Finseca Report
Marketplace

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How Can Blended Families Use Life Insurance to Simplify Legacy Planning and Minimize Conflicts

Market Trend: Families today often involve former and current spouses, children from prior and current relationships, and other extended family members, which require changes to the conventional planning wisdom.

Synopsis: While conventional estate plans focus on a “traditional” family notion of one husband, one wife, and their children, families today often involve far more complex relationships. Thus, modern-day families often present unique planning issues, such as the need to satisfy obligations under marital agreements, the goal to provide simultaneously for both the surviving spouse and children from prior relationships, and the desire to ensure “fair” treatment of children from prior relationships, all while minimizing potential conflicts between the spouse and those same children. The acquisition of life insurance, as well as other “tweaks” to the conventional core plan, can address these objectives.

Take Aways: Straightforward strategies involving life insurance to equalize the inheritance of family members or to provide for liquidity can offer simple planning solutions for modern-day families. Coupling life insurance solutions with other modifications to the overall estate plan, such as the review of marital trust distribution provisions, the appointment of independent trustees, and the coordination of asset titling and beneficiary designations with the core estate planning documents, can minimize the potential for conflict and promote family harmony.

The Base Line: Conventional Planning

Today, the concept of family for estate planning purposes extends far beyond a husband and wife and their children to include former and current spouses, children from prior and current relationships, step-children, extended family members, etc., all of which can test the limits of conventional or "traditional" family estate plans. This complexity, however, does not necessarily need to overly complicate the planning, as life insurance can offer simple and flexible solutions to address the unique needs of today's families.

In a conventional plan, the predeceasing spouse typically wants to make all assets available to the surviving spouse, either through outright bequests or by using a combination of trusts designed to utilize the federal estate tax exemption and the federal estate tax marital deduction. For higher net worth families, this means the bulk of the estate passes solely to or for the benefit of the surviving spouse, generally with the inheritance of children and the associated estate taxes occurring at the death of the surviving spouse. This structure also is designed to maximize financial security and control for the surviving spouse.

Unique Issues in Planning for Blended Families

Unfortunately, conventional wisdom and planning often fail to address the unique aspects of the modern-day, or "blended," family, which include the following:

Satisfying Marital Agreements/Elective Shares. Clients may have pre- or post-nuptial agreements that mandate specific asset allocation for the surviving spouse. Also, if not addressed, applicable state law commonly provides a surviving spouse with rights to the predeceased spouse's assets, which may include an outright, "elective share" of the predeceased spouse's estate (e.g., up to one-third of the decedent's "augmented" estate, including prior gifts and non-probate assets, like retirement accounts and life insurance), which prevents spouses from disinheriting each other.[i]

Timing of Inheritance. Modern family clients may want to provide for the surviving spouse and children simultaneously, rather than in succession, particularly if the surviving spouse is closer in age to the children from prior relationships. Otherwise, those children must wait much longer for, and will be much older when they receive, their inheritance if conditioned on the surviving spouse's passing.

Heightened Potential for Conflicts. Conventional plans can actually create conflict for blended families. Typically, the conventional plan creates a family or bypass trust to hold the predeceased spouse's federal estate tax exemption, which primarily benefits the surviving spouse, although children also may be current beneficiaries. The surviving spouse, as the primary beneficiary, will want to maximize income and distributions from the assets, while children, who will likely receive the remaining assets, will want the trust invested for long-term growth. Further, children may question trust distributions to the surviving spouse, especially if they come largely from trust principal and/or are not made pro rata to all trust beneficiaries.

Equalization of Children of All Relationships/Marriages. For clients with children from both current and former partners, leaving all assets to the surviving spouse may not ensure equal benefits to all children, as the surviving spouse may favor his/her <u>own</u> descendants in his/her estate plan.

Allocation of Estate Taxes (Apportionment). The apportionment of estate taxes among beneficiaries is an important but often overlooked issue. If a client's will fails to apportion estate taxes to beneficiaries of specific bequests and non-probate assets, they will not share in the liability. This leaves the burden solely with beneficiaries of the remaining (residuary) estate, potentially resulting in the inequitable allocation of the liability and estate assets.

