SAUNDERS NORVAL PARGAMAN & ATKINS

What You Should Know About Your Estate Plan

Estate planning involves more than just a will. Timely estate planning can provide you and your family the maximum benefit from your assets, both during your lifetime and following your death. This process requires coordination of your personal, financial and business affairs and goals, with close attention to income and transfer tax consequences. However, while the entire process involves much more than just the preparation and execution of a will, a will remains the foundation of every sound estate plan.

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Why do I need a will?

A will sets forth the plan for distributing your property.

The primary goal of a will is to distribute your property among your intended beneficiaries. If a person dies intestate (*i.e.*, without a will), state law will determine who your beneficiaries are and how much each will receive. Unfortunately, that "will" that the state of Texas has written may not agree with your wishes, and always requires more expensive and complicated probate proceedings.

Assets passing under a will or the laws of intestacy are generally referred to as "probate" assets. However, even if you leave a valid will, you probably have significant "nonprobate" assets that pass outside your will. Common examples of nonprobate assets include insurance proceeds or retirement plan proceeds that pass to designated beneficiaries pursuant to the policy contract or retirement plan, and property transferred during your lifetime to a trust for your own benefit designed to "avoid probate," commonly known as a "living trust." Similarly, if you hold assets in a joint account that contains survivorship provisions (meaning that the assets will belong to the surviving accountholder when one dies), those assets will pass pursuant to the account agreement, and the distribution provisions of your will won't apply to those assets.

Therefore, an important element in implementing your estate plan is to review the beneficiary designations for your insurance policies and retirement plans as well as the provisions of any "inter vivos" trusts (trusts created during lifetime) and possible survivorship agreements (including joint ownership agreements for bank and brokerage accounts) in order to coordinate the distribution of these assets with the overall distribution of your other assets under to your will.

A will plans for the administration of your estate.

Another important reason for a will is to provide for the orderly administration of your affairs at your death. Your "executor" is responsible for collecting your assets, paying all outstanding debts and any income, estate and inheritance taxes, and distributing your property among the beneficiaries set forth in your will. Since Texas law allows for the appointment of executors who may administer your estate free of court supervision ("independent executors"), estate administration in Texas is usually much more efficient and much less expensive and complicated than in many other states (See the discussion of estate administration in Texas below).

A will addresses the particular needs of your beneficiaries.

Your will should also address any special needs of your beneficiaries. For example, if a family member needs assistance in responsibly managing his or her property, either because of age or lack of financial responsibility, your will may address this need by placing that beneficiary's share in a trust for the beneficiary. This allows a third party (*e.g.*, a friend, relative, bank trust department or private trust company) to manage the property for the beneficiary as long as you believe third-party management is needed. At a minimum, your will should provide contingent trusts for any property passing to a minor beneficiary (in Texas, someone under the age of 18), but may require that property remain in trust for a number of years after a minor becomes an adult. Similarly, your will should provide contingent trusts for any property passing to adult beneficiaries who happen to be incapacitated due to physical or mental impairment at your death. Addressing these needs through contingent trusts in your will avoids the possible need for expensive and complicated court-supervised guardianship proceedings for a beneficiary at your death.

A will may address the potential impact of transfer taxes.

Since the impact of transfer taxes (*i.e.*, gift, estate, and generation-skipping transfer taxes) can be significant, your will should take advantage of any opportunities to minimize these taxes in a manner consistent with your estate planning goals (See the discussion of transfer tax planning below).

Does a will cover all of my estate planning needs?

No. Some of the most important documents you may have are documents that plan for your potential incapacity.

Everyone hopes to remain independent during their life. Even if advanced age and disease decrease your physical or mental capacities, you probably want to maintain control of your decisions as long as possible. However, without advance planning, if you become incapacitated, state laws will limit you and your family. A court may determine when you need a guardian, who the guardian will be, and the cost, bond premiums, fees, etc., to be paid (from your property). There are several ways to plan for the management of your property should you become unable to do so for yourself.

A Financial Power of Attorney.

