ATTORNEYS AT LAW
Marvin E. Blum*▪ Gary V. Post* John R. Hunter°▪ Steven W. Novak* Len Woodard▪
Amanda L. Holliday*▪ Lora G. Davis* Edward K. Clark°▪ Catherine R. Moon*▪
Laurel Stephenson* Laura L. Haley* Amy E. Ott▪ Rachel W. Saltsman
Christine S. Wakeman Kandice R. Damiano▪ Kerri G. Nipp Julie A. Plemons
Anna K. Selby Kelsey A. Brock Kent H. McMahan,* Senior Counsel

ESTATE PLANNING FOR THE BLENDED FAMILY

Wichita Falls Chapter of Texas Society of CPAs

May 20, 2014

by Gary V. Post

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▪Certified Public Accountant Board Certified by the Texas Board of Legal Specialization in *Estate Planning & Probate Law °Tax Law
777 Main Street, Suite 700, Fort Worth, Texas 76102 Phone: 817.334.0066 Fax: 817.334.0078 TheBlumFirm.com

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GARY V. POST
BIOGRAPHICAL INFORMATION

Gary V. Post, a Partner in The Blum Firm, P.C., with law offices in Fort Worth, Dallas, Houston, and Austin, specializes in the areas of estate planning and probate, asset protection planning, planning for closely-held businesses, and charitable planning. He received his J.D. from Southern Methodist University School of Law and his B.B.A. magna cum laude/Beta Alpha Psi from Texas A & M University. Mr. Post is a frequent speaker and author on various estate planning topics. He is Board Certified in Estate Planning and Probate Law, a Past President for the Tarrant County Probate Bar Association, past Chairman for the Estate Planning and Probate Law Exam Commission for the Texas Board of Legal Specialization, member of the Estate Planning and Probate Law Advisory Commission, is recognized as a Texas Super Lawyer by *Texas Monthly*, and is also a Fellow of the American College of Trust and Estate Council. Mr. Post is active in the community and served as Chairman of the Board of the American Cancer Society, receiving the *2004 Volunteer of the Year Award*.

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I. INTRODUCTION

Estate planning for married couples is normally accomplished for both spouses on a coordinated basis. The couple usually has a single investment advisor, insurance professional, a CPA, 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 of these challenges will be referred to as a "blended family."

Estate planning for "blended families" often requires balancing the spouses' often divergent interests. Consequently, their advisors must be aware of these differing goals along with other issues particularly unique to planning for blended families, and be prepared to offer solutions for achieving an overall plan that will fulfill the specific objectives of each spouse. This outline explains some of the common issues professionals should expect to encounter during the course of representing a blended family and offers solutions they 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. Next up is a presentation of various ways in which a "conventional" estate plan will often fail to address issues commonly encountered with a blended family and solutions whereby spouses can accommodate those unique issues through an estate plan specifically tailored for their situation. The outline also includes a discussion of the issues to be considered in lifetime gift planning and concludes with a discussion of a few additional issues one should be aware of in planning for a blended family.

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777 Main Street, Suite 700, Fort Worth, Texas 76102 Phone: 817.334.0066 Fax: 817.334.0078 TheBlumFirm.com

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This outline assumes the following:

- The engagement of an 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.

- 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. SHORT COURSE IN ESTATE AND GIFT TAX PRINCIPLES

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

A. General Nature of Estate and Gift Tax System. 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 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 the estate tax exemption amount (discussed below). As a result, each individual may make up to the exemption amount 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 taxable gifts in excess of that amount 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 qualifying 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 $14,000 per donee, or $28,000 per donee if the election to "gift-split" is made by spouses pursuant to IRC Section 2513); or

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

*Note, a gift to a charitable remainder trust or a charitable lead trust may qualify <u>in part</u> 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.

> EXAMPLE: Husband and Wife made a gift of $50,000 of community property cash to their son in 2014 to assist him in buying a house. That is the only gift they made to him for that year. As the gift was community property, each spouse is treated as making a $25,000 gift to the son. After applying each spouse's $14,000 annual gift tax exclusion for 2014, each spouse has made a $11,000 taxable gift to the son.

2. Estate Tax Exemption Amount.

The IRC provided each individual with an exemption against estate taxes in an amount equal to $5,000,000 (with adjustments scheduled as described below). However, the required 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 dollar-for-dollar by his/her use of the lifetime gift tax exemption. Under the estate tax system, 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 marital deduction applies.

