assets. In addition, the body of the Agreement also included the provision that all income from separate property of a spouse would be that spouse's separate property.

2. In planning for the disposition of their respective estates, Mr. and Mrs. H. brought different philosophies and family scenarios to the table. Though there were some issues with respect to her children and grandchildren, including divorces, Mrs. H. did not believe in trusts and planned for the outright transfer of her estate in equal shares to her heirs upon her death. Mr. H was more of a "control from the grave" personality and that approach was supported by the fact that his children and grandchildren would benefit from the placement of their inheritance in lifetime trusts due to creditor, divorce, spendthrift and transfer tax exposure. Thus, Mr. H.'s plan included (in addition to the continued maximum annual exclusion gifts to all children and grandchildren that both spouses built into their plans) a $1 million taxable gift to a GST exempt trust for his children and grandchildren in 2008. In addition, beginning in 2009, each year's annual exclusion gift to his children and grandchildren would go to the GST exempt trust. This trust was designed to be divided into separate share trusts for his children upon his death, with each trust to continue for the lifetime of that child and then pass on from generation to generation until the trust would terminate by rule of law.

As part of Mr. H.'s plan, he would file a 2008 gift tax return on which he would allocate $1 million of his GST exemption to the gift made to the GST exempt trust during 2008. However, this created a problem for Mr. and Mrs. H. Up to that point, Mr. H. had made full annual exclusion gifts each year out of his separate property to his children and grandchildren (11 total) from his first marriage. Likewise, Mrs. H. used her separate property to fully fund annual exclusion gifts to her children and grandchildren (6 total) from her first marriage. Thus, in 2007 Mr. H. had gifted $264,000 ($24,000 x 11) out of his separate estate to his children and grandchildren as annual exclusion gifts and Mrs. H. had gifted $144,000 ($24,000 x 6) out of her separate estate to her children and grandchildren as annual exclusion gifts. In addition, Mr. and Mrs. H. had gifted $24,000 of community property to their joint child. Without any planning, $132,000 of Mr. H.'s gift would constitute annual exclusion gifts ($12,000 x 11) and the remaining $132,000 gift would be a taxable gift and would reduce his $1 million gift tax exemption accordingly. Likewise, $72,000 of Mrs. H.'s gifts would qualify as annual exclusion gifts and the remaining $72,000 would be a taxable gift and would reduce her $1 million gift tax exemption accordingly. Up and through 2007, Mr. and Mrs. H. had addressed this problem by electing gift splitting on their respective gift tax returns. This allowed each spouse, with respect to his or her children and grandchildren, to use the other spouse's annual exclusion for those descendants and thus double the annual exclusion available from $12,000 per descendant to $24,000.

However, as mentioned in Case Study No. 1 of this outline, that gift-splitting solution becomes problematic when GST planning/gifting is introduced into one of the spouse's plans. In this case, if Mr. and Mrs. H. were to elect gift splitting for 2008, Mrs. H. would be treated as having made a $500,000 gift to the trust for Mr. H's descendants and would allocate $500,000 of her GST exemption to that gift. Given their overall estate planning strategy, Mrs. H.'s estate plan included the use of her GST exemption for her descendants and she did not want to shift the benefits of $500,000 of that exemption from her descendants to Mr. H.'s descendants. Thus, the gift-splitting election was not an option for 2008.

However, as mentioned above, Mr. and Mrs. H.'s children and grandchildren had "budgeted" the $24,000 annual exclusion gift into their 2008 expenditure plans and Mr. and Mrs. H. were going to make the full $24,000 gift to each descendant. Still, Mr. H (Mrs. H.) did not want to use $132,000 ($72,000) of the limited $1 million gift tax exemption on those or any future annual exclusion gifts. The solution to this problem carried out as follows. Under Texas law, spouses are allowed to enter into an agreement wherein they convert one spouse's separate property into community property. Pursuant to this law, Mr. and Mrs. H. entered into an agreement wherein they converted $264,000 of Mr. H.'s separate property and $144,000 of Mrs. H.'s separate property into community property. They then gifted $264,000 of that community property to Mr. H.'s descendants and $144,000 of that community property to Mrs. H.'s descendants to provide each such descendant with a full $24,000 annual exclusion gift. As the gifts were made from community property, one-half of each gift was reported on each spouse's federal gift tax return and fully excludable as an annual exclusion gift. Mr. H. also reported the $1 million gift in trust on his federal gift tax return. As he had used up his full annual exclusion for the trust donees, the $1 million gift constituted a taxable gift and used up his $1 million gift tax exemption. Also, for GST purposes, he was reported as the sole transferor of the $1 million gift to the trust and thus $1 million of his GST exemption was allocated to the trust to fully exempt that trust from the GST.

