the Estate Planner

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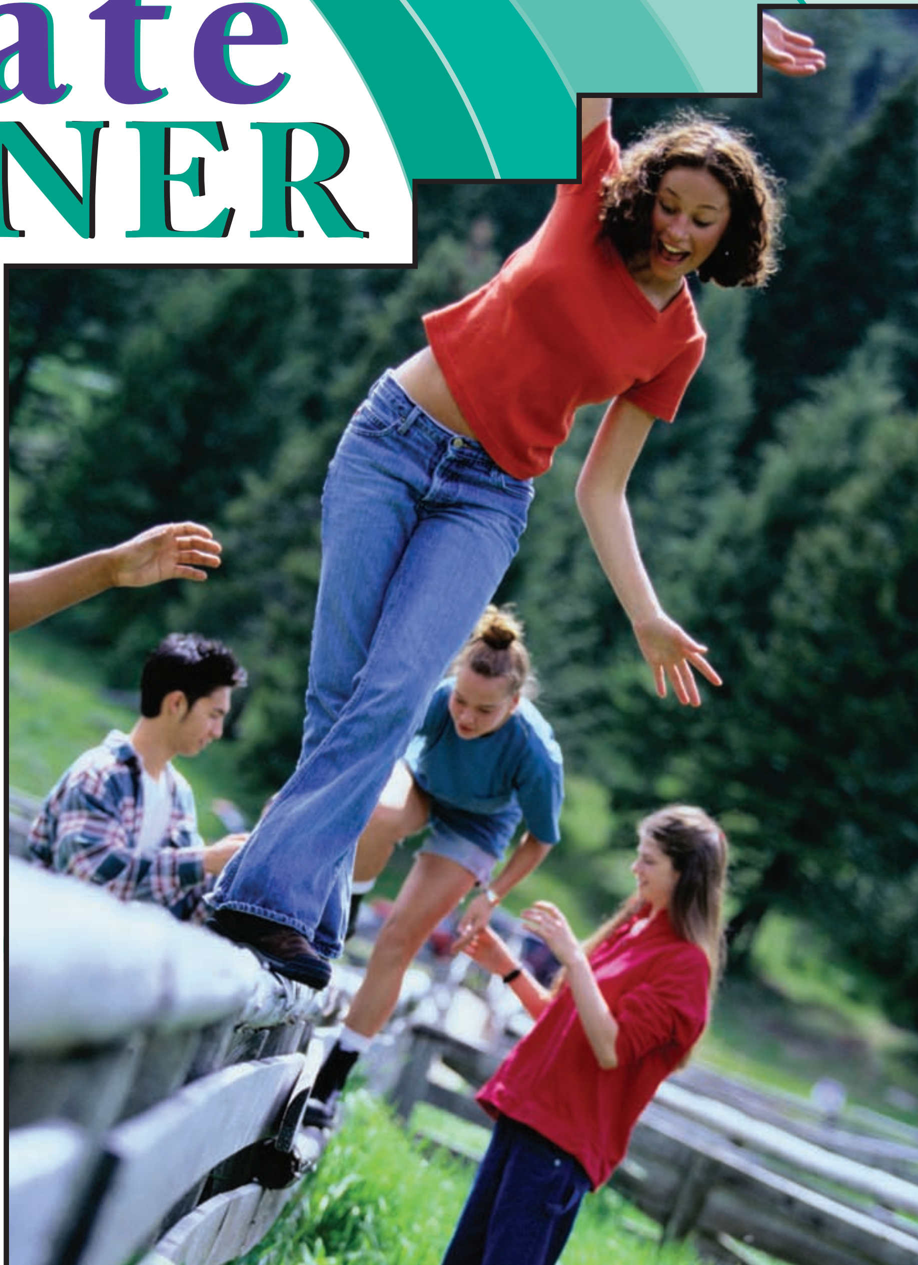

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OUR ESTATE PLANNING ATTORNEYS