As a result of the Tax Act passed at the end of 2012, the estate tax exemption amount increased to $5,000,000 in 2011 and increases by a cost of living adjustment each year (on January 1). The estate tax exemption amount for 2014 is $5,340,000.

C. <u>Unlimited Marital Deduction</u>. Congress passed the Economic Recovery Tax 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 Section 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 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 <u>until</u> 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.

D. <u>Unlimited Charitable Deduction</u>. Each individual has the opportunity to transfer property to a qualified charity described in IRC Sections 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 applicable exemption remaining at the time of the gift).

E. <u>Generation-Skipping Transfer Tax ("GST")</u>. 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 (and thus transferred by) the child's <u>trust</u> (and not the child) at death.

To curb these perceived tax "abuses," Congress enacted the current GST provisions as part of the 1986 Tax Reform Act. In <u>addition to</u> 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 Section 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 Section 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. With certain exceptions, 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. Definition of Separate Property. 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 (but with responsibility for certain expenses) 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 maintenance 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 ("owner costs"). If the spouses owned the residence as community property but the deceased spouse's children from a prior marriage receive his/her one-half community property interest at death, the surviving spouse will bear one-half of the owner costs and the children will bear the other one-half.

Other "spousal" rights exist under state law, but are outside the scope of this presentation.

B. Definition of Community Property. The Texas Family Code defines "community property" to be all property acquired during marriage that is not "separate property." TFC Section 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 one-half of the property by each spouse). Upon the death of the first spouse to die, the deceased spouse may dispose of his/her one-half of the community estate in whatever manner he/she chooses, and the surviving spouse takes his/her one-half of the community.

Although each spouse technically owns one-half of each community asset, 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 can divide up the community other than on a strictly pro rata basis (i.e., one-half of each community asset for each). The income tax issue presented is whether a non-pro rata funding will 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 one-half in each community asset followed by an exchange of assets resulting in the actual desired division of the community estate. 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. <u>Inception of Title Rule</u>. 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 common law state to a community property state like Texas. The general rule is that property acquired in a common law 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 SECTION 7.002(1).

F. Planning for New Texas Residents and Couples Planning Marriage. 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 common law 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 common law state will maintain its character as determined by the 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.

Those rules have a similar application to Texas couples who are planning to be married. The law provides that the property they each own at the time of the marriage is his/her separate property. However, once they are married the community property system applies to determine the character of their property. This reality is particularly important in situations where one spouse-to-be has significantly more money than the other or where one (or both) prospective spouse(s) has (have) children from a prior marriage (i.e., where they are forming a blended family). Accordingly, at a minimum, couples in these situations should be advised as to the community property system (as discussed above) and its impact on their respective ownership rights with respect to marital property, and advised to take one of the following action steps.

1. **Do Nothing.** 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 commingled 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 commingling may unintentionally convert separate property into community property by default.

2. **Do Nothing But Keep Very Good Records.** 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. **Keep The Income And Corpus Separate.** In order to facilitate the requisite 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") periodically into a separate community property account or joint revocable management trust.

4. **Marital Property Agreement.** The final alternative (and often the recommended alternative) for the clients is to enter into a marital agreement 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 Section 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 one-half 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 Section 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 Section 4.101, et. seq.

5. **Summary of Planning.** Regardless of which action step 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. On the other hand, nonprobate property passes in accordance with a beneficiary designation (e.g., an insurance policy or retirement account), 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), or in accordance with the terms of a management trust (if the property is titled in the name of the trust during the decedent's lifetime).

1. **Intestate Distribution.** The laws of descent and distribution in the Texas Estates Code determine the distribution of the decedent's probate property

in the absence of a Will. Specifically, Section 201.002 of the Texas Estates Code deals with the distribution of separate property and Section 201.003 of the Texas Estates 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. **Separate Property Intestate Distribution.** Section 201.002 of the Texas Estates 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 one-half 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. **Community Property Intestate Distribution.** Section 201.003 of the Texas Estates Code provides that upon the death of a spouse, one-half 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 one-half interest in the community property will pass to the surviving spouse if the deceased has no children or descendants, or if 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 not children of the surviving spouse, then the deceased's one-half interest in the community property will pass to all children and descendants of the deceased spouse.

2. **Testate Distribution.** 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 one-half interest in the community property (or, if a Pour Over Will directs the probate estate into a revocable management trust becoming irrevocable at death, the trust will provide for that result).

