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Different Ways to Establish an Estate Plan in a Blended Family

Creating an estate plan that is equitable and fair to your new spouse and your children from a first marriage can be difficult to think about. In practice, there are a number of practical solutions and planning techniques that resolve conflict. The lack of understanding as to the options keeps many people from doing any planning. Fears and thoughts like the following often cause inaction: I don't want to start a fight; If I am fair to my children, my spouse might get mad; If I am fair to my spouse, I might not be doing right by my children.

Before the second marriage, many couples create a premarital agreement outlining the rights and responsibilities of each person in the event of death. If you do not create such an agreement, an estate plan can still be created to benefit and protect both parties: the surviving spouse and the surviving family.

Below you will find several plans that outline various approaches. Look at the approach that works best for your circumstance. Also, calculate the needs of each group so you can determine the funding source of the needs that are important to you.

Plan 1 – All to children.
You can set up an estate plan that leaves all of your estate to your children from the first marriage and leave nothing to your spouse. This is typical when the other spouse has ample resources and would not need assets from you.

Plan 2 – All to Spouse.
You can set up an estate plan that leaves all of your estate to your spouse and leave nothing to your children. This is typical when your children are adults and you do not feel the need to leave them an inheritance.

Plan 3 – Percentage Method.
You can set up a plan which leaves outright a percentage to your spouse and a percentage to your children. This is a clean approach from the perspective that all assets, regardless of the source, are divided by the percentage. If assets go up or down, both groups share in the appreciation and depreciation. There is no continuation of the estate plan under this method. Both groups take their respective share.

Plan 4 – Specific Assets Method.
In this plan, specific assets are allocated to your spouse and your children. This can be based on financial need, family heirlooms, or any other criteria you decide is important. You decide on an asset-by-asset basis which is better left to a specific person. For example, the surviving

spouse is left the home, 75% of the financial assets, and the retirement account while the children inherit 25% of the financial assets and all of the life insurance.

Obviously, the spouse who resides in the home and has shared the cost of maintaining the home should keep it. The minor children would presumably live with the surviving parent or, if they are adult children, they probably live outside of the marital home. Retirement assets are better left to a spouse because a spouse can roll over the retirement account and continue delaying income taxes on the IRA. Generally, it is easy to leave life insurance to children because that money did not exist prior to your death and is created by your passing.

Plan 5 – AB or ABC Trust.
One of the fears of leaving assets directly to a surviving second spouse is that upon his/her death, the assets will pass to the second spouse's family and not yours. For example, your estate is worth one million dollars and you leave half to your spouse. Your spouse inherits $500,000 and your children inherit $500,000. However, if your spouse dies three weeks after you, the $500,000 received by him/her would pass under the spouse's will to his or her children or other family members. Rather than leaving the money directly to the spouse, you can leave the spouse's share in a Trust. The Trust pays income and principal for certain expenses to the spouse for life. Upon the spouse's death, the remainder of the Trust is distributed to your children. Thus, the spouse would have use of the $500,000 in Trust, but at his/her death the principal would pass to your children not your spouse's children. Thereby, your children receive the whole million dollars. As an example, $500,000 would be allocated to the A Trust with income for life to your spouse with the remainder to your children. The B Trust is allocated the other half of the estate for the benefit of your children.

An ABC Trust is a version of the AB Trust concept except that various assets are allocate to each Trust and each Trust has a different set of rules. Look at the following example:

A Trust – the house and 25% of the money to be distributed outright to the spouse.

B Trust – 50% of the money held In Trust with income for life to your spouse, but on the death of your spouse, the remainder back to your children.

C Trust – 25% of the money and the life insurance to be distributed to your children.
Under this plan your children receive 25% of the money and the life insurance at your death and another 50% upon the death of the second spouse from the B Trust. The spouse receives the A Trust free of any restrictions. The terms of the B Trust are irrevocable. Therefore, If the spouse gets remarried, gets sued, goes to a nursing home, or dies, the B Trust is totally protected for your children.

Need based analysis.
Once you decide on a plan that splits the estate between the two groups, how do you know what the right split is? How do you determine the needs of each group? Do you focus on the support needs of the children, which might be large if they are young? Do you start with the income needs of the surviving spouse? The third option is to calculate both groups' needs and

then add life insurance to cover any shortfall between the size of your estate and the needs calculated.

Spouse's income needs.
If you died, there can be debts to be paid, like half of the mortgage on the house. Further, your spouse may need to replace some level of your income that is now gone. Assume at your death, you want $100,000 to pay off half of the mortgage on the joint house and you want to replace an income stream of $40,000 per year. In that case, the spouse's share of the estate is about $1,100,000. Use $100,000 of the estate to pay off half of the mortgage. That leaves $1,000,000 at a 4% return to produce $40,000 per year indefinitely. The rule of thumb is that a retirement cash flow can be maintained on a 4% payout. Thus, you need $1,000,000 to produce $40,000 per year. If you are very conservative you can use 3%. Any CPA or financial advisor can easily run these projections.

Under this approach, the spouse needs must be met first. The spouse would get the first $1,100,000 of assets and the children would get the rest. This approach may over-fund or under-fund your obligation to your children. Remember if you construct an AB or ABC Trust plan, the children from the first marriage can inherit some or all of the Trust when the second spouse dies. That fact may give you reason to overfund the spouse's needs knowing that at the spouse's death the Trust reverts back to your children.

Children's support needs.
If you focus first on the children's support needs, you have to consider their current age. A child, age three, needs some contribution towards support until age 18. Further, that child needs money for a college education. Thus, if you took $12,000 per year for 15 years and $100,000 for college, the correct level of funding for that child would be $280,000. The first $280,000 of estate assets are then directed to that child and the spouse then receives the rest of the estate either outright or in a Trust as indicated above. Because you started with the child's support needs, the balance could overfund or underfund the spouse's income needs.

Consider and fund both sets of needs.
The optimal approach is to calculate both the needs of the spouse and the needs of the children. If you do not have enough assets to fund both, you can purchase life insurance to create the assets to fund both in the event of your death. In the example above, the spouse's needs are $1,100,000. The child's needs are $280,000. If you are only worth $800,000, then you need $580,000 in life insurance to meet both groups' needs.

I hope this helps you with your retirement planning, estate planning, tax planning, and financial planning journey. Let me know if I can be of assistance. I welcome the opportunity to be a part of your team.

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