Christopher L. Edgar	ChrisEdgar@lwr.com	Stuart F. Cheney	SCheney@lwr.com
John M. Huff	JohnHuff@lwr.com	Richard J. Puhek	RichPuhek@lwr.com
Steven J. Tjapkes	SteveTjapkes@lwr.com		

LAW WEATHERS & RICHARDSON

Professional Corporation
Attorneys and Counselors

800 BRIDGEWATER PLACE • 333 BRIDGE STREET, N.W. • GRAND RAPIDS, MICHIGAN 49504-5320
TELEPHONE (616) 459-1171 • FACSIMILE (616) 732-1740 • www.lwr.com

Balancing act

Estate planning for blended families

Estate planning can be an emotional high-wire act. As you strive to provide for loved ones with competing needs without hurting anyone's feelings (all while minimizing gift and estate taxes), one misstep can trip up your plans. And if you're part of a blended family — that is, one with children from two or more marriages — it's even harder to keep your balance.

If you have children from a previous marriage, there are several techniques you can use to provide for them while also taking care of your current spouse and any children from your current marriage. The right strategy depends on your personal circumstances, including your children's ages and the age difference between you and your spouse. But one thing is certain: You need to have a plan. Even in the most harmonious of families, a lack of planning can lead to tension and conflict.

Don't work without a net

All families should have an estate plan, but, for blended families, working without one is particularly dangerous. At the very least, you should have a will to be sure your wishes are carried out. Otherwise, a significant portion of your estate may go to your children from a previous marriage, even if they're adults and don't need the assets as much as your current spouse and children. Or, if your children from a previous marriage are minors, your former spouse could end up with control of the assets.

One of the most effective estate planning tools for blended families is a qualified terminable interest property (QTIP) trust. A QTIP trust is a marital trust designed to qualify for the estate tax marital deduction, meaning that assets you transfer to the trust aren't taxed when you die, and the entire amount is available for your spouse's support.

Unlike an ordinary marital trust, however, a QTIP trust provides your spouse with income for life but preserves the principal for your children (either from your current or previous marriage) or other beneficiaries. Note that, when your spouse dies, the trust assets are subject to tax as part of his or her estate.

Case in point

Let's look at an example. John and Jennifer got married two years ago. They're in their late 50s and each has adult children from previous marriages. Jennifer has substantially more wealth than John and is concerned about estate taxes. (As of 2006, she can transfer up to $2 million — less any used portion of her $1 million gift tax exemption — at death estate tax free to persons other than her spouse.)

Jennifer wants to ensure that John can maintain his standard of living if she dies before him. But she also wants to preserve the bulk of her wealth for her children and minimize estate taxes. Jennifer can leave all of her assets to John using the unlimited marital deduction to shield those assets from estate taxes on her death. (Note that, if John isn't a U.S. citizen, he must take additional steps to shield the assets.) But Jennifer isn't comfortable with this solution. Although she trusts John to leave the assets to her children from the previous

marriage, there are no guarantees: John may remarry. He may die before changing his will. He may become estranged from Jennifer's children.

Jennifer's estate planning advisor suggests a QTIP trust. If Jennifer dies first, the trust will pay John a generous income for the rest of his life. When John dies, the assets will go to Jennifer's children according to her instructions. However, the assets of the QTIP trust are included in John's estate at his death.

So Jennifer may choose not to place all of her assets in the QTIP trust. She may want to transfer enough to the trust to provide for John, and transfer some of her wealth directly to her children, taking advantage of her estate tax exemption that would otherwise be wasted by giving all of her assets to John.

Consider age imbalances

Under the right circumstances, a QTIP trust is a great tool for balancing competing estate planning goals and preserving family harmony. But in some cases — particularly when one spouse is considerably older than the other — it can hinder estate planning efforts.

Consider Bill and Suzanne, who got married 10 years ago and have two children, ages eight and six. Bill is 62 and has two children from a previous marriage, ages 27 and 30. Suzanne is 36 and this is her first marriage. Bill wants to make sure that Suzanne and their young children are provided for after he's gone, but he also wants to share his wealth with his older children. In addition, it's important to him that everyone in the family feels they've been treated fairly.