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 following chart 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

D. Planning for the Residence. Particular care should be taken in addressing the ownership and use of the spouses' residence since it is often the most valuable asset involved and is often the asset with the most "emotional" importance. The following discussion highlights the issues to be addressed with respect to the ownership and use of the residence both during and after the marriage (whether that should occur due to divorce or the death of the first spouse) and potential solutions for resolving those issues.

1. **State Law Provides Default Rules.** If spouses do not provide otherwise in a marital property agreement, Texas law will dictate how their residence will be disposed of upon the termination of their marriage by divorce or by the death of the first of them to die. As discussed below, the deceased spouse can, to a certain extent, override those provisions applicable at death via a Will/Revocable Trust, but not entirely.

a. Divorce

i. If the Residence is a Spouse's Separate Property. If one spouse owned the residence prior to the marriage (or acquired it as separate property during the marriage), that spouse will continue to own it as his/her separate property and will retain it in the event of a divorce. If community property funds, or the separate property funds of the nonowner-spouse, are expended to benefit the residence, the nonowner-spouse may have a claim for reimbursement under Texas Family Code Section 3.402 against the owner-spouse's separate property estate (see the Note below). However, the nonowner-spouse will have no claim to the residence itself.

ii. If the Residence is Community Property. If the spouses own the residence as community property, the ownership of the residence will be resolved either by the spouses in a marital property settlement or (if the spouses cannot agree) by the judge. Either spouse could have a claim for reimbursement against the community property estate if that spouse's separate property funds had been expended to benefit the residence (see the Note below).

Note: The ownership of a marital property residence upon the end of a marriage by divorce or death of a spouse is determined as provided in this Section D.1. However, at that time, though it does not change the ownership or control of the residence, Section 3.402 of the Texas Family Code (as amended by the Texas Legislature in its 2009 session, effective September 1, 2009) creates a claim for reimbursement in certain circumstances. Specifically, if the funds of a spouse's separate property estate (the community property estate) are applied to (1) reduce the principal amount due on a note secured by a lien on, or (2) make capital improvements to, the

residence owned by the other spouse's separate property estate or the community estate (one spouse's separate property estate), the nonowner-spouse (the community estate) will have a claim for reimbursement. The amount of the claim for reimbursement for capital improvements to a residence is measured by the enhancement in value to the owner-estate.

For example, assume that Husband and Wife live in a residence owned by Husband as his separate property prior to the marriage and, during the marriage, Wife's separate property is used to convert the garage to a fully enclosed and expanded recreation room. Husband and Wife file for divorce on September 14, 2009, and Husband retains 100% ownership of the residence, including the new recreation room. However, pursuant to TFC Section 3.402, Wife has a claim for reimbursement against Husband's separate property estate in an amount equal to the enhancement in the value of the residence from the garage conversion/expansion. However, that claim for reimbursement may be <u>offset</u> by an amount equal to the value of Wife's use and enjoyment of the residence.

As noted, TFC Section 3.402 as outlined herein is effective for a marriage terminating (1) by divorce, if the action is filed on or after September 1, 2009 and (2) by death of a spouse, if that spouse dies on or after September 1, 2009. For divorces filed, and deaths of a spouse, before September 1, 2009, the prior versions of TFC Sections 3.402 and 3.403 apply.

The primary differences in these laws with respect to marital residences is that: the pre-September 1, 2009 law (1) creates a different claim, a claim for economic contribution, that is computed under a more mechanical method than the claim for reimbursement and (2) there is no offset for the nonowner-spouse's use and enjoyment of the residence during marriage; and, the post-August 31, 2009 law directs the Courts to use more discretion and apply "equitable principles" in determining the amount of reimbursement and offsets, where appropriate.

b. <u>Death</u>. For purposes of the following discussion (and for general ease of reference), assume the first spouse to die has a Will providing for his/her <u>entire</u> estate to pass to that spouse's children from a prior marriage and that all of such spouse's ownership interest in the residence passes pursuant to that Will.

i. <u>If the Residence is a Spouse's Separate Property</u>. If one spouse owned the residence prior to the marriage (or acquired it as separate property during the marriage), that spouse will continue to own it as his/her separate property and will have testamentary control over who will become the owner of the residence at the owner-spouse's death. The nonowner-spouse (or that spouse's estate) may have a claim for reimbursement

against the owner-spouse's separate property estate to the extent community property funds (or the nonowner-spouse's separate property funds) were used to benefit the residence, but the separate property nature of the residence will not be altered.