A person (the principal) may give another person (the agent or attorney-in-fact) the right to make financial decisions for the principal (so long as the principal has capacity at the time those rights are given). The agent is normally the principal's spouse, child, or other trusted relative or friend, and is given very broad powers to deal with the principal's property. The powers granted to the agent do not terminate when the principal becomes incapacitated. Texas has an optional statutory form for a financial power of attorney called a "Statutory Durable Power of Attorney." While powers of attorney do not have to follow the statutory form, we believe that a "modified" statutory form is easiest to use, because it looks like a statutory form, but with modifications that we believe improve it.

A Revocable Management Trust.

A revocable management trust, commonly known as a "living trust," is another means of providing for property management. An individual creates a trust of this type while still competent, but the trust may or may not initially contain significant property. The person creating the trust is known as the "settlor," and often names himself or herself as the initial trustee. The trust contains provisions for the appointment of a successor if the settlor becomes unable to continue as trustee. If the settlor has not transferred his or her property to the trust, the settlor usually gives another person a financial power of attorney with the right to transfer the settlor's property to the trust if the settlor is incapacitated. The management trust often contains provisions distributing the trust at the settlor's death, in which case it also acts as a will substitute.

"Avoiding probate" is one of the primary advantages of a management trust that directs the disposition of the property at the settlor's death. However, in order to "avoid probate," all of the settlor's assets (except for nonprobate assets that are disposed of by beneficiary designation or contract at death) must be retitled in the name of the trust during the settlor's lifetime. Because the "probate" portion of an estate administration is relatively simple and inexpensive in Texas (see the discussion of estate administration below), most of our clients typically choose a management trust only if the trust will provide a solution to special circumstances other than "avoiding probate." These include the ownership of out-of-state real property (to avoid probating your will in that state at your death), the probability of long-term management by a third-party trustee due to the settlor's incapacity, a strong desire for privacy, or the probability that the settlor will move to another state (since many other states may not provide for simple and inexpensive probate proceeding like we have in Texas). Avoiding probate saves court costs and attorneys' fees at death but the costs of funding a management trust (*i.e.,* transferring title to assets into the trust) may equal the cost of probate in an independent administration. Therefore, if "avoiding probate" in Texas is the only reason that a "living trust" is being considered, the issue is whether the expected savings in "probate costs" will exceed the immediate cost of creating, funding and administering the management trust.

Advance Directives – A Medical Power of Attorney and Directive to Physicians.

You should also have a medical power of attorney, a directive to physicians and family or surrogates (regarding the prolongation of life by artificial means), also known as a "living will," and consider planning anatomical gifts and addressing specific burial or cremation instructions if you have strong feelings in these areas. These last two matters should be addressed independently of your will, since your family will need to carry out these wishes before the time they would normally read your will.

Lifetime gift program.

Another ingredient of an estate plan may be a gift program which not only benefits your family during your lifetime but also reduces the potential estate tax impact upon your estate at your death. The gift program may also accomplish some income tax savings However, for most people, the increased tax-free amounts for transfer tax purposes has lessened the motivation to make gifts for tax reasons. (See the discussion of the tax aspects of gifts below).

If I get sued, which assets are protected from my creditors?

Your home is protected.

Texas has one of the most generous homestead exemption statutes of any state. The homestead is exempt from creditors' claims other than liens for the purchase or improvement of the homestead (and now voluntary "home equity loans") and taxes. Generally, a homestead in an urban area consists of a house and lot of up to ten acres, regardless of the value. A rural homestead provides protection of up to 200 acres for a family or 100 acres for a single person, regardless of the value. However, if a Texas resident files for bankruptcy, the homestead exemption may be limited as to value depending on how long the resident has owned the homestead.

Certain household goods and personal effects are protected.

Various items of personal property are exempt from creditors. The exempt personal property can have a value of up to $100,000 for families and $50,000 for single adults.

Life insurance and annuities are protected.

Life insurance and annuity proceeds and cash values are also exempt.

Retirement plans are protected.

In addition to the personal property exemptions, all qualified retirement plans, profit-sharing plans, pension plans and individual retirement accounts are exempt – at least in the hands of the original participant and his or her spouse. (There is some uncertainty about the exemption once retirement proceeds are inherited by others, such as children.)