CASE STUDY NO. 3: DIVISION OF ASSETS RAISES HOMESTEAD ISSUES AND WATERS DOWN THE MARITAL DEDUCTION

Steve is currently married. He has two children from a prior marriage, and his wife, Anne, also has children from a prior marriage. Upon his death, Steve is interested in providing for both Anne and his children, while also preserving assets to pass to his children upon Anne's subsequent death.

Two assets that are especially important to Steve are (1) his house, which was purchased prior to his marriage, and which was almost entirely paid for from separate property funds, and (2) his business, also a separate property asset.

Steve chose to distribute the house as follows:

a. It is Steve and Anne's understanding that the house is Steve's separate property. He is choosing to leave a one-half (½) interest in the house outright to Anne. Steve also made specific reference to the fact that if Anne should assert (i) a claim for a community property interest in the house, or (ii) a claim for economic contribution (for community property funds being expended during the marriage on the house), that this devise is intended to be in full satisfaction of any such claim(s).

b. The remaining one-half (½) interest in the house is being placed in a trust. Under the trust terms, Anne will have the right to live there, rent free, until the earlier of (i) her death or (ii) the sale of the house. Anne's right to live in the house is conditioned upon her obligation to pay property taxes, casualty insurance, and expenses associated with necessary repairs and maintenance. At Anne's death or upon the sale of the house, this interest in the house (or one-half (½) of the sales proceeds) will be distributed to a trust for Steve's children.

c. Steve recognizes that there may be a conflict of interest with respect to the sale of the house, so he further provides that Anne has the right to sell the house at any time, and the trustee of the trust is directed to participate in the sale, conditioned on the sale being for fair market value.

With respect to Steve's company, he wants to leave the company divided between trusts for Anne and his children, with forty percent (40%) in trust for Anne and sixty percent (60%) in trust for his children. Because of the estimated value of Steve's estate and the current estate tax exemption amount, it is anticipated that the forty percent (40%) interest in the company will be in a marital trust.

Homestead and Claim for Economic Contribution Issues

As discussed in the outline, regardless of Steve's estate plan (barring a pre- or post-marital agreement to the contrary) Anne has an absolute right in Texas to continue residing rent-free in the house that she and Steve lived in during their marriage. As part of that homestead right, Anne would be responsible for paying the property taxes and repairs and maintenance. Steve's plan actually exceeds the homestead requirements, in that he has given Anne an outright ownership in one-half (½) of the house. The only area in which he deviates is in requiring her to pay for the casualty insurance (which would normally be split between owners, in this case, Anne and the trust), but Steve's plan provides Anne with additional assets with which she can pay this expense.

Watering Down the Marital Deduction

As stated above, based on the estimated value of Steve's estate and the current estate tax exemption amount, it is anticipated that Anne's interest in Steve's company will be placed in a marital trust. While, for estate tax purposes, the company will be valued at its full fair market value (as Steve owns 100% of the company), for marital deduction purposes, the interest Anne receives will be subject to a discount. For example, the company may be valued at $3,000,000, so Anne's 40% interest would be $1,200,000. But if this interest is subject to a discount of 35% for lack of control and lack of marketability, then the marital deduction will be reduced to $780,000, subjecting $420,000 ($1,200,000 estate tax value, less a $780,000 marital deduction) in value of the company to be subject to estate tax. At a 45% estate tax rate, Steve is subjecting his estate to $189,000 in estate tax as a result of the division of the company between trusts for Anne and his children. In this case, Steve is choosing to focus on the non-tax benefits of the plan, and is willing to risk incurring the additional estate tax.

CASE STUDY NO. 4: RICH SPOUSE/POOR SPOUSE; POOR INITIAL DRAFTING; CHANGING CIRCUMSTANCES AND COMPLEX ESTATE TAX AND GST PLANNING

Barry and Jean are each on their second marriage, and each have two children from prior marriages. In accordance with their Premarital Agreement, Barry has $3,000,000 in separate property, Jean has $500,000 in separate property, and there are assets Barry has agreed to make community property, with a current estimated value of $4,000,000.

Barry and Jean are in agreement that they want their separate property assets to go solely to their naturally born children, but that the community property assets are to be divided equally between the four children.

<u>Poor Initial Drafting</u>

While Barry and Jean were in agreement as to how they wanted their assets to pass, their original estate plan had several flaws. In their Wills, the separate property was to go to the naturally born children of the deceased spouse and the community property was to be distributed outright to the surviving spouse. The Wills then provided that upon the second death, the "community property" was to be divided equally between the four children. The actual results of the plan are as follows:

1. By transferring all of the community property <u>outright</u> to the surviving spouse,

    a. the provision in the surviving spouse's Will leaving "community property" assets to the four children is ineffective, as there will no longer be any community property assets (barring a subsequent marriage by the surviving spouse, which would create a multitude of problems), and

    b. in any case, the deceased spouse's Will provides no assurance that such spouse's community property remaining at the death of the second spouse will pass to the four children because, as it is owned outright by the surviving spouse,

        (i) if the spouse remarries, the property will be subject to commingling and, as community property, one-half would pass to the new spouse, and

        (ii) any amount that was the surviving spouse's separate property (or one-half community share) would pass by that spouse's Will, which could be changed to pass the property to his or her children only or to other persons or entities.