However, as noted in III.A above, Texas provides the surviving spouse with a "homestead right" (see Texas Estates Code Section 102.003), which entitles the surviving spouse to continue residing in the residence rent-free for the remainder of his/her lifetime **regardless of whether the surviving spouse owns any interest in the residence and regardless of whether the surviving spouse remarries.** In other words, even if the owner-spouse leaves the residence (his/her separate property) to his/her children, the children will take title to the residence subject to the nonowner-spouse's right of occupancy. The children cannot sell the residence as long as the nonowner-spouse wishes to assert that spouse's homestead occupancy rights. This will be the case, even if the nonowner-spouse retained ownership of his/her prior residence and could move back into it.

A surviving spouse asserting his/her right of homestead occupancy is responsible for paying property taxes, mortgage interest, and other maintenance expenses typically imposed on the owner of a legal life estate. The actual owners of the residence (the deceased spouse's children) will be responsible for paying casualty insurance premiums and mortgage principal payments.

Caution: The Tax Court has ruled that the surviving spouse's homestead right is a nonqualified terminable interest and therefore does not qualify for the federal estate tax marital deduction in the deceased spouse's estate. *See Estate of Kyle v. Commissioner*, 94 TC 829 (1990).

ii. If the Residence is Community Property. If the spouses own the residence as community property, each spouse will have testamentary control over who is to receive his/her community share in the residence at death. Either spouse (or that spouse's estate) may have a claim for reimbursement against the community estate if that spouse's separate property funds had been expended to benefit the residence.

To the extent the deceased spouse elects to leave his/her share of the residence to that spouse's children, the surviving

spouse will have two different "claims" to the residence. The surviving spouse will own one-half of the residence, representing his/her community share. The surviving spouse will also have a homestead occupancy right in the other one-half of the residence, even though title to the deceased spouse's one-half of the residence passed to his/her children at death. In that event, the surviving spouse will be responsible for paying all of the maintenance costs, mortgage interest and property taxes plus one-half of the mortgage principal and casualty insurance premiums (as owner of one-half of the residence).

Note, if the surviving spouse remarries and predeceases the new spouse, the new spouse will have a homestead occupancy right in the surviving spouse's one-half of the residence but will have no such right in the other one-half that previously belonged to the deceased spouse.

iii. Potential Issues Created. Obviously, less than ideal situations can result under the aforementioned scenarios if the surviving spouse wants to assert the homestead right:

- Tensions can develop between the deceased spouse's children and the surviving spouse over the use of the residence. For example, if the children were living in the house they could be forced to move out, unless the surviving spouse decides to be accommodating and permits them to stay.

- The children may lack sufficient funds to pay the insurance and mortgage principal payments (unless the deceased spouse provides them with those funds) and may therefore prefer to sell the residence to avoid continuing to incur those expenses. The surviving spouse may wish to remain in the residence and elect not to accommodate the children's desire to sell it.

- The surviving spouse may endure hardships in paying the maintenance costs, mortgage interest and property taxes, if the deceased spouse leaves little else to the surviving spouse and the surviving spouse does not have sufficient resources of his/her own.

- The surviving spouse may be unable to make the modifications/improvements to the residence he/she would like, if the children do not approve of the proposed alterations. Query, if certain modifications are necessary in order to provide the surviving spouse with the ability to

continue living in the residence (e.g., a wheelchair ramp or widening door frames to accommodate a wheelchair), would the deceased spouse's children be able to "veto" those modifications?

- The surviving spouse may wish to "downsize" and move into a smaller, less expensive home. However, the homestead occupancy right only applies for the residence the spouses shared during their joint lifetime. So, unless the children decide to be accommodating, the surviving spouse might not be able to relocate to a residence he/she might find more suitable.

2. **Recommended Approach: Specifically Address Ownership/Use of the Residence in Will and (As Necessary) a Marital Property Agreement.** Spouses should seriously consider addressing (either prior to or early on in the marriage) how the residence is to pass upon the termination of the marriage, whether due to divorce or death. The agreed upon arrangements should be formalized in the owner's(s') Will(s). The arrangements should also be incorporated in a marital property agreement, if the spouses want to make the agreed upon arrangements legally binding. As a result, spouses will help to avoid the potential tensions and disagreements between the surviving spouse and the deceased spouse's children discussed above. Discussed below are different scenarios that may apply with regard to the ownership/use of a residence, along with suggested ways of balancing the interests involved.

