CIVISTA
WEALTH MANAGEMENT

Trust & Investment INSIGHTS

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"Blended families" and their estate planning issues

Reduced death taxes—even elimination of them—don't eliminate the need to plan

Here's a question that we have heard several times:

"I'm planning to remarry, and I know that means I should take a look at my will. Right now I've left my property to my kids from my first marriage. I'd like to include my new spouse in my plan, yet I don't want to cut out the children completely. Is there an easy solution?"

In situations such as this, we've seen a lot of interest in the *Qualified Terminable Interest Property Trust* or, more commonly, *QTIP Trust.* The trust is "qualified" for the marital deduction from the federal estate tax, provided the surviving spouse is a U.S. citizen. The trust is "terminable" because it ends at the spouse's death, and the spouse usually doesn't have the right to change who gets the property at that point. In other words, the inheritance for your children is secure.

Another benefit of the QTIP trust is that the executor can elect a full or partial marital deduction, depending upon what's best for tax purposes. That flexibility is especially welcome during these volatile times when asset values can change suddenly.

That's the short answer.

Take nothing for granted

Here are three fictionalized examples of the failure to plan.

"It was a May-December marriage. He figured that because his son was much younger than his stepmother, it was easy enough to arrange for his new wife to receive income from some of his assets and the assets themselves to pass to his son after her death. But his son died first. One of his assets was a business that had been in his family for generations. I knew there were other relatives that he would have wanted to continue the business. But his new wife and her family run the business today."

Continued on next page

"He died with a very substantial life insurance policy. His will left everything to his new wife and the daughter from their marriage. Unfortunately, when I checked with the insurance company, it turned out that he had named his first wife as the beneficiary of the policy. The designation was very old, but it didn't matter. He never updated it, and his first wife was entitled to it all."

"They were both financially set when they married. Each had children from earlier marriages. They drafted new wills leaving everything to one another, thinking that each would provide for the other's children when one of them died. That was when things were rosy. It turns out that he grew to actively dislike her children. When she died, it became clear to her children that he had no intention of changing his will in their favor. I had to tell them that there wasn't anything that I could do about it."

Basic steps

As you contemplate how to integrate your new marital status in your estate planning, these steps are particularly important:

Make sure that you have severed all financial connections to your ex-spouse. You may have accomplished much of this at the time of your divorce. Most people recognize the need for a new will upon a change of marital status. But a will only directs how your *probate assets* will pass. Some of your assets pass outside of your will and so require new beneficiaries to be named to receive distributions. Examples of such assets include proceeds from a life insurance policy, and accounts with designations that call for payment or transfer on your death.

Protect your own children's inheritance and provide for your new spouse. Advisors strongly recommend against giving your new spouse any discretion in managing or distributing assets that you want your own children to have. No matter how much you trust your new spouse or how strong your belief is that the relationships in your new family are solid, you are leaving the door open to the possibility that your children's inheritances will pass to your spouse's offspring. At the same time, especially if your new spouse is not financially independent, you will want to see to his or her financial well-being too. The tricky part may be finding the right balance.

Implementing your goals

Estate planning specialists have several techniques to help you accomplish these goals.

A premarital agreement. In a blended family situation, these agreements are less in contemplation of divorce, more a way to identify what each spouse brings to the marriage and to whom it's expected that each spouse's property will pass.

A discretionary trust. Many parents in blended families set up this kind of trust because it allows them to choose an unbiased and impartial trustee to oversee a child's inheritance. The trustee may be authorized to pay income from the trust's assets as well as distributions of the assets themselves, according to the standards set out in the trust agreement. You may also be providing a layer of protection for your child's legacy from, say, a child's financial immaturity or the clutches of his or her ex-spouse. You may also set out a long-term strategy as to who will inherit the assets in the trust should a child predecease you. For example, you can direct that his or her children or your surviving children receive that share.

A qualified terminable interest property (QTIP) trust. As mentioned above, this trust allows you to provide for your current spouse for life and your children in the future, at the spouse's death. The typical QTIP trust calls for your new spouse to receive all the income from the trust (paid at least annually). He or she may also have a limited right to receive additional distributions from the trust.