> *Example*: H and W have a net worth of $30 million, with most assets titled in H's name. H has one child from a prior marriage (X), and H and W have two children (Y and Z). H wants to ensure all children receive equal value. H dies first in 2022, specifically leaving $10 million to X, with the rest of his assets passing to a marital trust for W. At W's death in 2022, W's assets and the marital trust (total of $20 million) pass equally to Y and Z, after payment of $2,352,000 in estate taxes,[ii] leaving only $8,824,000 to each of Y and Z.

The Solution: Life Insurance

Make an ILIT Part of the Core Plan. Incorporating an irrevocable life insurance trust ("**ILIT**") into the core estate plan is a straightforward and effective solution that can fund spousal obligations under a marital agreement, provide immediate benefits to children at a parent's death, and/or provide separation among beneficiaries. For example, a bypass trust could benefit the surviving spouse and any children from that marriage, while life insurance in an ILIT could benefit children from a prior marriage, ensuring no delay in their inheritance and preventing family conflict over the distribution and investment of estate assets. Separate ILITs can be used as needed for beneficiaries in different classes (e.g., children from different relationships).

Use Life Insurance For Estate Taxes and Liquidity. Acquiring a second-to-die life insurance policy can address the estate tax apportionment issue by providing liquidity to cover the estate tax liability at the surviving spouse's death or to make up for the lack of tax apportionment. Ensuring sufficient liquidity for taxes and expenses also can minimize conflict about estate liquidation and asset allocation. Finally, life insurance proceeds can facilitate disproportionate distributions of assets, such as distributions of real estate or business interests to only certain family members while equalizing other heirs with cash.

Equalizing Spousal Wealth with Term Insurance. Often, spouses may not have equal assets in their individual names, particularly if a spouse is younger. In a more traditional setting, the portability of federal estate tax exemption between spouses makes this less of an issue, because any unused exemption of the predeceasing spouse can be transferred to the surviving spouse. Where the marriage is a second or later marriage for either or both spouses, however, the use of portability becomes more complicated, as the predeceasing spouse cannot control how the surviving spouse uses or allocates the "ported" exemption (which could be used to make gifts to children of a prior marriage). Acquiring convertible term insurance on the less wealthy spouse can be a simple and cost-effective solution for increasing that spouse's estate. The insured spouse can fully use his or her federal estate tax exemption if he or she is the predeceasing spouse and use the life insurance proceeds to provide benefits to his or her own family/children.

Still More Planning Options

Depending on family circumstances, the blended family's core plan could include the following:

Give Predeceasing Spouse's Estate Exemption to Children. If a predeceasing spouse has older children from a prior marriage, he could leave his federal estate tax exemption solely to his children, giving them a pool of separate assets from which they can immediately benefit.

Customize Marital Trust Provisions. Marital trusts should be a staple in a core estate plan for spouses in second or later marriages, but the trust provisions should be carefully reviewed. Spouses may want to limit principal distributions to an ascertainable standard (health, maintenance, and support) to preserve the remainder for children, as well as limit spousal control over distributions (e.g., avoid having the spouse serve as a trustee or have the spouse serve only as a co-trustee with very limited distribution powers). Also, spouses may want to avoid providing powers of appointment over marital trusts or ensure that the terms of any such powers do not allow the surviving spouse to exercise the powers to disinherit intended beneficiaries.
Clients also may consider capping the marital trust amount (such as by limiting funding to a fraction of the estate's value or to the amount necessary to satisfy a marital agreement obligation or an elective share right), which ensures a minimum amount immediately passes to the predeceasing spouse's other heirs (e.g., children). Depending on the size of the estate, this may generate an estate tax at the death of the first spouse.

Consider Independent/Institutional Trustees. Appointing an independent trustee who has sole authority over trust distributions may minimize conflicts over the propriety of trust distributions to the spouse (and children if both are trust beneficiaries) and the appropriateness of trust investments. Trust provisions also can provide limits on trustee removal and replacement; for example, if the spouse can remove a trustee, only corporate successor trustees may be appointed or the children must also agree to the successor, etc.

