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Trust UPDATE

Stillman BANK

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Estate planning and the "blended family"

There's more to estate planning than death taxes.

As important as it may be, preparing for estate and inheritance tax liabilities is just one component of a sound estate plan. Estate planners like to say that because every family is unique, there are no "cookie-cutter," one-size-fits-all solutions. The truth of that axiom is best demonstrated by looking at the unusual problems that can be presented by "blended families," those resulting from multiple marriages. High divorce rates are one source of the phenomenon, but so is growing life expectancy.

The following fictitious stories illustrate some of the estate planning problems that may crop up in these situations.

May-December marriage. Mark has remarried several times, but now he's found the one with whom he plans to stay for the rest of his life. Megan is quite a bit younger than Mark. In fact, she's younger than Mark's children from his first marriage!

Mark's estate plan gave Megan a lifetime income interest in his assets. She had the right to live in their home and receive all the income from their investments. At her

death, Megan did not have the power to direct these assets to others—Mark had seen to it that his children could not be disinherited. What Mark failed to anticipate was that Megan would live longer than any of his children, so none of them ever received any inheritance (but the grandchildren did, eventually).

The lost inheritance. Ann had been widowed for five years when she married Jack, a divorced man with two adult children from his first marriage. Ann had three grown children of her own. She was left in very good financial shape at her husband's death, and she had done a good job of managing her money on her own. Ann's big mistake was that she agreed that she and Jack should leave all their assets to each other. Ann was certain that she would outlive Jack anyway, as he was older and in poor health.

When Ann died unexpectedly, Jack inherited everything from her. Ann's children aren't likely to get any inheritance from their parents, as Jack has big plans for taking care of his own children.

An unexpected return. Tom and Sara lived the "Yours, Mine and Ours" story. They each brought a child to their marriage, and then they added two more. They succeeded in keeping friction among the stepsiblings to normal levels and appeared to be heading toward "happily ever after."

But when Tom died, an unexpected beneficiary appeared. It turned out that Tom never had changed the beneficiary designation on his 401(k) plan, so his first wife, Molly, inherited nearly $1 million. Sara and the couple's children were shortchanged.

Solutions

The first tool to think about in a second marriage situation is a prenuptial agreement, or "prenup" for short. Although these documents have their greatest utility in the context of divorce, because they spell out in advance what each spouse may expect, a prenup can be valuable for estate planning as well. The prenup will identify the assets that each partner brings to the marriage, and it may specify which assets will remain separate property. Provision may be made for the expected eventual distribution of the property. The process of inventorying assets lays a good foundation for subsequent estate planning.

Tom's mistake was that he never "finished" the divorce from his first wife. Steps needed to be taken to change beneficiaries for every life insurance policy, every IRA and retirement plan. A thorough asset review in connection with creating a prenup, before Tom and Sara married, would have revealed any oversights.

Ann's husband should have employed a Qualified Terminable Interest Property Trust (QTIP trust) to provide for widowhood, rather than leaving her their property outright. With a QTIP trust, the children's inheritance normally can't be diverted. The surviving spouse must receive all of the trust income, paid at least annually. The trustee also may be given the power to invade trust principal in specified circumstances. But at the widow's death, the remaining trust assets pass as specified by the person who established the trust.

Mark did use a QTIP trust, but the problem was that he failed to take into account the likely survivorship of his young wife. Mark would have been well advised to purchase life insurance to create an inheritance for his children at his death. He could have employed an irrevocable life insurance trust to avoid estate taxes on the insurance, while the QTIP marital deduction would eliminate estate taxes on what Megan would receive.

Long-term trusts

The most flexible approach to preserving an inheritance for children, whether they are minors or adults, is a trust. The trustee can take subsequent circumstances into account in sprinkling the income distributions among the beneficiaries. An irrevocable trust also provides financial protection in divorce, bankruptcy and lawsuits. It can be a mechanism for supporting financial discipline and avoiding irresponsible spending and the waste of an inheritance.