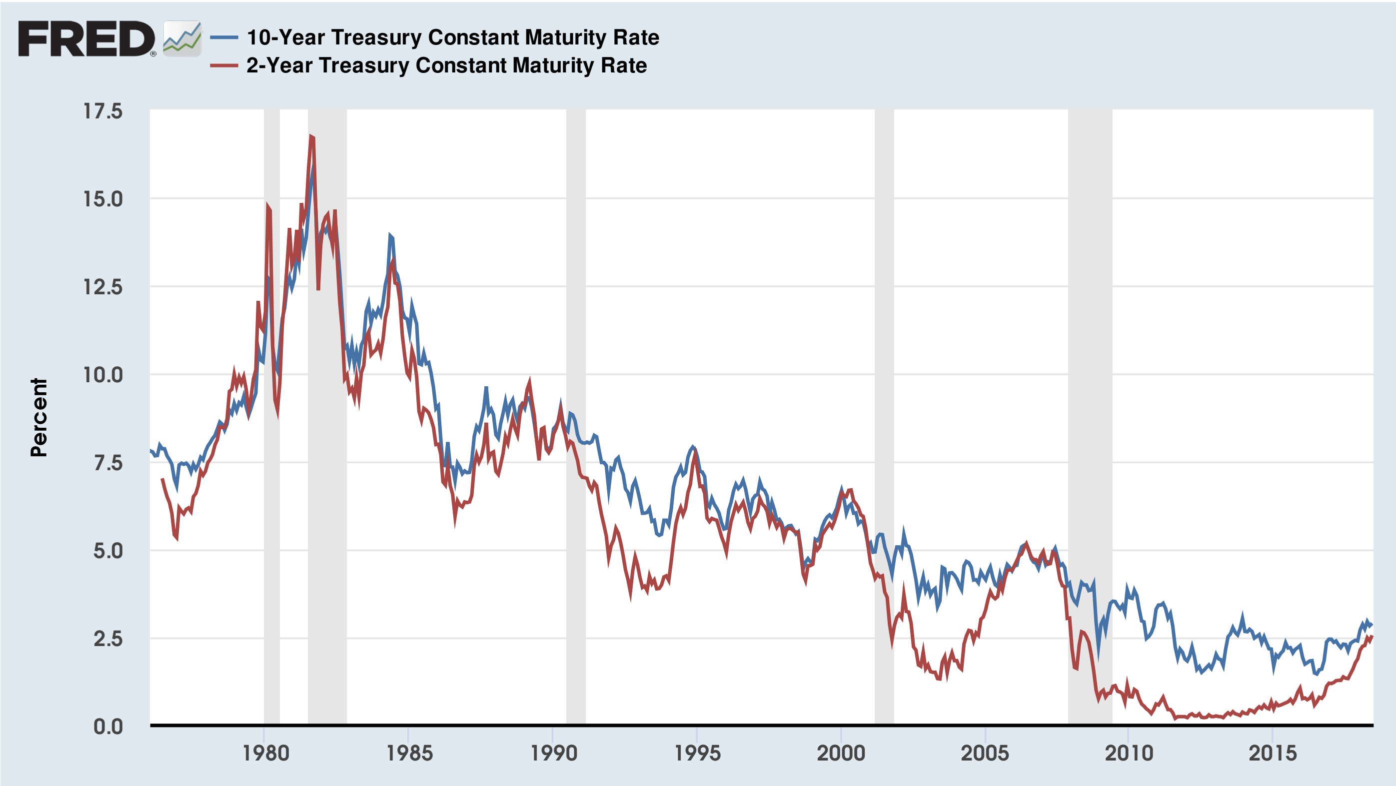
Put us on your team

If remarriage is on the horizon, we welcome the opportunity to assist you with your estate and trust planning. We will be glad to work with your other advisors to contribute to a smooth blending of your new family now and a secure financial future for you, your new spouse, and your children in the years to come. ☐

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

Source: Internal Revenue Code; M.A. Co.



Shaded areas indicate U.S. recessions. Source: Board of Governors of the Federal Reserve System (US)

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Yield curves

Unemployment is at an 18-year low. Corporate profits were sharply higher early in the year. Consumer confidence is very high. So is this a good time to worry about a recession?

