SELECT PORTFOLIO MANAGEMENT, INC.
Integrated Wealth Management
A Registered Investment Advisor

White Paper:

Estate Planning Issues That Concern Unmarried Couples

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Estate Planning Issues That Concern Unmarried Couples

What are estate planning concerns of unmarried couples?

In general

Estates must deal with two major areas of the law: probate law, which governs the distribution of your property after your death, and gift and estate tax laws, which govern the taxation of the property you transfer to others. As a partner in an unmarried couple, you have reason to be concerned with both of these areas. Laws that protect and favor married couples don't apply to you. Without proper protection, your surviving partner could be ordered out of a house you share, your next of kin could dispose of your estate in a way of which you would not approve, or taxes could take a big bite out of the bequest you leave to your partner. Your partner could be left out of financial and medical decision making if you become seriously ill or incapacitated. Don't take anything for granted. Get your estate plan in order. You owe it to yourself and your partner to ensure that your estate is handled according to your wishes.

Probate concerns

Your partner has no automatic legal right to inherit your estate. Unless you set up a will or will substitutes to provide for your partner, your estate will go to your next of kin.

Gift and estate tax concerns

Because you cannot take advantage of the unlimited marital deduction, your estate may be heavily taxed on any amount you leave to your partner. Property you hold as joint tenants with rights of survivorship will not necessarily escape estate tax. Gifts you make to your partner may also be taxable.

Illness and incapacity concerns

Without a durable power of attorney for health care (DPAHC), medical professionals and/or your partner's family may exclude you from medical decision making or even visiting your partner if he or she becomes seriously ill or incapacitated. Without a durable power of attorney for finances, you have no authority to manage your partner's financial affairs as he or she would wish.

The different roles of probate law and estate tax law

Probate laws govern the distribution of your estate, whereas gift and estate tax laws govern the taxation of your estate. Although these areas of the law often overlap, they each play a distinct role in the estate planning process. The assets included in your estate for purposes of probate law may differ from what's

included for purposes of gift and estate tax. The probate court generally reaches fewer assets than the gift and estate tax laws.

Four ways to transfer your estate to your partner

There are four ways you can transfer your estate to your surviving partner:

1. Automatically, by owning property in joint tenancy with right of survivorship (JTWROS); this can apply to any property with a title, such as real estate, vehicles, bank accounts, stocks, bonds, and mutual funds (for more information, see Property Ownership Issues That Concern Unmarried Couples)
2. By designating your partner as the beneficiary of your life insurance policy and/or retirement account (for more information, see Beneficiary Designations)
3. Through the provisions of a living trust (for more information, see Living Trust)
4. Through the probate laws of your state (for more information, see Probate)

Any property transferred through a JTWROS, a beneficiary designation, or a trust will not pass through probate. The probate court handles estates governed by a will, as well as those without a will that transfer assets according to the intestacy laws of your state.

Probate concerns

As a partner in an unmarried couple, your partner has no legal right to inherit your estate. Unless you set up a will or will substitutes to provide for your partner, your estate will go to your next of kin through the probate process. There are several reasons you may want to avoid probate. Remember that probate courts handle estates governed by wills as well as those without wills. If you transfer your estate to your partner in a will, certain disapproving relatives or certain other parties can contest it. If you die without a will, your estate automatically passes to your next of kin according to the intestacy laws of your state, which will leave your unmarried partner without a share of your assets. If you're concerned about the court having jurisdiction over the distribution of your assets, you might want to keep as much of your estate as possible out of probate. Another reason to keep your estate out of probate is that probate proceedings are a matter of public record, open to anyone who inquires about them.

Avoiding probate

You can use the following approaches to keep as much of your estate as possible out of probate:

- JTWROS
- Beneficiary designations on life insurance and retirement accounts
- Living trusts

For assets that cannot avoid probate

Use a will

You can use a will to transfer any assets that you cannot transfer through the probate-avoiding approaches mentioned above. Although probate courts generally respect the wishes outlined in a properly executed will, the threat of a will challenge from a hostile or disapproving family member can cause a lot of anxiety for your loved ones, since your estate is already in court when it enters probate.

Reduce the risk of a will challenge

A successful will challenge is hard to mount. Someone contesting your will must prove that it was executed incorrectly, that you were unduly influenced or not of sound mind when you made it, or that it was the result of fraud.