Section 529 plans are protected.

A Texas resident's right to the assets or benefits held in a Section 529 plan (a college savings plan) is exempt from creditors.

If I am married, how are assets owned by me and my spouse, and which assets are exposed to our creditors?

Community vs. separate property.

Most assets owned by married couples in Texas consist of "community property." Community property is owned half by each spouse. When a marriage ends, either by divorce or death of the first spouse, all property owned by either spouse is presumed to be community property, and thus owned 50-50, regardless of the name in which the property is held. A person claiming that property is "separate" must prove that the property is separate. A spouse's separate property consists of (i) the property owned by that spouse before marriage; (ii) the property acquired by that spouse during marriage by gift, devise, or descent; and (iii) the recovery for personal injuries sustained by that spouse during marriage (except any recovery for loss of earning capacity). Separate property also includes appreciation in value of separate assets, sales proceeds of separate assets, and any property acquired with the separate proceeds. However, income from a spouse's separate property is generally community property (except income from separate property created by gift from one spouse to the other). The distinction between appreciation and income is similar, but not identical, to the distinction between capital gain and ordinary income, for income tax purposes.

Types of community property.

Each spouse has the **sole** management, control, and disposition of any community property that spouse would have owned if single. Examples include that spouse's salary or wages, income from that spouse's separate property, recoveries for the spouse's personal injuries, and appreciation of and income from that spouse's sole management community property. Commingled sole management community property and all community property not subject to the sole management, control, and disposition of one spouse is subject to the **joint** management, control, and disposition of both spouses.

Marital property liabilities.

In general, if one spouse incurs a contractual liability before marriage, or without the other spouse's participation during marriage, that other spouse's separate property and sole management community property is protected from liability for the first spouse's debt. If a spouse commits a tort, however, that spouse's separate property and **all** of the community property (including the other spouse's sole management community property) becomes available for satisfaction of the tort liability.

What's all this I hear about "family limited partnerships?"

What is a family limited partnership?

Family limited partnerships, or FLP's, have received a great deal of publicity in recent years and have become popular estate planning vehicles. An FLP is simply a normal limited partnership structured under the laws of a state with family members as the partners. In fact, for estate planning purposes, the term FLP is generically used to refer to other entities involving family members, such as limited liability companies.

Why use an FLP?

Day-to-day management of an FLP is centralized in the general partner(s), and the limited partners have no say in that management. Retention and centralization of control is a common estate planning goal. A number of other benefits flow from FLP's:

- Gifts of limited partner interests in FLP's usually qualify for the federal gift tax "annual exclusion."

- The fair market value of limited partner interests in FLP's that are given to family members (or trusts for their benefit) is discounted for federal estate and gift tax purposes. In other words, due to the fact that a minority limited partner has no voice in day-to-day management, a significant discount is appropriate in valuing the partnership interest.

- The FLP can protect assets from transfers to outsiders through the transfer and buy-sell restrictions in the partnership agreement.

- A limited partner interest in an FLP is very easy to transfer to a transferee who is a "permitted transferee," such as another family member. The transfer is similar to the transfer of a share of stock.

- The assets in the FLP are not directly owned by the partners and, thus, are not subject to probate. Therefore, if a Texas resident owns an interest in an FLP that owns out-of-state real property, no probate is required in that state upon the death of a partner.

- Consolidating fragmented family interests in various assets can often be a significant advantage of an FLP.

- The partnership investment standard is lower than the standard applicable to a trustee.

- The partnership agreement provides that it can be amended or revoked. By comparison, an irrevocable trust cannot be amended or revoked.

- Limited partner interests in FLP's are only subject to a charging order in Texas in the event that a partner's creditor obtains a judgment against the partner, individually. The charging order simply allows the creditor to receive any cash paid out with respect to the partner's limited partner interests in the FLP, but does not otherwise allow the creditor to take control of the limited partner interest or the FLP's assets, or to be admitted as a limited partner.

Why doesn't everyone have an FLP?