A QTIP trust would allow Bill to spread his wealth among the family, but it has a big disadvantage: Bill's older children would have to wait until Suzanne died to receive their inheritance. And with an age difference of less than 10 years between the children and their stepmother, that could be a very long time. Bill worries that such an arrangement would create tension within the family.

As an alternative, Bill's advisor suggests an irrevocable life insurance trust (ILIT). The ILIT purchases insurance on Bill's life, and Bill makes annual exclusion gifts to the trust to cover the premiums. If the ILIT is designed properly, there won't be any estate tax on the insurance proceeds. Had the insurance policy been gifted to the trust, however, and Bill doesn't survive for at least three years after the gift, the proceeds of the policy would be included in his estate, assuming the transfer was a taxable gift.

When Bill dies, the trust collects the death benefit and pays it out to his children from the first marriage. The older children receive their inheritance immediately, and Bill's other assets remain available to provide for Suzanne and the younger children.

All families should have an estate plan, but, for blended families, working without one is particularly dangerous.

Life insurance not only can enable you to achieve a fair and balanced estate plan, but it also can augment your estate, helping to ensure that there's enough wealth to go around.

Share your plans

Whichever estate planning approach you choose, be sure to discuss your plans with your loved ones. Even if your plan is inherently fair, it may not be perceived that way without an explanation.

If your grown children from a previous marriage are financially independent, for example, it may make sense to leave all or most of your wealth to younger children from your second marriage. But to avoid hurt feelings, talk it over with your older children and be sure that they understand the motives behind your plan.

Explore your options

There are many techniques at your disposal to strike a balance between competing estate planning goals. The important thing is to explore all of your options and devise a strategy that works for you and your family. ■

Beyond death and taxes

Planning for incapacity

You may think of estate planning strictly in terms of providing for your loved ones after you're gone and minimizing estate taxes. But it's equally important — some may argue that it's *more* important — to make arrangements in the event you become incapacitated or incompetent. Without proper planning, your family may be forced to seek a conservatorship or guardianship through the courts — a process that can be expensive and can expose your personal affairs to public scrutiny.

To be sure that your wishes are carried out in life as well as death, create a disability plan that covers both health care and financial management issues.

Choosing a health care plan

Health care planning generally is accomplished through two documents. First, a living will or advance directive states your preferences for life-sustaining medical actions. You may customize this document to express your wishes regarding certain procedures — for instance, artificial nutrition and hydration, invasive diagnostic tests, and pain medication — and the situations in which these procedures should be used or withheld — such as coma or irreversible brain damage with little chance of recovery.

A health care power of attorney authorizes your spouse or another person to serve as your surrogate for making medical decisions when you're unable to make them yourself.

The second document is a health care power of attorney (HCPA), sometimes called a durable medical power of attorney or health care proxy. An HCPA is broader and sometimes overlaps with the terms of a living will.

An HCPA authorizes your spouse or another person to serve as your surrogate for making medical decisions when you're unable to make them yourself. It covers not only terminal illness, but also any medical emergency in which you're unable

to consent to medical treatment. Your health care surrogate has the power to authorize medical treatment on your behalf, to place you in a medical facility or nursing home, and, in some cases, to terminate life-sustaining treatment such as artificial feeding and breathing.

Some people choose to have only an HCPA and not a living will, leaving it to the health care surrogate to decide if and when life-sustaining procedures should be terminated. Others prefer to have both documents, sparing family members the agonizing decision of whether to terminate life support.