However, if you are seriously concerned about a will challenge, you can take the following steps to reduce the risk:

- Pass as much of your estate through these probate-avoiding mechanisms: JTWROS, beneficiary designations, and living trusts.
- Mention every member of your family in your will. If you're disinheriting someone, you may want to state a sensible reason why (but do not slander someone in your will). (A will challenge is most likely to come from a disinherited family member.)
- Add a "no contest" provision to your will. This means that anyone who contests your will gets nothing at all.
- If you have a debilitating disease such as AIDS, prepare your will early to ensure that there's no question that you're of "sound mind and body."
- Make sure that your will is executed properly. If your surviving partner is the beneficiary of the bulk of your estate, he or she should not be present when you execute the will. This helps minimize the chance that a disgruntled family member will later have grounds to claim undue influence.
- Share your plans with your family in advance. Avoid having your death be the occasion on which you "come out" to them. The shock of your death combined with the surprise of learning about your lifestyle can be doubly difficult for unsuspecting family members to handle. Communication now can prevent problems in the future when you're no longer here to explain your wishes for the disposition of your estate. If you can't come out to key family members, try to find at least one member in whom you can confide and who'll verify your wishes if your will is contested.

Gift and estate tax concerns

The estate you leave to your partner may be subject to estate tax

Everyone is entitled to leave an estate worth up to a certain amount free from federal estate taxes. This is called the estate tax applicable exclusion amount (formerly known as the unified credit). Your estate will be taxed on any amount you leave in excess of the applicable exclusion amount to any individual other than your spouse or charity. Married couples, however, enjoy a special tax break called the unlimited marital deduction, which allows them to transfer as much as they want to a surviving spouse while deferring estate taxes until the surviving spouse's death.

Technical Note: The applicable exclusion amount for estate tax purposes is $2 million in 2008 and $3.5 million in 2009. In 2010, the estate tax is scheduled to be repealed for one year only. The estate tax will be reinstated in 2011, and the applicable exclusion amount will be reduced to $1 million.

Property you hold through JTWROS may be subject to estate tax

Although it avoids probate, property you own through a JTWROS does not automatically escape estate taxes. The entire value of property you and your partner as an unmarried couple own through a JTWROS is included in the gross taxable estate of the first to die, unless your estate can prove your surviving partner contributed to the cost of the property.

Tip: It's important to keep accurate records of your individual contributions to property held as JTWROS to document your separate shares of the ownership. For more information, see Property Ownership Issues That Concern Unmarried Couples.

Property you hold as tenants in common may be subject to gift and estate tax

Property you hold as tenants in common is subject to probate. It does not automatically pass to your partner, as does property owned as JTWROS. It is transferred according to your will or, if you die without a will, to your next of kin according to the intestacy laws of your state.

If you add your partner's name to a title as a tenant in common without a fair exchange of value, this may be considered a gift subject to gift tax. You may be able to exclude gifts to your partner each year of amounts up to the $12,000 annual gift tax exclusion amount if they qualify. Gift tax owed, however, may be offset by your $1 million gift tax applicable exclusion amount, if it is available.

Caution: The applicable exclusion amount for gift tax purposes is fixed at $1 million even though the applicable exclusion amount for estate tax purposes increases through 2009 (see above). Any portion of your gift tax applicable exclusion amount you use for lifetime gifts effectively reduces your estate tax applicable exclusion amount that will be available at your death.

Assets you transfer to your partner while living may be subject to gift tax

Any assets you transfer to your partner while living without a fair exchange of value may be considered a gift subject to gift tax. You are entitled to transfer annual gift tax exclusion gifts to each individual you wish, provided the transfer is a present interest gift (something the beneficiary receives immediately). Ordinarily, you may think of a gift as something you give expecting nothing in return. For purposes of gift taxes, however, gifts include uneven exchanges of property. A married couple, however, can transfer any amount of assets to each other free of gift tax due to the unlimited marital deduction.

Example(s): Kim owns a $300,000 home. In 2008, Kim sells a half interest in the home to her partner, Jody, for $100,000. Assuming that the value of the half interest is $150,000, Kim has made a taxable gift to Jody of $50,000. Kim may exclude $12,000 under the annual gift tax exclusion, resulting in a taxable gift of $38,000 (which may be offset by Kim's available gift tax applicable exclusion amount).