Frankly, the main reasons that everyone doesn't have an FLP are the cost and paperwork associated with its creation and administration. Aside from the legal costs associated with the preparation of the partnership agreement and the transfer of assets to the FLP, the initial filing fee alone is about $800. The FLP is a separate taxable entity that must file its own income tax return each year (*i.e.*, accountant's fees will be incurred annually). Also, if you plan to make gifts of FLP interests, we highly recommend that an appraiser value the interests being gifted to determine the appropriate valuation discounts for lack of control and minority interest. If the underlying assets of the FLP are hard to value, separate appraisers may be required to value these assets. Because all of these costs can be significant, the advantages of FLP's often can only be realized when the value of the FLP is significant.

Tell me about taxes!

All of "your property" is subject to estate taxes.

All of "your property," whether probate or nonprobate, is included in your gross estate for federal estate tax purposes at your death. Your gross estate will also include any **life insurance** proceeds payable as a result of your death to the extent you own any rights in the policies, **retirement benefits**, and, in addition, other property which you have transferred (as a gift) during your lifetime, if you have **retained rights** to receive benefits or control that property. In addition, the value of any taxable gifts you have made since 1976 will be added to the value of your gross estate in determining your estate taxes (your estate will be given a credit for gift taxes that were payable during your lifetime). In other words, the concept of an "estate" for estate tax purposes is much broader than the probate estate (the portion of your "estate" that your will controls). Taxes are imposed upon this property regardless of whether it passes under your will, a beneficiary designation (*e.g.*, a life insurance, annuity or retirement plan beneficiary designation), a contract (*e.g.*, a bank or brokerage account contract), or in some other manner.

Does any property pass free of estate taxes?

Since the end of 2010, every U.S. citizen or resident has tax-free amount for estate and gift tax purposes of $5 million, indexed for inflation after 2011 (it is $5.49 million in 2017). Estates and taxable gifts above this amount are subject to estate or gift tax at a 40% rate.

Does this mean that if my estate exceeds the tax-free amount, my spouse will have to pay estate taxes?

Not necessarily. If you are married, all property that you give (during lifetime or at death) to your spouse passes free of estate and gift taxes (if your spouse is a U.S. citizen). This "unlimited marital deduction" allows a married couple, through proper planning, to postpone all estate taxes until the survivor's death, preserving all of their property for the support and maintenance of the survivor during his or her lifetime. This is accomplished by including a formula gift in the first spouse's will[1] giving all of that spouse's property in excess of his or her tax-free amount to the survivor in a qualifying manner (more on this below). This property (and its appreciation) will be taxed when the survivor dies, but in the meantime, the survivor gets the interest-free use of the tax dollars that would otherwise have been paid at the first spouse's death.

How do we make the best use of the tax-free amount and the unlimited marital deduction?

In many cases, when a couple's combined estate will exceed the tax-free amount, the marital deduction gift is combined with a gift to a "bypass" trust. All of the first spouse's property, up to the tax-free amount at the time of the first spouse's death, will be placed in a trust which "bypasses" the survivor's estate for estate tax purposes upon the survivor's death. The survivor is a still a beneficiary of the trust and usually is also the trustee of the trust. However, the assets in the trust (regardless of value) will not be taxed at the survivor's death. In other words, it's just the future estate taxes in the survivor's estate that are being "bypassed," not the survivor. When the survivor dies, the survivor's tax-free amount will be applied to the remaining property, effectively preserving the use of both tax-free amounts.

Do I really need a bypass trust to preserve the benefits of both tax-free amounts?

Maybe, maybe not. Since the end of 2010, any portion of a deceased spouse's unused tax-free amount may be carried over to the survivor. This concept is known as "portability" of the tax-free amount. As an example, assume a married couple has a combined community estate of $10 million. The husband dies first and gives his half outright to the survivor. Because that gift qualifies for the marital deduction, the husband didn't use up any of his $5+ million tax-free amount. So when the wife dies later (with all $10 million in assets), she not only has her tax-free amount of $5+ million, indexed for inflation after 2011, but also her husband's unused $5+ million tax-free amount, for a total tax-free amount of $10+ million (which covers all of the assets.