a. Divorce

i. If the Residence is Owned By One Spouse as Separate Property. As explained above, if the residence the spouses will share was owned by one of them prior to their marriage (or is acquired by one spouse during the marriage as his/her separate property), that spouse will retain ownership of the residence upon divorce. The nonowner-spouse may want an assurance that he/she will have a place to live if the spouses divorce. This may be of particular concern for the nonowner-spouse if that spouse sells his/her residence prior to the marriage and/or may otherwise lack the financial means to purchase a new residence in the event of a divorce. Given those concerns, the nonowner-spouse may suggest that the spouses enter into a marital property agreement providing in the event of a divorce for the owner-spouse to provide the nonowner-spouse with sufficient funds to acquire a suitable residence or other housing. Of course, the owner-spouse may not be receptive to such a suggestion. See Section III.F.4 of

this outline for a more detailed discussion of marital property agreements.

ii. If the Residence Is/Will Be Community Property. If the residence is or will be owned as community property, it may be prudent for the spouses to address ahead of time how the residence should be distributed upon divorce in order to avoid a judge making that decision for them. This will require addressing several issues:

- Should either spouse receive the residence in the settlement of the community estate? If so, what (if any) accommodations should be made for the other spouse from the community estate?

- Alternatively, should the residence simply be sold and the proceeds divided between the spouses? If so, in what proportions?

- If the residence is to be sold in the event of a divorce, should either spouse be permitted to continue living in the residence prior to its sale (and if so, for how long)? Should that spouse be required to pay rent in return? If so, how will that rent be determined (e.g., predetermined in the marital property agreement or based upon comparable rentals at the time of the use)? Who will be responsible for listing the residence for sale? Who will determine the list price?

b. Death

i. If the Residence is Owned By One Spouse as Separate Property. Again, if the residence the spouses will share was owned by one of them prior to their marriage (or is acquired by one spouse during the marriage as his/her separate property), that spouse will retain ownership of the residence and will have the ability to direct how it passes at that spouse's death, subject to the surviving spouse's homestead right. Of course, the nonowner-spouse may not have a strong desire to remain in the residence if he/she is the surviving spouse, particularly if the nonowner-spouse plans to retain his/her prior residence or would just as soon receive a cash bequest instead for use in purchasing a replacement residence. In that event, the owner-spouse might want to consider asking the nonowner-spouse to waive the homestead right, possibly in a marital property agreement in which the owner-spouse commits to leaving the nonowner-spouse

sufficient funds to find a replacement residence. In doing so, the owner-spouse will achieve the peace of mind that will come in knowing that this otherwise potentially contentious issue is resolved. He/she will now also be free to pursue lifetime planning techniques for the residence (e.g., transfer to a Qualified Personal Residence Trust, or "QPRT") without having to obtain the nonowner-spouse's consent, which would otherwise be required due to the surviving spouse's homestead right.

If, instead, the nonowner-spouse wants the ability to continue living in the residence for as long after the deceased spouse's death as the surviving spouse desires, it may be prudent to formalize those arrangements rather than rely on the homestead provision provided by state law (particularly if a marital deduction is desired and/or if the surviving spouse may not otherwise have the financial resources to pay the expenses required in order to assert the homestead right). In that event, the owner-spouse should consider incorporating in his/her Will the desired arrangement for the nonowner-spouse's use of the residence. It may also be appropriate to incorporate those arrangements in a marital property agreement as well (if a legally binding arrangement is particularly important to either or both of the spouses). The following discussion offers suggested applications of these principles.

- Alternative #1: Provide the Surviving Spouse Outright Ownership of the Residence. Under certain circumstances, it may be just as well for the owner-spouse (if the first to die) to leave the residence to the nonowner- spouse (along with funds necessary for its upkeep, if appropriate). This may be an acceptable solution, particularly if the owner- spouse has sufficient other wealth to leave to his/her children and the children have no particular sentimental attachment to the residence. As a result, the owner-spouse's children and the surviving spouse can all "go their separate ways."

  The surviving spouse will be free to make whatever improvements/modifications to the residence he/she desires (and can afford). Alternatively, the surviving spouse can "downsize" as appropriate by selling the house and purchasing a smaller residence (perhaps using the excess proceeds to cover future maintenance

expenses and property taxes). As a bonus, the deceased spouse's estate will receive an offsetting estate tax marital deduction for the gift of the residence (and any additional funds) to the surviving spouse. (Again, the deceased spouse's estate would not be entitled to an estate tax marital deduction if the surviving spouse were simply provided with his/her homestead right.)