Take the next step

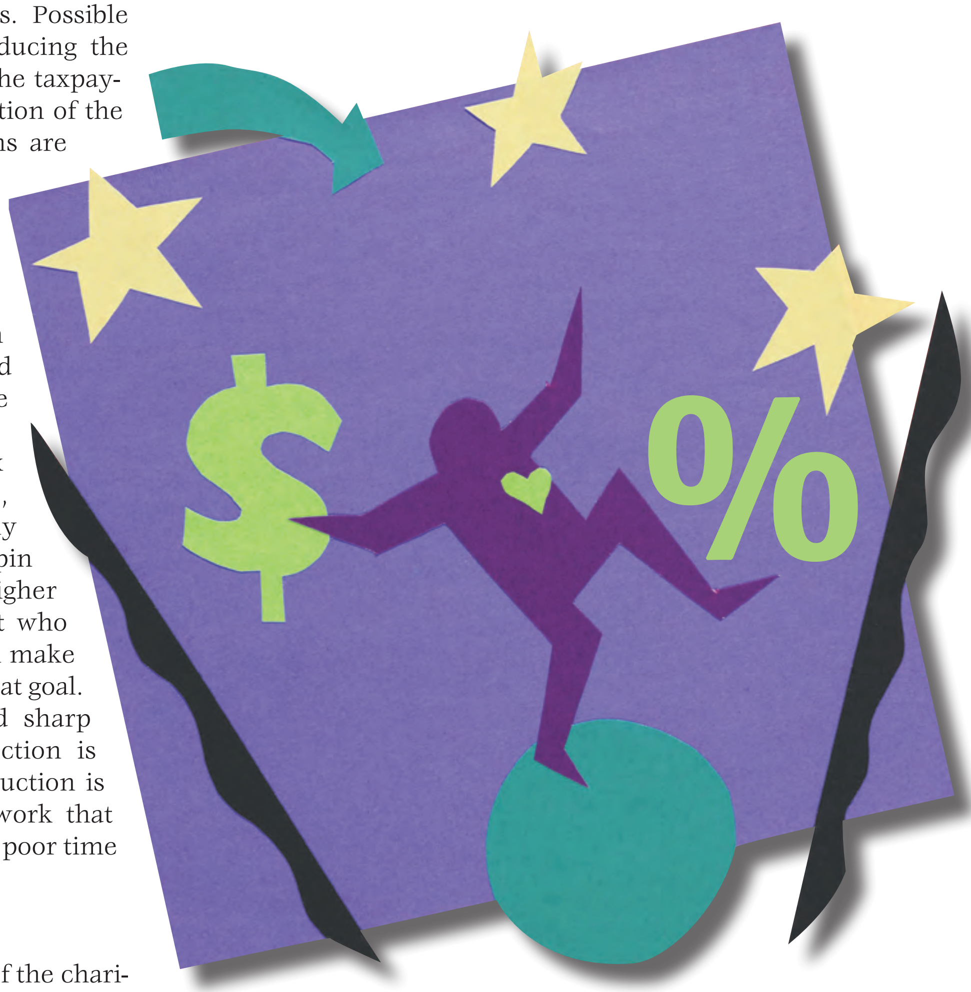
Basic estate planning for blended families requires care and regular review. An estate planning attorney's supervision will be required. We will be pleased to offer our counsel as well. ☐

Choices for marital trusts

Trust type	Estate tax exposure at spouse's death	All income to spouse?	Spouse can direct remainder?	Comment
Traditional marital deduction trust	Yes	Yes	Yes	Best for larger estates, paired with a credit shelter trust
Qualified Terminable Interest Property (QTIP) Trust	Elective	Yes	No	Best for multiple-marriage situations
Credit shelter trust	No	Elective	No	Appropriate by itself for smaller estates, but may be paired with traditional or QTIP trust
Qualified Domestic Trust (QDOT)	Yes	Yes	Elective	For a spouse who is not a U.S. citizen

Is the charitable deduction at risk?

In the quest for more revenue, some tax reformers have put the charitable deduction in their sights. Possible changes include capping the deduction, reducing the value of the deduction by delinking it from the taxpayer's marginal tax rate, and complete elimination of the charitable deduction. Nonprofit organizations are vigorously resisting any changes.



