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The QTIP trust: A powerful planning tool for blended families

Remarriages are increasingly common. According to recent data from the U.S. Bureau of Labor Statistics, by age 55, nearly 27% of those who've married have done so more than once. As a result, "blended" families — in which one or both spouses have children from a previous marriage — are also increasingly common.

Estate planning for blended families can be challenging. You'll likely want to ensure that your current spouse is well provided for, while also preserving a portion of your estate for your children from a previous marriage.

If you leave assets to your current spouse outright, however, there's nothing to prevent him or her from spending them, mismanaging them or leaving them to a new spouse, effectively disinheriting your children. One strategy that can help achieve your objectives is a qualified terminable interest property (QTIP) trust. It may also offer tax and asset protection benefits.

What's a QTIP trust?

A QTIP trust is an irrevocable trust that pays out its income to your surviving spouse at least annually and meets certain other requirements. After your spouse dies, the trust's remaining assets go to your children or other beneficiaries, but they're treated as part of your spouse's estate for tax purposes.

A QTIP trust can help you balance competing objectives by providing your spouse with income for life while preserving the trust assets for your other beneficiaries. The assets are protected by 1) appointing a qualified trustee to ensure they're invested and managed wisely, and 2) restricting your spouse's access to the trust principal.

However, if you'd like your spouse to have limited access to principal in the event of unexpected needs or financial challenges, you can authorize the trustee to make discretionary distributions for your spouse's health, maintenance and support according to standards that you set.

What are the tax benefits?

At one time, QTIP trusts were commonly used in estate planning to defer estate taxes. That's because assets transferred to a QTIP trust are sheltered from gift and estate taxes by the unlimited marital deduction. When the beneficiary spouse dies, the trust assets are included in his or her estate but are usually protected against tax by that spouse's gift and estate tax exemption. Ordinarily, to qualify for the marital deduction, you must transfer property

Accelerating your children's inheritance

One drawback of a qualified terminable interest property (QTIP) trust, especially if your current spouse is considerably younger than you, is that your children may have to wait years or decades before they receive the trust principal. If you'd like your children to receive their inheritance sooner, consider using a life insurance policy to create immediate benefits for them while leaving other assets to your spouse. If estate taxes are a concern, consider placing the policy in an irrevocable life insurance trust (ILIT). A properly structured ILIT generally allows the insurance proceeds to bypass your taxable estate.

to your spouse outright or through a trust in which your spouse's interest won't terminate. A QTIP trust is an exception to this rule.

Now that the federal gift and estate tax exemption has grown to an inflation-adjusted $15 million ($30 million for married couples filing a joint tax return), those taxes aren't a concern for most families. However, QTIP trusts also provide valuable income tax benefits. Because the trust assets are included in the beneficiary spouse's estate for tax purposes, they enjoy a stepped-up basis (to fair market value) in the hands of the remainder beneficiaries (for example, your children). That means the remainder beneficiaries can sell the assets without triggering a hefty capital gains tax on the appreciation that occurred during the beneficiary spouse's life.

What are the asset protection benefits?

A QTIP trust also offers some protection against claims by the beneficiary spouse's creditors or a future spouse. The level of protection depends on several factors, including applicable state law and the trust's structure.

For example, asset protection may be stronger if the trust has an independent trustee, restricts the beneficiary spouse's access to or control over the trust assets, and either prohibits distributions of principal to the spouse or limits them to discretionary distributions by the trustee to meet the spouse's health, maintenance and support needs.

It may also be helpful to include a "spendthrift" clause that prohibits the use of trust assets to pay the beneficiary's debts.

Is a QTIP trust right for you?

For blended families whose wealth is well within the gift and estate tax exemption amount or is unlikely to reach it in the future, a QTIP trust can be a powerful tool for achieving their planning goals while providing children or other remainder beneficiaries with valuable income tax benefits.

A QTIP trust can help you balance competing objectives by providing your spouse with income for life while preserving the trust assets for your other beneficiaries.

However, these trusts may not be the best choice for reducing gift and estate taxes. If you expect your wealth to be exposed to these taxes, it may pay to consider additional tools, such as a credit shelter trust, which offers a blend of estate and income tax benefits. Contact your estate planning advisor to help determine if a QTIP trust would be beneficial for your situation.

Closely held business owners, listen up!

An ESOP can benefit your estate plan

As an owner of a closely held business, you're likely familiar with how an employee stock ownership plan (ESOP) can offer an exit strategy and provide a tax-efficient technique for sharing equity with employees.

What you may not be aware of is that an ESOP can be a powerful estate and retirement planning tool. Indeed, ESOPs can help business owners address several planning challenges, including a lack of liquidity and the need to provide for children outside the business.

ESOPs basics

An ESOP is a qualified retirement plan, similar to a 401(k) plan. But instead of investing in a selection of stocks, bonds and mutual funds, an ESOP invests primarily in the company's own stock. ESOPs are subject to the same rules and restrictions as qualified plans, including contribution limits, minimum coverage requirements and nondiscrimination testing. They also require an annual stock valuation by an independent appraiser.