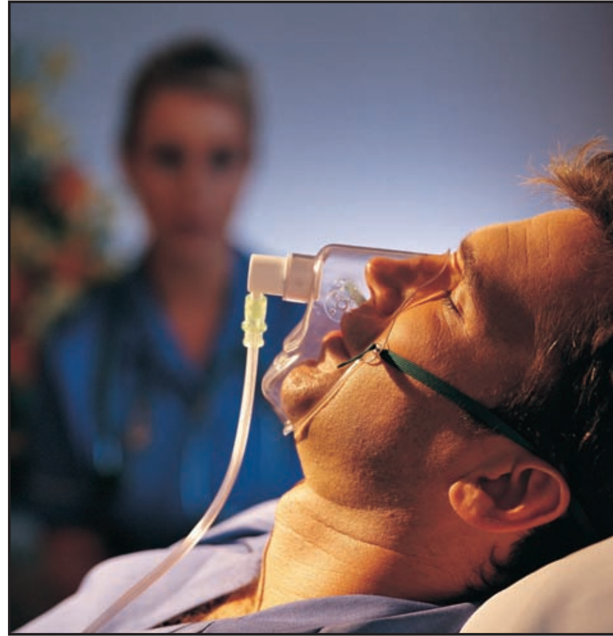
Managing your finances

On the financial side, there are two primary methods of handling your affairs. One common technique is a revocable living trust (RLT). An RLT is a self-settled trust — a trust that you create during life for your own benefit — and to which you transfer all or most of your assets during your life. You can remain in control of your property by serving as trustee, but, if you become incapacitated, a person you choose replaces you as trustee.

Appointing the right surrogate

The person you appoint as your surrogate under a health care power of attorney or your agent under a durable power of attorney (they need not be the same person) will have control over your life in the event you become incapacitated. These are important positions, so carefully consider who would be the right person or persons. Choose someone who is good with details, is in good health, has time to devote to these tasks and is well acquainted with your wishes.

Following an incapacity, your successor trustee manages your financial affairs and is responsible for using the trust property to meet your needs and, if so provided, the needs of your spouse and family. An RLT provides far more flexibility and privacy



than a court-supervised guardianship or conservatorship, and also it avoids probate at your death.

Another vehicle to avoid guardianship is a durable power of attorney (DPOA), which authorizes your agent to manage your investments, pay your bills, file tax returns, and otherwise control your property on your behalf while you're incapacitated. Like an HCPA, you can customize a DPOA to limit your agent's authority to act, or it can be broadly worded to permit your agent to do anything you could do with your assets if you weren't disabled.

Some states permit "springing" powers of attorney, meaning your agent can act only after you become incapacitated. Others allow your agent to act at any time, even if you're not incapacitated. Even if you establish an RLT, you also should have a limited DPOA to authorize your agent to add property to the trust and to handle nontrust assets, such as retirement plans.

Keep your plan up-to-date

Review your disability plan regularly as part of an overall estate plan review. Although most financial institutions and health care providers are familiar with HCPAs and DPOAs, they may hesitate to rely on a document that's several years old. To ensure your plan works smoothly, update documents every few years, if required. Estate planning is as much about life as it is about death. Don't overlook this important part of your plan. ▮

Not all assets are created equal

When deciding how to distribute wealth among heirs, many people mistakenly assume that all assets are created equal — in other words, leaving someone $1 million in cash is the equivalent of leaving that person a $1 million IRA. But once you consider the impact of federal and state income taxes, you may find that you've made the government an unintended beneficiary of your estate.

Who gets what?

Kaye has $1.5 million in assets, consisting of $500,000 in cash, a $500,000 IRA and $500,000 worth of stock that she bought for $200,000. She wants to treat her two children equally in her will, so she leaves the IRA to her daughter, Elizabeth, the stock to her son, Steve, and the cash to her favorite charity.

The value of Kaye's assets is well within the estate tax exemption ($2 million in 2006), so federal estate tax isn't an issue. But, assuming Kaye hasn't made taxable gifts during her lifetime, taxes still will affect the assets received by her children. Why? Because distributions from the IRA are considered income in respect of a decedent (IRD), which is taxed at the recipient's ordinary income tax rate, which may be as high as 35%. Assuming Elizabeth is in the 35% tax bracket, the real value of her $500,000 inheritance is only $325,000 — even less if she's hit with state income or inheritance taxes.