2. In Barry's case, the separate property assets going to his children exceed the current estate tax exemption amount and thus would trigger an estate tax at his death (see

below). The Will did provide that his children could disclaim assets into a marital trust, to qualify for the marital deduction, but it is highly unlikely that his children would be inclined to put assets into trust for Jean for life, rather than take $0.55 on the dollar for the amount in excess of the estate tax exemption.

3. If Jean, as the poorer spouse, was to die first, then the initial plan would stack assets in Barry's estate rather than preserving her estate tax exemption, resulting in additional estate taxes being paid (see below).

4. The plan did not address manners in which to maximize the utilization of estate tax and GST tax exemptions (see below).

Revised Plan. A new plan was created for Barry and Jean to address the aforementioned shortcomings in their initial plan.

1. Community and Separate Property

Rather than use Wills to achieve their planning goals, Barry and Jean decided to utilize three living trusts. Each has a separate property living trust, and they have a joint living trust for their community property. Their intent is to fund, during their lifetime, all assets into these trusts based on the characterization of the property. Their pour-over Wills direct that if any assets are not titled in the trusts at that spouse's death, that separate property assets will be distributed to the deceased spouse's separate property living trust, and the deceased spouse's one-half community property interest in any assets will be distributed to the joint living trust. To further address the handling of the community property at the second spouse's death, Barry and Jean added a provision that they would fund all community property assets into the joint living trust at the death of the first spouse, but if that funding is not complete, at the second death community property will be identified as those assets owned by Barry and Jean at the first death, including any permutations, mutations and income or other increases in those assets.

This is still not a perfect solution, as (a) it can create a tracing nightmare for the children upon the second spouse's death, and (b) it still does not prevent the surviving spouse from changing his or her Will, but if no action is taken by the surviving spouse, it is more likely to create the results Barry and Jean hope to achieve. Because of these issues they are both inclined to have the joint living trust funded during life.

2. Estate Tax

Under the initial plan, due to the underutilization and preservation of estate tax exempt assets, if Jean (the poorer spouse) is the first to die, Jean's and Barry's joint estates would pay an additional estate tax of $675,000, as illustrated below. Also, as illustrated, their estates would fail to take full advantage of the marital deduction deferral opportunity. Under the revised plan, by including bypass and marital trusts within all three living trusts, Barry and Jean are assured that (a) under current tax law, both would be able to fully utilize and preserve their estate tax exemption amounts, and (b) estate tax will be deferred to the second death.

A. Estate Tax if Barry is First Spouse to Die

<u>Calculation of Estate Tax Due at Barry's Death</u>

Estimated Estate (separate property plus one-half of community property)	$5,000,000.00
Less: Assets passing to Jean, subject to the marital deduction	(2,000,000.00)
Equals: Taxable Estate	$3,000,000.00
Estate Tax	**$ 450,000.00**

<u>Calculation of Estate Tax Due at Jean's Death</u>

Estimated Taxable Estate (separate property, original one-half of the community property, and outright inheritance from Barry)	$4,500,000.00
Estate Tax	**$1,125,000.00**

<u>Total Estate Tax Due if Barry is the First Spouse to Die</u>

Estate Tax at Barry's Death	$450,000.00
Estate Tax at Jean's Death	$1,125,000.00
<u>Total Estate Tax Paid</u>	**$1,575,000.00**

B. Estate Tax if Jean is First Spouse to Die

<u>Calculation of Estate Tax Due at Jean's Death</u>

Estimated Estate (separate property plus one-half of community property)	$2,500,000.00
Less: Assets passing to Barry, subject to the marital deduction	(2,000,000.00)
Equals: Taxable Estate	$ 500,000.00
Estate Tax	**$ 0.00**

<u>Calculation of Estate Tax Due at Barry's Death</u>

Estimated Taxable Estate (separate property, original one-half of community property, and outright inheritance from Jean)	$7,000,000.00
Estate Tax	**$2,250,000.00**

<u>Total Estate Tax Due</u>

Estate Tax at Jean's Death	$ 0.00
Estate Tax at Barry's Death	$2,250,000.00
<u>Total Estate Tax Paid</u>	**$2,250,000.00**

3. GST Tax Allocation

Where most of the devises under the initial plan were either outright gifts, or to trusts that would terminate during a child's lifetime, the initial plan did not maximize the GST exemptions available to Barry and Jean. In revising their plan, Barry and Jean wanted to provide for GST exempt trusts, but did not want either set of children to be penalized because their parent was the first to die. The proposed solution:

A. Upon the first spouse's death, GST exemption is allocated first to that spouse's separate property assets. If there is remaining GST exemption, it is allocated to the marital trusts, with the direction that the remaining GST exemption will first be allocated to the trusts created with community property assets for the children of the first spouse to die.