Review and Coordinate Asset Titling and Beneficiary Designations. Clients and advisors should carefully review the titling of assets held by the spouses and the beneficiary designations of non-probate assets. Property and accounts titled jointly with rights of survivorship or as tenants by the entirety will pass entirely to the surviving spouse by operation of law, not according to the predeceased spouse's estate planning documents, which may unintentionally disinherit other heirs. Similarly, beneficiary designations on retirement accounts and life insurance policies will control the distribution of those assets. Not only will clients want to ensure these designations coordinate with their existing estate plan, they also will want to make sure the designations have been accurately updated to reflect changes in marital status (e.g., retirement accounts do not name former spouses as beneficiaries).

Summing it up: Conventional Vs. Modern-Day Family Planning

	Conventional	Modern-Day

Distributions at First Death	• **Objective**: Provide maximum financial security for spouse
	• **Plan**: Provide all assets to surviving spouse (outright or in bypass trust/martial trust with spouse as primary/sole beneficiary) with the remainder to children at surviving spouse's passing
		• **Objective**: Provide for both surviving spouse and prior children immediately while minimizing potential conflict
		• **Plan**: Provide separate pools of assets for each party.
		  ○ ILIT to acquire life insurance solely benefiting prior children and estate assets to spouse
		  ○ Leave estate tax exemption solely to children, other assets to spouse

	Conventional	Modern-Day
Marital Bequest	• **Objective**: Maximize financial provisions for spouse and fully use the federal estate tax marital deduction • **Plan**: Distribute assets above federal estate tax exemption outright to spouse or in marital trust with liberal principal distribution	• **Objective**: Satisfy marital agreement/ elective share rights or otherwise provide for spouse but ensure sufficient remainder for children • **Plan**: ○ ILIT to acquire life insurance solely benefiting the spouse (in amount needed to satisfy marital rights) or solely for the children ○ Cap marital amount to specific fraction or amount needed to satisfy marital rights, and leave remainder to children (use life insurance to help with any resulting estate tax if amount left to children exceeds federal exemption)
Tax Apportionment	• **Objective**: Simplicity in tax allocation, remainder beneficiaries bear taxes • **Plan**: Apportion all estate taxes to remaining estate assets, no allocation to specific bequests or recovery from non-probate assets	• **Objective:** Ensuring beneficiaries receive equal or proportionate value after accounting for taxes • **Plan**: Review impact of taxes on specific and remainder distributions. Acquire survivorship life insurance to provide liquidity for estate taxes, to make up for the lack of tax apportionment, or to facilitate disproportionate asset distributions to certain family members while equalizing other heirs with cash
Trustee Selection	• **Objective**: Maximize control and comfort of the surviving spouse • **Plan**: Appoint surviving spouse as sole trustee or co-trustee with sole authority to make distributions to himself/herself (per ascertainable standard)	• **Objective**: Minimize conflict and ensure independent trust management and distributions • **Plan**: ○ Appoint an independent or institutional trustee with distribution authority. Provide limits on trustee removal and replacement by spouse/children ○ Create separate trusts solely benefiting a single class of beneficiaries to avoid disputes

Take Aways

Straightforward strategies involving life insurance to equalize the inheritance of family members or to provide for liquidity can offer simple planning solutions for modern-day families. Coupling life insurance solutions with other modifications to the overall estate plan, such as the review of marital trust distribution provisions, the appointment of independent trustees, and the coordination of asset titling and beneficiary designations with the core estate planning documents, can minimize the potential for conflict and promote family harmony.[iii]

[i] Often, the surviving spouse can elect to receive this share unless he or she has waived the right in accordance with applicable state law (e.g., as part of a marital agreement) or the predeceasing spouse's estate plan provides the surviving spouse with commensurate value (e.g., all assets received by the surviving spouse under the estate plan, including the present value of the spouse's interest in any marital trusts, equals the elective share amount).

[ii] Simply calculated, for illustration purposes only, as 40% of $5,880,000 ($30 million net worth minus H and W's combined federal estate tax exemptions of $24.12 million ($12.06 million each)).

[iii] This article was originally published on October 29, 2015 by Jonathan M. Forster, Martin Kalb, Richard A. Sirus, Steven B. Lapidus, Rebecca Manicone, Gerald H. Sherman (Counsel Emeritus 1932-2012), and Stuart Lewis (Counsel Emeritus 1945-2012) of Greenberg Traurig, LLP.