- Alternative #2: Provide the Owner- Spouse's Children With Ownership of the Residence and Make Alternative Provision for the Nonowner-Spouse. If the owner-spouse's children are minors and the owner-spouse wants to provide his/her children with the option of continuing to use the residence (or if the owner-spouse's adult children have a particular sentimental attachment to the residence), it may be appropriate to leave the residence to the children. The owner-spouse can then provide the nonowner-spouse with a lump sum designed to provide him/her with the means to acquire a replacement residence. An offsetting estate tax marital deduction would be available for the funds left to the nonowner-spouse.

- Alternative #3: Leave the Residence to a Trust (Possibly a "QTIP"). If the owner-spouse wants to provide the nonowner-spouse with continued use of the residence but ultimately provide for it to pass to the owner-spouse's children at the nonowner-spouse's death, it may be preferable to leave the residence to a Trust. The nonowner-spouse would be granted the right to live rent-free in the residence, which will pass upon his/her death to the owner-spouse's children. The Trust could also be funded with funds sufficient to cover any future mortgage payments/property taxes/other associated expenses. In funding the Trust with funds sufficient to cover all expenses relating to the residence, the owner-spouse can avoid the issues that might otherwise arise with the shared responsibility for expenses that would be imposed on the nonowner-spouse and the owner-spouse's children if the homestead provisions were applicable.

  If desired, the Trust can be structured as a QTIP so that assets left to it by the owner-spouse will qualify for the federal estate tax marital deduction, which

defers any estate taxes otherwise due on those assets until the nonowner-spouse's death. (Typically, the QTIP bears whatever estate taxes are caused by its inclusion in the surviving spouse's estate, although spouses can make alternative arrangements in that regard.)

As a caveat, in order to qualify the Trust for the marital deduction, the nonowner-spouse must be given certain rights:

- The nonowner-spouse has to be given the ability to force the Trustee to sell the residence, invest the proceeds in income producing assets, and receive distributions (at least annually) of the resulting income. Consequently, if the owner-spouse wants to ensure that the residence will be retained for his/her children's ultimate use, the owner-spouse may be forced to forgo the estate tax marital deduction.

- The nonowner-spouse's right to the continued use of the residence (and the ability to force its sale) must be unconditional, meaning that the owner-spouse cannot provide for those rights to be extinguished in the event the nonowner-spouse remarries. (Of course, the homestead right provides the nonowner-spouse with a similar ability to retain use of the residence after the owner-spouse's death, even in the event the nonowner-spouse remarries.)

If the owner-spouse finds these conditions for securing the estate tax marital deduction to be unacceptable, it may be preferable to forgo the deduction and instead structure the Trust in whatever manner the owner-spouse (and the nonowner-spouse, if the owner-spouse is feeling accommodating) finds more acceptable.

Note, a legal life estate for the nonowner-spouse may also be an appropriate alternative, provided the drafting of such contains the elements necessary to qualify the provisions made for the nonowner-spouse for the estate tax marital deduction (if desired).

ii. If the Residence is Owned by the Spouses as Community Property. Many of the same concerns discussed above will apply (and offered solutions may be appropriate) if the residence is held by the spouses as community property. Of

course, in that event the surviving spouse will own one-half of the residence and thus will have an equal say in how the residence will ultimately pass once both of the spouses are deceased (unless the spouses provide otherwise in a marital property agreement).

Note, the spouses may wish to convert the residence from one spouse's separate property into community property. See Section III.F.4 of this outline for factors that might affect the spouses' decision in this regard.

3. Ensure Titling of Residence Is Consistent with the Objectives and Intent. The titling of the residence should be consistent with whatever plans the spouses have made for it. For example, if one spouse intends to purchase a new residence using separate property funds and wishes to have the residence correspondingly considered his/her separate property, title should be taken in that spouse's name only. Otherwise, if the spouse providing the funds for the acquisition takes title in both spouses' names, the Texas Courts have held that such spouse has made a gift to the non-contributing spouse and they each own a one-half separate property interest in the residence. *See Long v. Long*, 234 S.W.3d 34 (Tex. App.- El Paso 2007, pet. denied).

Also, keep in mind that even if the residence is to be held as community property, it should not be titled with survivorship rights (unless the spouses and their attorney(s) have chosen to do so for specific reasons). Survivorship rights will cause the residence to pass upon the deceased spouse's death directly to the surviving spouse. As a result, any tax and/or marital property planning provided for the residence in the deceased spouse's Will/Revocable Trust will not apply with regard to the residence. In addition, titling the residence with survivorship rights could be deemed an amendment to a previously executed marital property agreement and thus could defeat any planning for the residence contained in that agreement. In effect, the titling of the residence with survivorship rights could potentially reintroduce the sorts of conflicts that the spouses intended to avoid through specific planning in their testamentary documents and/or a marital property agreement.