Also, by definition, ESOPs are available only to corporations. Both C corporations and S corporations are eligible, but the two entity types are subject to different rules. For example, S corporation owners, unlike their C corporation counterparts, can't defer any gain on the sale of their shares.

ESOPs in action

Typically, a business makes tax-deductible cash contributions to the ESOP, which uses the funds to acquire stock from the current owners. This doesn't necessarily mean giving up control, though. The owners' shares are held in a trust, and the trustees — usually officers or other insiders — vote the shares (except on mergers or other major issues). A "leveraged ESOP," which borrows the funds used to acquire stock, offers the greatest tax benefits. The company's contributions cover the loan payments, essentially permitting it to deduct both interest *and* principal.

An ESOP's earnings are tax-deferred: Participants don't recognize taxable income until they receive benefits — in the form of stock or cash — when they leave the company, die or become disabled. In closely held companies, employees who receive stock can sell it back to the company at fair market value for a period of time. This creates a potentially significant "repurchase obligation," which the company should prepare for by setting aside reserves or purchasing key person life insurance.

Estate planning benefits

If a large portion of your wealth is tied up in a closely held business, a lack of liquidity can create challenges as you approach retirement. Short of selling the business, how do you fund your retirement and provide for your family after your death?

An ESOP may provide a solution. By selling some or all of your shares to an ESOP, you convert your shares into liquid assets. Plus, if the ESOP owns at least 30% of the company's outstanding common stock immediately after the sale, and certain other requirements are met, you may be able to defer or even eliminate capital gains taxes. How? By reinvesting the proceeds in qualified replacement property (QRP) — which includes most securities issued by U.S. public companies — within one year.

QRP provides a source of retirement income and allows you to defer your gains until you sell or otherwise dispose of the QRP. From an estate planning perspective, a simple yet effective strategy is to hold the QRP for life. Your heirs receive a stepped-up basis in the assets, permanently eliminating capital gains.

If a large portion of your wealth is tied up in a closely held business, a lack of liquidity can create challenges as you approach retirement.

If you want more investment flexibility, you can pay the capital gains tax upfront and invest the proceeds as you see fit. Or you can invest the funds in qualifying floating-rate long-term bonds as QRP. You avoid capital gains, but can borrow against the bonds and invest the loan proceeds in other assets. In addition, you can use a QRP to fund a charitable remainder trust (CRT). Not only does a CRT provide you with a current charitable income tax deduction and an income stream for life, but it can dispose of QRP without triggering tax liability.

If estate taxes are a concern, you can remove QRP from your estate, without triggering capital gains, by giving it to your children or other family members. These gifts are subject to gift and generation-skipping transfer taxes, but you can minimize those taxes using traditional estate planning tools, such as grantor retained annuity trusts (GRATs).

In addition, an ESOP can be an effective strategy when some of your children are active in the business, and some aren't. For example, you might sell a portion of your stock to an ESOP and use the proceeds to provide for children outside the business, and give the remaining stock to children in the business. Ideally, gifted stock would be sufficient to maintain family control of the business.

Is an ESOP right for you?

An ESOP can be a valuable component of your estate plan, offering a tax-efficient way to transition business ownership while helping preserve your legacy. By selling shares to an ESOP, you may be able to generate liquidity for your family, diversify their personal wealth and potentially reduce estate tax exposure. Because every business and family situation is unique, it's important to work closely with your estate planning and business advisors.

Clarity counts

A letter of instruction can be a valuable addition to your estate plan

Most people understand the importance of having a valid will as part of their estate plans. A will helps ensure that your assets are distributed according to your wishes and can provide legal guidance for your loved ones after your death. However, there's another estate planning document that's sometimes overlooked yet can be extremely beneficial: a letter of instruction.

Key information to include

A letter of instruction is a personal document that accompanies your estate plan. It serves as a practical guide that can help your family members, executor and other trusted individuals understand your wishes and manage important details during a difficult time.

Unlike a will, it's generally not a legally binding document: It doesn't replace a will, trust or other legally enforceable estate planning documents. Thus, your letter can't direct the distribution of assets or override provisions in your will.

One of the greatest benefits of a letter of instruction is that it allows you to communicate information that may not belong in a will or other legal documents. For example, the letter can detail vital financial information that has been omitted or glossed over in the will.

Along with account numbers, list the locations of documents. And don't forget to provide contact information for your estate planning team. Typically, this will include your attorney, CPA, investment advisor and life insurance agent. These professionals can assist your family following your death.

Make it personal

A letter of instruction can also help reduce confusion and stress for your family. While a will may specify who inherits certain assets, it often doesn't explain the reasoning behind those decisions or address personal matters. A letter gives you an opportunity to share your thoughts, explain special family considerations or express personal wishes that may help your loved ones better understand your intentions.

In addition, the letter can address practical matters that aren't typically covered by legal estate planning documents. You may wish to include information about:

- Funeral or memorial service preferences,
- Care instructions for pets,
- Guidance regarding family heirlooms or sentimental items, and
- Personal messages to family members.