B. Upon the second spouse's death, GST exemption equal to that allocated at the first spouse's death will be allocated to the children of the second spouse to die. Any remaining GST exemption will be allocated equally among the four children's trusts, based on available assets. Any remaining GST exemption will then be allocated to the other spouse's children's trusts.

<u>Example</u>:

If Barry is the first spouse to die, and the GST exemption is $2,000,000, then upon his death his full GST exemption will be allocated to the separate property trusts created for his children. <u>Result</u>: His children have GST exempt trusts equal to $2,000,000.

At Jean's subsequent death, the GST exemption is $3,500,000. The first $2,000,000 (the amount of the GST exemption at Barry's death) will be allocated to her children's trusts. So her children would receive $500,000 in GST exempt trusts from her separate property assets, and $1,500,000 in GST exempt trusts from the community property assets, for a total of $2,000,000 in GST exempt trusts.

This leaves $1,500,000 remaining in GST exemption, to be divided equally among the four children (or $375,000 per child). The assets remaining to pass to Jean's children equal $500,000 ($250,000 each) [her $2,000,000 half of the community plus $500,000 separate property, less $2,000,000 passing to the GST exempt trust], and $3,000,000 remaining assets to pass to Barry's children [his $2,000,000 half of the community plus $3,000,000 separate property, less $2,000,000 passing to the GST exempt trust at his death]. The $1,500,000 remaining GST exemption will be divided as follows:

1. $500,000 ($250,000 each) to Jean's children's GST exempt trusts;

2. $1,000,000 ($500,000 each) to Barry's children's GST exempt trusts.

The remaining $2,000,000 to pass to Barry's children will pass in equal shares to non-GST exempt trusts for those children.

CASE STUDY NO. 5: COMMUNITY PROPERTY GIFTING AND THE BLENDED FAMILY

Mr. and Mrs. Johnson were married in 1984. At that time, Mr. Johnson was 45 years of age, had been married previously, and had two children from that prior marriage, and Mrs. Johnson was age 46, had also been previously married, and had one child from that prior marriage. Mr. and Mrs. Johnson each brought approximately $800,000 of separate property into the marriage. Still, neither spouse was interested in taking steps to, and they made no attempts to, segregate or to maintain the separate property character of their estates, and from a point shortly after the marriage all of their property was community property.

In 2008, for tax and non-tax reasons, Mr. and Mrs. Johnson decided that they wanted to fund 529 Plans for their six grandchildren, four of whom were descendants of Mr. Johnson and two of whom were descendants of Mrs. Johnson. For federal transfer tax reduction purposes, they decided they wanted to take advantage of the opportunity to make a lump sum payment to each 529 Plan consisting of five years of annual exclusion gifts. Thus, they planned to transfer $120,000 (five years times $24,000) of community property into a 529 Plan for each grandchild, resulting in a total community property transfer of $720,000.

As this plan was evolving, Mrs. Johnson pointed out that the economics of the deal were not favorable to her. Specifically, pursuant to the plan $480,000 of community property funds were going to be transferred to Mr. Johnson's grandchildren, but only $240,000 of community funds would pass for the benefit of her grandchildren. As noted above, Mr. Johnson did not have any separate property funds that he could use to fund the 529 Plans for his grandchildren in excess of the amount of community property that was going to be funded to the 529 Plans for Mrs. Johnson's grandchildren. The following solution was developed to address this problem. In addition to the transfer of $720,000 of community property funds to fund the 529 Plans, Mr. and Mrs. Johnson entered into a marital property/partition agreement wherein they agreed to convert $240,000 of community property into Mrs. Johnson's separate property. The agreement further stated that all of the income from that separate property would be her separate property. To ensure that Mrs. Johnson's separate property remained segregated and not commingled and converted back into community property, Mrs. Johnson formed a living trust agreement and transferred title of the $240,000 to that trust. Mrs. Johnson was the trustee and sole beneficiary of that trust during her lifetime and, upon her death, the trust agreement provided that the trust proceeds would be funded (subject to GST exemption limitations) to trusts for her grandchildren.

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TEXAS SOCIETY OF CERTIFIED PUBLIC ACCOUNTANTS
ADVANCED ESTATE PLANNING CONFERENCE
SAN ANTONIO, TEXAS

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