For the deduction

Americans are very generous, giving some $218 billion to charity in 2011. Of those who itemized their deductions in 2009, more than 80% claimed the charitable deduction, and itemizers were responsible for 76% of the charitable gifts.

For a taxpayer in the 35% bracket, the tax deduction reduces the cost of a gift by 35%, the marginal tax rate. A $10,000 gift costs only $6,500 after taxes. But charities routinely spin the math around in order to encourage higher donations. Someone in the 35% tax bracket who can afford a $10,000 reduction in income can make a charitable gift of over $15,000 and achieve that goal.

Some experts reportedly have projected sharp decreases in charitable giving if the deduction is reduced, approaching a 25% drop if the deduction is eliminated altogether. Given all the good work that nonprofits do, the charities conclude, this is a poor time to be choking off their source of funding.

Con

Over long periods of time, the actual impact of the charitable deduction is hard to discern. Top marginal tax rates fell steeply in the 1980s, from 70% to 50% and then to 28%, which decreased the tax reward for giving. Top rates rose in the 1990s, then fell again after 2001. Throughout this time, charitable giving remained at about 2% of gross domestic product. The marginal tax rate changes didn't appear to have much effect on aggregate giving.

Most of the benefit of the charitable deductions goes to the taxpayers with the highest income. Taxpayers with income over $100,000 represent 13.5% of all tax returns, but they claim 81% of the dollar value of the charitable deductions. Those who make more than $200,000, just 3% of all tax returns, take 55% of the deductions. These folks can still afford to make charitable gifts with a less generous incentive.

A taxpayer in the 28% bracket, who is in some sense less able to afford to make a large charitable gift, has an after-tax cost of $7,200 for a $10,000 gift. In other words, the real cost is more than 10% higher for the lower-bracket person than for someone in the 35% bracket. For that reason, President Obama proposed last year that the tax benefit of all charitable gifts be limited to 28%, rather than the taxpayer's marginal rate. That's still a good deal for the taxpayer, just not quite as good as it used to be.

Any of these changes would have no effect on donors who are not itemizing their deductions, who provide 24% of the support charities get, because they already get no tax benefit from their gifts.

Growth

In the long run, the better answer to meeting the needs of the government for more revenue and stronger funding for nonprofits is more economic growth. What is the tax formula that optimizes the operation of the economy? That turns out to be a difficult political question.

Philanthropy is not motivated by taxes, but it generally must be carried out in a tax-conscious, tax-efficient manner. Before making any major philanthropic commitments, be sure to check with your tax advisors. ☐

IRAs are important

A new study by the Investment Company Institute (ICI) reveals that IRAs play a crucial role in retirement financial security for more and more Americans. Among the findings:

- IRAs are now owned by 40% of U.S. households. The majority of these IRAs are traditional, tax-deferred ones.
- IRAs now hold $5.1 trillion in assets. That figure represents more than 25% of all retirement assets (including money set aside in employer retirement plans), and it is more than 10% of all household financial assets.
- The growth in IRA assets has been fueled by IRA rollovers, which account for more than half of all IRAs.
- IRAs are being used for retirement, as Congress intended. Only 7% of IRA withdrawals in 2012 were made by IRA owners who were younger than 59½.
- Age and income are correlated with IRA ownership. Only 28% of those under age 35 have an IRA, while 47% of those age 55 to 64 have one. Among those with income from $35,000 to $50,000, 36% have an IRA. Not surprisingly, 82% of those with income over $200,000 have one.

What do retirees plan to do with their IRA money? Pay regular living expenses and keep it as an emergency fund, and not blow it on big-ticket items. The table below adds up to more than 100%, because multiple responses were allowed.

What do you plan to do with your IRA withdrawals?	
Pay for living expenses	63%
Use for an emergency	62%
Reinvest or save in another account	41%
Pay healthcare expenses	31%
Home purchase, repair or remodeling	27%
Pay for education	14%
Buy a car or boat	9%
Other	18%

Source: ICI Research Perspective, *The Role of IRAs in U.S. Households' Saving for Retirement, 2012* (December 2012)