Maybe so. The current expansion has been going on since 2009, longer than average. Some investors are beginning to worry about the "yield curve."

The yield curve is a comparison of short-term interest rates to long-term interest rates. Normally, the longer the maturity of a bond, the higher the interest rate that it commands. Long-term bonds have greater risks—the chance of an economic downturn, leading to potential default, for example, or the possibility of inflation eroding the bond's real value. Investors need to be compensated for taking on those added risks.

When there is little difference between short-term rates and the long-term rates, the yield curve is said to "flatten." And if short-term rates are higher than long-term rates, the curve is "inverted." An inversion of the yield curve is not a mere curiosity, it is a fairly reliable indicator of economic trouble ahead. All of the recessions since 1955 were preceded by a yield curve inversion. Only once was the prediction wrong. That time there was an economic slowdown, but one not so severe as to be labeled a recession.

Where are we now?

Recently, the yield curve has been flattening, as shown in the graph above from the St. Louis Federal Reserve Bank. The graph shows the interest rates on two-year and 10-year federal debt. In June the gap was only 0.34%. That's what has some investors worried and has caused them to watch for an inversion.

One problem with the yield curve indicator is that the time of onset of the economic downturn varies, from six months to two years. A lot can happen in two years.

Caveat

Perhaps the most famous last words in investing are, "This time it's different." But the market for Treasury bonds really is different at this time, because central banks bought trillions of dollars worth of government bonds after the great recession, in an unprecedented attempt to boost the economy. The Fed is now slowly unwinding that position. That action may be what is behind the failure of long-term rates to rise as expected as the economy improves. At the same time, the Fed has been boosting short-term rates, and so it is the central bank that is behind the flattening of the curve.

Some have suggested that in this circumstance, the yield curve is no longer so accurate a signal of the health of the economy. Time will tell.

Do you need a second opinion?

Do bonds play an important role in your portfolio planning? Are you satisfied with your understanding of the current bond market forces and the effects that they may have on your investments? Would you benefit from hearing the unbiased views of an experienced investment professional?

If so, we would be pleased to be of service to you. ☐

"Newman's Own" tax controversy

The cornerstone of legendary actor Paul Newman's estate plan, mentioned in his will, was the "Amended and Restated Living Trust Number One," executed before the will. The terms of that trust were not published, nor what assets it held. We do know that the living trust was the residuary beneficiary of Newman's estate; that is, any property not identified and transferred specifically by the will passed to the trust. We know from a provision in the will that the living trust provided for Newman's descendants, and that should such descendants be less than 35 years old when Newman died, separate trusts would be created for them. Finally, we could tell from the will that a marital deduction trust was carved out of the living trust for the benefit of Newman's surviving spouse, Joanne Woodward. The will provided that the marital trust would be funded with Newman's interests in production companies and the royalties and residuals due Newman from his acting career.

Somewhat more detail was provided regarding the legacy to Newman's Own Foundation, which has continued his philanthropic work. The Foundation acquired all "Publicity and Intellectual Property Rights" of the Newman estate. Newman urged vigilance upon his executors in protecting his image after his death, hoping that his likeness never would be used in ways that he did not approve of during his life, nor to sell food products inferior to the current Newman's Own line.

The Foundation also received 100% of the ownership of Newman's Own food company, which is a for-profit company that gives all of its after-tax profits to charity. There is a tax trap here that Mr. Newman may not have known about. Foundations are forbidden to own more than 20% of a for-profit company (35% in some circumstances). Accordingly, Newman's Own Foundation had until November 2018 to divest itself of 80% of the company or face ruinous income taxes.

After nearly 10 years of lobbying, earlier this year the Foundation succeeded in securing a new tax code loophole to protect it from this fate. The taxes will not apply if:

- a foundation has 100% ownership of the for-profit company;
- 100% of the profits of the business pass to the foundation;
- the foundation is not controlled by its creator or family members, and
- the business cannot have outstanding loans to substantial contributors or family members.

The exception has been drawn so narrowly that it likely does not currently apply to any foundation other than Newman's Own Foundation. On the other hand, it may prove to be a template for similar arrangements in the future. ☐