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All in the Stepfamily

Blended families have become the majority in the U.S. Do you have the tools in place to address their unique planning needs?

by Pamela Peters

We've all heard the story: John and Susan, who have a child — Adam — get divorced. Both remarry spouses who also have children from previous relationships. When John dies, he leaves his money to his new wife, Joan. But because John's financial plan didn't account for the intricacies of his blended family, when Joan dies, the money goes to her children. Young Adam is disinherited.

This scenario is just one of myriad planning crises blended families could face. And since this demographic has become the majority — according to the U.S. Census Bureau, blended families now outnumber "traditional" nuclear families — your role as financial advisor becomes crucial.

Each blended family, like each individual client, is unique. Perhaps both spouses have children entering college at the same time. Perhaps they plan to have a child of their own. Each scenario requires additional planning and tools that may or may not be your specialty. Make sure you have the right team — CPAs, estate planning attorneys, even family counselors if necessary — on board before the family walks through your door.

It doesn't help that most remarried couples carry some kind of emotional baggage. People don't split up for happy reasons: divorce, illness, death or some combination of the three rarely brings out the best in anyone. As a result, decision-making is tough. In a cloud of emotional smoke, options and risks become unclear. Initiating the planning process for these families is a fine balance between gleaning all the information you need to create an appropriate strategy while maintaining some sensitivity to the family's feelings.

The discussion should focus on the liabilities and benefits that could come out of two families' commingled finances. Make certain the clients understand the potential effects and plan accordingly. Help them discover all of the "what ifs": What if the wife dies? What provisions are in place to take care of her children? What if the husband dies? What if one spouse has a child with special needs? Does everyone in the family feel like they would be properly taken care of? And since more than 60 percent of second marriages end in divorce, what if they divorce?

Once you've assembled the planning team and cleared the air with your clients, consider these tools and potential scenarios as you formulate a plan that will protect the entire

family in every contingency.

Transfer Tools

The Uniform Transfers to Minors Act (UTMA) and the Uniform Gifts to Minors Act (UGMA) allow a client to open a custodial account in a child's name, making the account the child's asset, not the parents'. Unlike trusts these accounts do not require an attorney and can be set up through an advisor. Rules for UGMA and UTMA accounts vary from state to state.

The type of transfer you use will depend on the types of assets the client wants to transfer. UGMA only permits the transfer of bank deposits, securities and insurance policies while UTMA allows the transfer of property like real estate or jewelry.

The custodian carries the fiduciary responsibility to manage that money for the child until the account is turned over when the child reaches the age of majority (either 18 or 21, depending on the state). Be wary, however. "Since the parent can change the beneficiary on this account, there would have to be a clause in the original divorce decree to ensure that the ownership and beneficiary not be changed," says Gary Williams CFP® Certificant, of Williams & Associates in Columbia, Md.

Another caveat: if the account donor is also the custodian, and the donor dies before the account is transferred to the child, the assets in that account become part of the donor's taxable estate.

Insurance & Trusts

Hands down, life insurance is the best way to make certain everyone in a family is adequately compensated, says Kyle Krull CFP® Certificant Certified Divorce Financial Analyst and estate planning attorney from Overland Park, Kan. Life insurance can be used to cash out any number of people in the family, provide for college education and more. But in the case of blended families, life insurance is best used in conjunction with a trust to disperse the assets. This will ensure that assets wind up exactly where the insurance policy holder intended.

An irrevocable life insurance trust (ILIT), which owns life insurance and collects and holds life insurance proceeds for distribution to its beneficiaries, can provide an income stream for a living spouse. Here's a scenario where an ILIT might come into play in a blended family: A husband in a second marriage owns a business that he wants to pass on to two sons from a first marriage who joined the family firm. Since the sons will have control of the business after he dies, the husband wants to provide his wife income that is not contingent on the success of the business or the willingness of the sons to provide for their stepmother. By purchasing a life insurance policy inside an ILIT, the business owner can set up the trust so the insurance policy provides his new wife with an income stream after his death. And there's a bonus: "Because (the policy) is owned by the trust, it's not subject to estate taxes," says Williams.

The qualified terminable interest property trust (QTIP) is designed to provide income and possibly principal for a surviving spouse's lifetime. A QTIP can also protect the living spouse if he or she remarries and then divorces. "At the new spouse's death, the remaining assets would go into a long-term discretionary trust (LTD) that was set up for the children," adds Williams. The LTD trust would administer the children's inheritance through a trustee appointed by the parent.

Disinheriting the Ex-Spouse

Although not all divorces are destined for the Jerry Springer show, some blended families feel they must plan for the worst-case scenario. If an ex-spouse is not properly disinherited, he or she could potentially inherit the money intended for the children.

To avoid this contingency, make certain the ex-spouse is not the beneficiary on any formerly-blended assets. Check and then double check. According to the U.S. Supreme Court ruling in *Egelhoff v. Egelhoff*, an ex-spouse who is still the designated beneficiary on a retirement account will inherit that account, even if state law specifically disinherits the spouse.

Next, create an LTD with a third-party trustee to administer the inheritance for the client's children. The LTD would maintain ownership of the assets if the client's children pre-decease the new spouse until the grandchildren are able to inherit the money.

Without a third party trustee, if one spouse from the new marriage dies, the ex-spouse from the previous marriage would likely control the money for the minor children. "A third party trustee is obliged to make sure that ex-spouse uses the funds only for the children's

interests," says Williams.

As an added tax benefit, an LTD allows your client to take advantage of generation-skipping transfer tax planning for assets up to \$1.5 million. As a result, these assets would not be included in the estates of the client's children. "It can help protect the assets in the event that those children experience their own divorce, lawsuit or bankruptcy," says Krull.

College Planning

Blended families often have multiple children attending college at the same time. Add to that the rising cost of higher education, and it becomes incumbent to devise a plan that will address these hefty bills.

The ever-popular 529 Plan is one option for tax-advantaged educational savings, however Charles Sterck, a CPA with Sterck Kulik O'Neill in San Francisco, warns that even a small sum in a 529 account could impede a child's eligibility for other financial aid, like a Pell Grant, because aid applications count the account balance toward tuition.

For a larger sum of money, between \$100,000 and \$150,000, a 529 is an excellent way to protect educational funds from taxes.

For clients who aren't able to allocate large sums to a 529 account, Sterck recommends earmarking a standard savings account as the "college fund," paying the taxes on the interest, and letting the child seek out other sources of financial aid before adding those savings into the equation.

Another factor to consider as you develop a college savings plan for a blended family is that the financial aid process typically counts both spouses' incomes toward college payments, even if the child is a stepchild of one spouse. This could hamper a child's opportunity for financial aid. Let's say a husband marries a woman who has a daughter from a previous marriage. The daughter has no college savings to speak of. The wife has very little personal income and the daughter's biological father left the scene years ago. Had the mother been single, the daughter would be eligible for financial aid. However, the new husband's \$150,000 annual income counts toward the daughter's financial aid eligibility. If the new husband feels no obligation to pay for his stepdaughter's education, the child is in dire straits.

The obvious rift this type of situation could create is a perfect example of why clear communication and proper planning before the marriage is key. If both parents understood the daughter's desire to go to college and the financial issues it would create, they may have been able to find money within non-qualified accounts to pay for her college or even postponed the marriage so the daughter could qualify for financial aid.

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