Also use caution when titling an out-of-state vacation or rental property for your clients. In a recent case, Husband and Wife (both Texas residents and the second marriage for each) planned to buy a vacation home in another state and, upon the death of the second spouse to die, leave that home to Husband's siblings, nieces, and nephews who lived in that state. Wife did not know (had never met) those relatives of Husband. The house was purchased with community property. Husband and Wife engaged an attorney in the state in which the property was located to handle their purchase of the real estate. The resulting deed listed both Husband and Wife as the owners of the real estate.

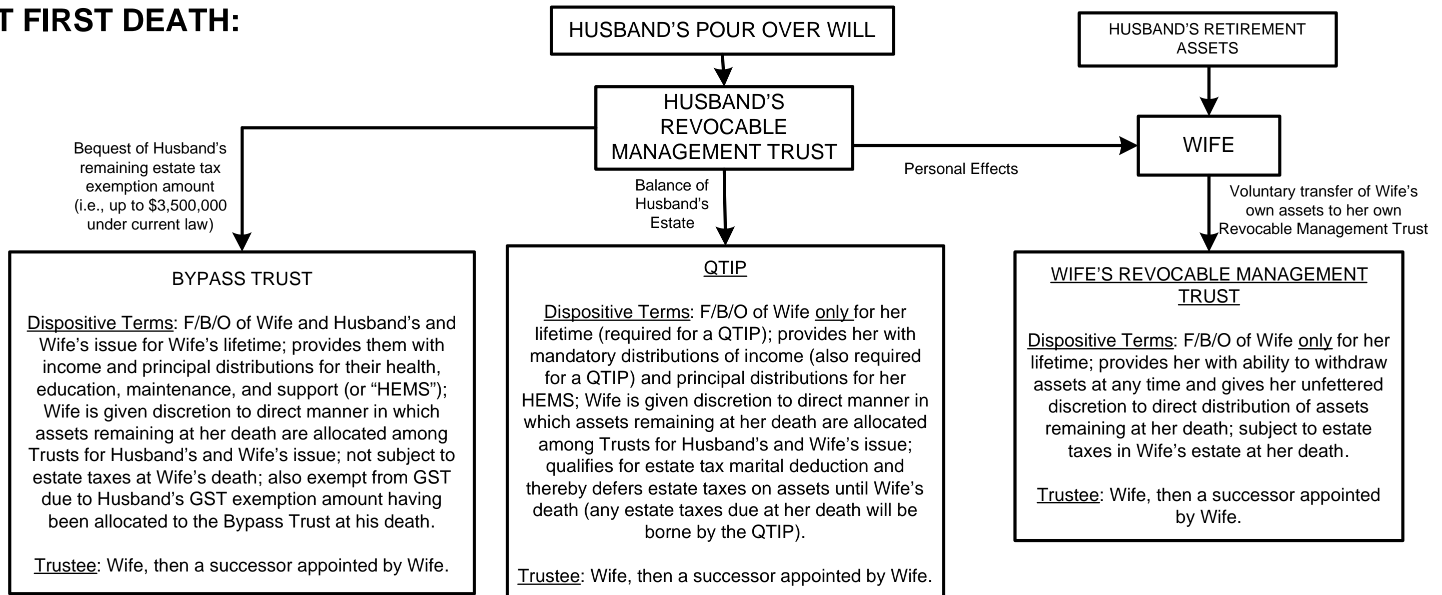
Husband died, leaving Wife surviving. Husband's Will was probated in Texas and his son was appointed Executor of the Estate. The Will transferred Husband's interest in the out-of-state real estate to his relatives, but, in working to accomplish that transfer, son was stunned to find that -

> under the laws of the state where the vacation home was located, by titling the real estate in the names of Husband and Wife, with no other language, title to the property was taken in a survivorship mode and, upon Husband's death, by law, a 100% ownership interest in the property passed to Wife.

That's the end of this story, except to note that Wife's children and grandchildren sure did like that vacation home.