Even if you simply add your partner's name to a deed, if there is not an exchange of fair value, this may constitute a gift subject to tax on the amount the value of the gift exceeds the annual gift tax exclusion.

Example(s): In 2008, Pat, who owns a house worth $300,000, adds his unmarried partner David's name to the deed as a 50 percent owner without a fair exchange of value. The IRS considers this a $150,000 gift. Pat is taxed on $138,000 ($150,000 less the $12,000 annual gift tax exclusion), assuming Pat has already used his entire $1 million gift tax applicable exclusion amount.

Caution: A potentially big source of problems for unmarried couples is gift taxes that arise from commingled assets, such as real estate, automobiles, and joint bank and investment accounts. Keep accurate records to prove what share of the property you each own.

The state may tax assets you leave your partner at higher rates than assets you leave to family members

Almost every state imposes some form of estate tax. Although the state rate may be lower than the federal rate, state taxes may apply to a larger portion, perhaps all, of your estate. State taxation laws vary widely and are beyond the scope of this discussion. However, the important point to know is that bequests you make to your unmarried partner may be taxed at higher so-called collateral rates. In most states, transfers of assets between spouses and other relatives are either fully or partially exempt from tax or taxed at the lower lineal rates.

Avoiding estate tax

Make tax-free gifts

You can reduce the amount of tax your estate will owe by making tax-free gifts to others during your lifetime, thereby reducing the size of your taxable estate.

- Making tax-free gifts to your partner--Recall that you and your partner can each leave an estate worth up to $2 million free from federal estate taxes. If your estate exceeds the estate tax applicable exclusion amount and the value of your partner's estate is less than that, you can equalize your estates by making gifts to your partner that qualify for the annual gift tax exclusion. This reduces the size of your taxable estate and does not result in any tax on your partner's estate as long as the gifts don't cause your partner's estate to exceed the estate tax applicable exclusion amount.
- Making tax-free gifts to others--You can further reduce the size of your estate tax by giving as many tax-free annual exclusion gifts during your lifetime as you can to those you might otherwise plan on remembering in your will. If you give more than the annual gift tax exclusion amount to any one person, the amount that exceeds the exclusion will be applied against your $1 million gift tax applicable exclusion amount, if available.

Tip: Keep in mind that the annual exclusion applies only to gifts of a present interest in property, which means that the beneficiary must presently have the right to possess and enjoy the gift. For example, a gift of cash is a present interest, but a gift of the right to receive your house when you die is not.

Give life insurance

The proceeds of a life insurance policy are included in your taxable estate only if you have incidents of ownership over the policy or directly or indirectly name your estate or executor as the beneficiary of the policy. You can transfer ownership of your policy to your partner or any other person to keep the policy out of your taxable estate. The new owner then becomes responsible for paying the premiums though you may pay premiums as additional gifts. Once you transfer all incidents of ownership over your policy, assuming neither your estate nor your executor are beneficiaries, the value of the policy stays out of your taxable estate as long as the transaction occurs three years before you die. However, if you die within three years of transferring ownership of the policy, the proceeds from the policy are included in your taxable estate.

Think carefully before transferring ownership of your policy. The gift of a life insurance policy is irrevocable. The new owner can change any beneficiaries you've named, borrow against the policy, change the payment options, or even surrender or cancel the policy. If you give the policy to your partner and your relationship later ends, you cannot get the policy back.

Cross-own life insurance

With this method, you each buy a policy on the life of the other. Because your partner doesn't own the policy on his own life, the proceeds from that policy are not included in his or her estate.

Example(s): Shawn and Max are an unmarried couple. They each buy a life insurance policy on the other. When Shawn dies, Max invests the proceeds from the policy on Shawn's life and lives off the interest. Because Max owns the policy, the proceeds from the policy on Shawn's life are not part of

Shawn's estate and thus not taxable when she dies. The value of the policy on Max's life will be included in Shawn's estate at its value at Shawn's death, but this value is likely to be far less than the proceeds of the policy.