Steve, on the other hand, receives the full value of the stock. Even though the stock enjoyed significant appreciation in value during Kaye's life, assets are entitled to a "stepped-up" basis at the owner's death. In other words, Kaye's $200,000 basis in the stock is stepped up to $500,000 — the stock's fair market value when she dies. That means Steve could turn around and sell the stock for $500,000 without incurring capital gains taxes.

Should you gift your IRA to charity?

A better strategy for Kaye is to leave her IRA to charity (by naming the charity as beneficiary) and the cash to Elizabeth. This way, all three beneficiaries receive the full value of their bequests. Elizabeth gets $500,000 in cash, Steve gets $500,000 worth of stock and the charity gets the $500,000 IRA balance. Unlike Elizabeth in the previous example, however, the charity pays no income tax on the IRA.

If you're uncomfortable designating a charity as your IRA's sole beneficiary, consider naming it as a contingent beneficiary. When you die, the primary beneficiary — your spouse, for instance — can decide whether to accept the IRA funds or allow them to go to the charity by filing a tax-qualified disclaimer.

These strategies also may apply to other tax-deferred retirement vehicles, such as 401(k) or 403(b) plans, profit-sharing plans, Simplified Employee Pension (SEP) plans and Keogh accounts. Note, however, that the tax considerations discussed above apply to traditional IRAs, not Roth IRAs. Distributions from Roth IRAs generally are tax free, so they can provide a tax-efficient vehicle for leaving assets to your children or other heirs.

What is a "stepped-down" basis?

As shown in the previous example, the stepped-up basis rules usually provide your heirs with a big tax advantage. But if you own stock that has declined

in value, you may need to rethink your strategy. If the stock is worth less than you paid for it, your heirs will receive a "stepped-down" basis.

If the value of Kaye's stock had dropped to $100,000, for example, Steve's basis would also be stepped down to $100,000. If the stock's value later climbs to $175,000, and Steve sells it, he will be hit with a $75,000 capital gain though the stock is still worth less than what Kaye originally paid for it.

A better strategy would be for Kaye to sell the stock, or give it to Steve during her lifetime. By selling, she'd be able to deduct the loss before gifting the cash to Steve. If, instead, Kaye gives the stock to Steve while she's alive, his basis for tax purposes would depend on what the stock was worth when he sold it, with the amount being anywhere from the $100,000 value at the time of the gift up to Kaye's $200,000 cost basis, or more if a gift tax was paid at the time of the transfer.

What steps should you take?

As you develop your estate plan, consider the value of and tax attributes associated with your various assets. Armed with this information, you can allocate your assets among your heirs and other beneficiaries in a manner that best achieves your estate planning objectives.

Estate planning red flag

When minors or legally incompetent persons are beneficiaries of life insurance

Naming a minor or a legally incompetent person as beneficiary of a life insurance policy is asking for trouble. Insurance companies won't pay large death benefits directly to them, so the money will be tied up until a court can appoint a guardian or custodian — often an expensive and time-consuming process.

Even after the money is released, guardianship isn't the best option. In the case of minors, a court-appointed guardian's job is not to look after the minor's best interests, but to preserve the funds until the minor reaches the age of majority. A guardian may care for a legally incompetent person's needs indefinitely, but all decisions are left to the guardian's judgment; you have no say as to how the money is used.

Usually, the best strategy is to establish one or more trusts to receive the life insurance proceeds on behalf of a minor or incompetent beneficiary. A trust can be designed to meet their specific needs, offering both flexibility and financial security. It can allow the trustee to use the money for the loved one's education, health care, entertainment and comfort.

In the case of a minor, another advantage of a trust is that it allows you to control when and how the child will gain access to the funds. There's no need to release the funds to the beneficiary outright when he or she reaches age 18 or 21.

A simpler and potentially less expensive approach is to make arrangements with the insurer for settlement options, such as converting the death benefit into a long-term or life annuity. This may be a good alternative if you'd like a beneficiary to receive modest, fixed monthly payments.