Because a letter of instruction generally isn't subject to the same legal requirements as a will, it can be updated more easily as circumstances change. For example, if you open new financial accounts, change advisors or update your digital assets, you can revise the letter without necessarily amending your will. Of course, it's important to ensure that your estate planning documents remain consistent and work together effectively.

Put pen to paper

A letter of instruction's value lies in helping your loved ones understand your wishes and navigate practical matters that legal documents may not fully address. If you haven't done so already, draft a letter of instruction and make sure that others know where and how to locate it. Your attorney or estate planning advisor can help fill in the blanks if you need help.

ESTATE PLANNING RED FLAG

You didn't place restrictions on your charitable gifts

Charitable giving allows you to support causes you care about while potentially reducing your estate tax burden. However, making *unrestricted* gifts to charity without careful estate planning can create unintended consequences that may diminish both your benefits and the gifts' long-term impact.

An unrestricted gift gives a charitable organization complete discretion over how the funds are used. While this flexibility can help charities address their most pressing needs, you may be disappointed if your contributions aren't directed toward the programs or initiatives that you intended to support. Once you make the gift, you generally have no control over how the charity will allocate the funds.

Additionally, unrestricted gifts may not align with your broader estate planning objectives. Individuals with significant assets may benefit from considering charitable trusts, donor-advised funds or private foundations, which can offer greater control, flexibility and tax efficiency.

Fortunately, you can take steps to preserve your charitable legacy. Begin by placing restrictions on your gift at the time of the donation. Typically, you might limit the use of the funds to a specific cause or function of the charity, such as stating that the money must be spent on medical research or shelter for the homeless. Have this documented in your will, a trust or an endowment fund agreement.

The exact rules will vary based on applicable federal and state laws, but properly structured restrictions may provide additional protection if a charity later encounters financial difficulties. The charity is generally expected to honor donor intent, and properly documented restrictions may be legally enforceable.

Best approach: Do your homework before making substantial charitable gifts. Consider using the IRS Tax Exempt Organization Search (TEOS) tool. TEOS provides access to information about charitable organizations, including their latest tax returns, IRS determination letters and eligibility to receive tax-deductible contributions.

What role does real property play in your legacy?

Real property can be a critical cornerstone to your family's future and requires special attention in estate planning.

Photo Credit: iStock

In fact, real property ownership *demands* close attention. The complexities of real property ownership require careful planning to protect your legacy and ensure smooth transitions for those you cherish.

Your real property – whether a family home, vacation property, commercial building, or investment real estate – is often a cornerstone of an individual or family's estate. For practical estate planning puposes, it's vital to understand that real property is far more than physical assets. It encompasses land, improvements, and a bundle of legal rights (use, possession, exclusion, and transfer) that introduce unique challenges if not properly addressed.

At The Michael Law Group we understand and pay specific attention to the nuances of real property within your estate plan. We navigate the legal, financial, and familial complexities, helping clients structure ownership so that transitions remain seamless, efficient, and aligned with their intentions.

Why does real property require special attention?

A significant aspect of estate planning flows downstream from two fundamental questions: Who owns the property, and what is the nature of that ownership? Real property adds layers of complexity:

- *Titling and Ownership Forms:* Choices like sole ownership, joint tenancy with right of survivorship, tenancy in common, tenancy by the entirety, or business entities (e.g., LLCs) determine control, liability exposure, probate requirements, and how assets pass to heirs.
- *Probate Implications:* Without proactive planning, real property often enters a lengthy, costly, and public probate process that can delay distributions and increase expenses.
- *Tax and Liability Issues:* Considerations include property taxes, capital gains, basis step-up, creditor claims, and risks associated with rental or commercial holdings.
- *Family and Transfer Dynamics:* Multi-generational properties or co-ownership can lead to disputes or unintended outcomes without clear directives.

If overlooked, these factors can significantly affect the futures of your loved ones.

How do we help?

We understand the full implications of real property as part of your estate planning; not just the law, but how it intersects with your personal goals. Our team works with clients to tailor strategies that:

- Optimize ownership structures to avoid probate, enhance asset protection, and support efficient transfers.
- Integrate real property into revocable living trusts or other similar planning vehicles for privacy, control, and flexibility.
- Utilize entities such as LLCs to shield personal assets while maximizing tax and management benefits for investment properties.
- Coordinate with your broader estate plan for consistent and holistic protection.
- Conduct regular reviews to adapt to life changes, market shifts, and evolving laws.

Our clients benefit from ownership transitions that are seamless, cost-effective, and free of unnecessary complications, preserving wealth and family harmony.

Which approach best serves your legacy?

Laws vary by location and change over time, so what works today may need adjustment tomorrow. We recommend reviewing your assets and estate plan on a semi-regular basis or upon major life events.

To learn more about how the Michael Law Group can support your real property and estate planning needs, call 312-900-0151. We are always happy to discuss your situation and provide clear, actionable guidance.

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