You may need to demonstrate an insurable interest to purchase life insurance on each other. Married couples are assumed to have an insurable interest. Couples who own a house or business together are also considered to have an insurable interest, although only up to the value of their shares of the mortgage or business. You can prove insurable interest by providing evidence of jointly owned assets and, possibly, copies of your wills or trust documents.

Create an irrevocable life insurance trust (ILIT)

With this method, you establish a trust managed by a trustee that buys and owns a life insurance policy. You provide the trust with the funds to pay the premiums. For more information, see Irrevocable Life Insurance Trust.

Tip: Because the trust owns the policy, the proceeds are kept out of your taxable estate.

Caution: You can transfer an existing policy into the plan, but if you die within three years, the value of the policy will be included in your taxable estate. An irrevocable trust must be set up carefully to avoid adverse tax consequences. It is costly to set up, and, as its name implies, once it is established, it generally cannot be revoked.

Set up irrevocable living trusts

Here, you establish an irrevocable living trust that allows you to transfer property directly to your beneficiaries. By irrevocably relinquishing your control, you give up your ownership rights, thus keeping the assets in the trust out of your taxable estate.

Caution: Once you transfer assets into an irrevocable trust, you lose control over them. If you need them in the future, you can't get them back. Transferring assets to an irrevocable trust will generally incur gift taxes.

If you can't avoid estate tax, life insurance can provide cash to replace it

In general

Life insurance can provide a vehicle to generate cash to replace wealth lost due to estate taxes.

ILIT

For information, see above.

Cross-owning life insurance policies

You can each cross-own a policy on the life of the other to replace the estate value lost due to the estimated estate tax. Because this policy is not your partner's property, it's not included in his or her estate.

> **Example(s)**: Sydney and Rudy are an unmarried couple. They each buy a life insurance policy on the other. Rudy dies in 2008. Her estate is valued at $2,050,000. $50,000 (the amount over the estate tax applicable exclusion amount of $2 million) is taxable at 24 percent (the applicable estate tax rate). In this case, $10,600 in federal estate taxes would be due (assuming no other variables).

The life insurance policy proceeds can be used to pay the estate taxes.

Planning for illness and incapacity

Durable power of attorney for health care (DPAHC)

You should also take the time now to plan for possible illness or incapacity. If you are seriously ill or injured and can't express your wishes or make your own medical decisions, who would you want to represent you? Medical personnel often look to immediate family members for authority to act. Your unmarried partner may be forced to stand on the sidelines while medical decisions are made. He or she may even be barred from visiting you if you're in intensive care. If you want your partner to represent you in case of serious illness or incapacity, you should prepare a DPAHC (also called a health-care proxy). You may also want a living will to make your wishes clear. For more information, see Planning for Incapacity.

Durable power of attorney for finances

If you become incapacitated or incompetent, who will manage your financial affairs? Will your affairs be handled as you would wish? You can designate your partner as your representative with a durable power of attorney for finances. This authorizes your partner to deal with banks, insurance companies, and investment brokers on your behalf. It gives your partner access to your bank and investment accounts. For more information, see Durable Power of Attorney.

> **Tip**: You should be aware of possible gift tax consequences if you authorize your unmarried partner to act as your power of attorney for finances. Unless the power of attorney is drafted properly, the IRS could consider some transactions as gifts. In order to prevent this, your partner should be prohibited from using the power of attorney to benefit himself or herself and his or her creditors.

Support your estate plans with a domestic partner agreement

A domestic partner agreement can support your estate planning documents, whether they are a JTWROS property titles, beneficiary designations, trusts, or a will. By referencing these documents and

restating your intentions for the distribution of your estate, you clarify your wishes in case they're questioned.

Disclosures

This material does not constitute the rendering of investment, legal, tax or insurance advice or services. It is intended for informational use only and is not a substitute for investment, legal, tax, and insurance advice.

State, national and international laws vary, as do individual circumstances; so always consult a qualified investment advisor, attorney, CPA, or insurance agent on all investment, legal, tax, or insurance matters.

The effectiveness of any of the strategies described will depend on your individual situation and on a number of other factors. After reviewing your personal situation, we may recommend that you not use any strategy in this document but instead consider various other strategies available through our practice.

Securities offered through Securities Equity Group, member FINRA, SIPC, MSRB

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