If your child or other beneficiary is severely disabled or legally incompetent, consider setting up a special needs trust. These trusts are designed to provide for your loved one without jeopardizing his or her eligibility for government benefits, including Medicaid, Supplemental Security Income (SSI) and certain other assistance programs.

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Estate Planning Group

THE FIRM. The members of Law, Weathers & Richardson, P.C. are committed to our clients, dedicated to our profession, and devoted to our community and families. Working with these values, the firm has provided counsel and legal advice to individuals, businesses, and municipalities throughout Michigan since 1868. Large enough to offer expertise in virtually every area of the law, yet small enough to ensure personal attention and easy access, we strive to anticipate our clients' needs and help them avoid legal problems before they arise. Prompt and reliable service is our overriding priority. Our Estate Planning and Probate Practice Group attorneys are available at (616) 459-1171. The firm fax number is (616) 732-1740.

Christopher L. Edgar, chairperson of the Estate Planning Practice Group, concentrates his practice in estate planning, where he advises on business succession planning and uses advanced techniques such as family limited partnerships and limited liability companies, split interest trusts, irrevocable life insurance trusts and educational trusts, as well as incorporating life insurance and charitable giving in estate planning. He is experienced at handling probate-related litigation and has an extensive practice as an arbitrator for the American Arbitration Association. Chris is a member of the American Bar Association Real Property and Probate, Taxation and Business Law Sections and the State Bar of Michigan Probate and Estate Planning Council. He is also a Fellow of the American College Trusts and Estates Counsel and a past president of the West Michigan Estate Planning Council.

John M. Huff works with the firm's clients on the entire breadth of estate planning issues, including living trusts, charitable trusts, life insurance trusts, qualified personal residence trusts, and family limited liability companies and partnerships. He is a member of the Real Property, Probate and Trust Law Section of the American Bar Association, the Probate and Estate Planning Section of the State Bar of Michigan, and the West Michigan Estate Planning Council, as well as being an accredited Estate Planner for the National Association of Estate Planners and Councils. A frequent lecturer on estate planning and probate issues, John is a member of the East Grand Rapids Community Action Council and the Planned Giving Advisory Council for Albion College.

Steven J. Tjapkes focuses on business succession planning, estate planning, and probate. He works with business owners and executives to effectively transfer businesses and other assets to succeeding generations. Previously a veterinarian in private practice in mid-Michigan, Steve received his Bachelor of Arts degree in history from Calvin College, a Doctor of Veterinary Medicine degree from Michigan State University, and his law degree cum laude from the University of Michigan Law School. Steve is a member of the Grand Rapids Bar Association and the Probate and Business Law sections of the State Bar of Michigan.

Stuart F. Cheney engages in a tax based practice concentrated in corporate, securities and business law together with estate tax planning for the principal corporate owner. He received his law degree from the University of Michigan, where he also received a Masters of Business Administration degree and a Bachelor of Science degree in Mechanical Engineering. Stuart has acted as a guest lecturer for Chartered Life Underwriters estate planning courses and adjunct professor of estate tax planning at Grand Valley State University.

Richard J. Puhek brings his extensive experience in estate and gift taxation, estate planning and income taxation to the firm after many years at BDO Seidman, LLP, the former Old Kent Bank and Trust Company and Manufacturers National Bank. He received his B.B.A. from the University of Michigan and his Juris Doctor from the University of Detroit Law School. Rich holds Master of Business Administration and Master of Laws in Taxation degrees from Wayne State University, as well as Series 7 and Series 66 securities licenses.

Barbara L. Gracki, a legal assistant with the firm since 1983, assists the practice group and their clients with the administration of probate estates, consults with them regarding post mortem tax planning; and prepares federal estate tax and gift tax returns. She received a Master of Science degree from Brown University and a Masters of Business Administration from Grand Valley State University. Barbara serves as Board Chairperson of the Visiting Nurse Foundation and previously served as chair of the AIDS Resource Center board and on the Grand Valley State Legal Studies advisory board.