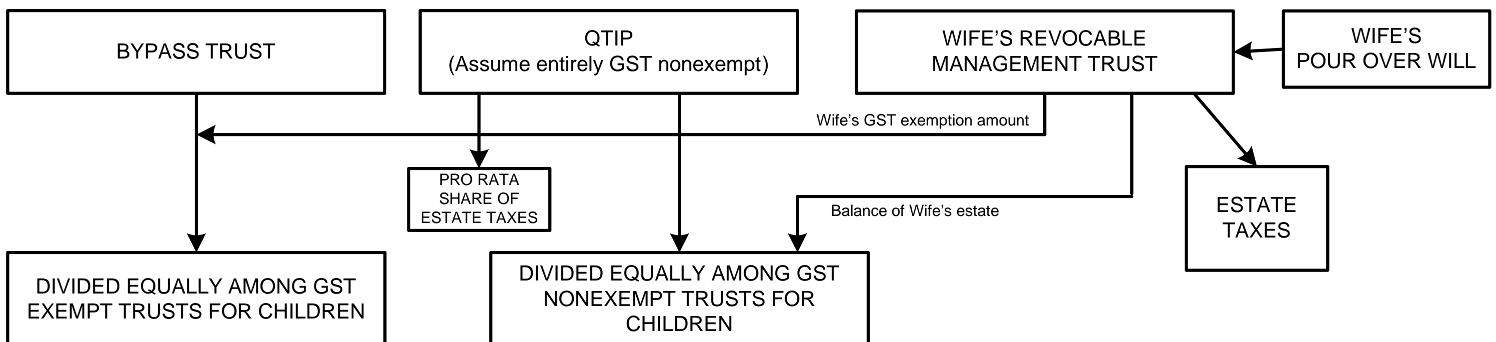
V. TESTAMENTARY PLANNING FOR BLENDED FAMILIES

A. Typical Estate Planning for Married Couple. 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):



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.



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 Blended Family.

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 one-half 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. The "portability" provisions introduced in the 2010 Tax Act can allow spouses

to address this issue by allowing the decedent spouse to "transfer" his unused estate tax exemption amount to the surviving spouse.

> EXAMPLE: Assume that Mr. and Mrs. Park have a $8,000,000 community property estate and Mrs. Park has inherited $2,000,000 worth of property, which she holds as her separate property. If Mr. Park dies in 2012, and portability does not come into play, his entire estate will consist of his $4,000,000 interest in the community property estate. If such property passes to a Bypass Trust for the benefit of Mrs. Park, such assets will not be included in Mrs. Park's estate, however, she will have a gross estate of $6,000,000 (i.e., $4,000,000 in community property and $2,000,000 in separate property). Had Mr. and Mrs. Park's combined estate been split evenly for estate tax purposes at each death, no estate tax would have been owed.

- **Potential Problem #7**: 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.

- **Potential Problem #8**: 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. Potential Solutions.

- **Potential Solution to Potential Problems #1, #2, and #3:** 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 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 2000-2, 2000-1 C.B. 305 and Revenue Ruling 2006-26, 2006-22 I.R.B. 939 (modifying and thus superceding Rev. Rul. 2000-2 in part) 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 Section 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 Section 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 Section 2036 or IRC Section 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 Section 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 Section 2523(f)(5)(B), which indicates that Wife's retained interest in the property after Husband's death (at which point IRC Section 2044 applies) will result

in the inclusion of the affected property in her estate under IRC Sections 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 one-half 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 Section 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 Section 2036 or IRC Section 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 Section 2044, the same reasoning should apply with this technique even though Husband acquires his "transferor" status at his death under IRC Section 2041). Of course, the same concerns with the apparent inconsistency between Treas. Reg. 25.2523(f)-1(f), Example 11 and IRC Section 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 Section 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.

- **Potential Solution to Problem #7:** 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.

- **Potential Solution to Problem #8:** 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. FACTORS UNIQUE TO A BLENDED FAMILY IMPACTING LIFETIME GIFTING

A. Gift of Community Property. A gift of community property is considered a gift of one-half of the property by each spouse. Accordingly, each spouse should file a separate Federal Gift Tax Return (IRS Form 709), reporting one-half 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 Section 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 Section 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 $28,000 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 Section 2513(a)(2), the non-donor spouse will not use any of his/her lifetime gift tax exemption on the gifts, but $14,000 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 Section 2632(c) to block the automatic allocation of GST exemption amount to the Trusts (assuming the Trusts are "GST Trusts" pursuant to IRC Section 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, Texas Estates Code Section 123.001 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, Texas Estates Code Section 123.052 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. Ensure Client Complies with Support Obligation Owed to Prior Spouse and/or Children from Prior Marriage and Marital Property Agreements. 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 spouse 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 Section 2207A</u>.** Consider whether the surviving spouse should waive the entitlement his/her estate has under IRC Section 2207A to be reimbursed for the estate tax due on a QTIP included in his/her estate at death.