But despite its simplicity, "portability" has certain disadvantages which make us reluctant to recommend reliance on the concept:

[1] Since we don't know who the "first spouse" will be, we include this formula gift in both wills, but it will only apply if in the case of the first spouse's death.

- First, the survivor only gets to take advantage of the unused tax-free amount of the survivor's last deceased spouse. Assume in the example given above that the survivor remarries a wealthy man. The second husband dies with a will leaving his substantial estate to his children, and uses all his tax-free amount on those gifts. When the wife dies later, her last deceased spouse is this second husband, not the first, and she's lost the benefit of the first husband's unused tax-free amount.

- Second, while the $5 million tax-free amount is adjusted for inflation after 2011, this inflation adjustment doesn't apply to the first spouse's unused tax-free amount. So assuming again the same $10 million estate, if the assets and the tax-free amount both increase by 10% after the husband's death, the estate will be worth $11 million at the wife's death (the original $10 million plus 10%), but the tax-free amount will only cover 10.5 million of those assets (the wife's original $5 million tax-free amount adjusted upwards by 10%, plus the husband's unadjusted original $5 million tax-free amount.)

- Third, estate tax returns are not required if the decedent's gross estate does not exceed his or her tax-free amount. However, in order for the survivor to take advantage of the first spouse's tax-free amount, the executor of the first spouse's estate must file an estate tax return making that election. Thus, in the example above, no estate tax return would normally be required where the husband's $5 million half of the combined $10 million estate is covered by his $5 million tax-free amount. But an estate tax return will have to be filed in order to take advantage of portability.

- Fourth, if the spouses want to provide for lifetime "generation-skipping" trusts for their children and their descendants, the first spouse's $5 million GST tax exemption is **not** portable.

These are not all of the potential disadvantages of relying on portability, and there are some situations where portability has advantages beyond its "simplicity." However, due to these concerns, we are likely to recommend the continued use of bypass trusts where they would otherwise make sense in the absence of portability, since they eliminate the adverse consequences of most of these concerns.

So I shouldn't use a bypass trust if estate taxes at the survivor's death are unlikely?

Maybe, maybe not. Trusts can provide other, non-tax, benefits. For example, assets placed in a bypass trust for the survivor can be protected from the survivor's creditors (*e.g.*, if the survivor is involved in an automobile accident with serious injuries sustained by others). Or a bypass trust might provide some protection for the couple's children in the event the survivor remarries. But these benefits might be offset by the costs of a bypass trust (*e.g.*, an extra income tax return each year) or the fact that assets in a bypass trust, unlike those owned outright by the surviving spouse, will not receive a new basis (for capital gains purposes) at the survivor's death.

What gifts are eligible for the marital deduction?

As noted above, if bypass trust planning is utilized, the balance of the first spouse's property (not passing to the bypass trust) usually passes to the survivor in a manner that qualifies for the marital deduction. The two most common options for this marital deduction gift are an outright gift of property to the survivor or a gift of property to a special trust for the survivor's benefit, called a "QTIP" trust, which stands for **q**ualified **t**erminable **i**nterest **p**roperty. In order for a gift to this trust to qualify for the marital deduction, the survivor must be entitled to all of the income from the trust for life, and no distributions may be made to anyone else during the survivor's lifetime. The assets in this trust will be subject to estate tax at the survivor's death.

Why not just give the marital deduction gift outright?

Congress first authorized the use of QTIP trusts in 1981 in response to the rising number of second marriages. Before then, in order for the first spouse's estate to take advantage of the marital deduction, the survivor had to be given the right to dispose of the assets at the survivor's death. If the first spouse had children by a prior marriage, this would put those children at risk of being disinherited by the survivor. The QTIP trust was an attempt to address this problem by eliminating the requirement that the survivor have the power to dispose of the assets. In fact, if the first spouse wishes, he or she can name someone other than the survivor as trustee, prohibit distributions of principal to the survivor, and control the disposition of these assets at the survivor's death.

So why would I want a QTIP trust if I don't have children by a prior marriage?

While many of our clients may have no desire to place these types of restrictions upon the survivor, QTIP trusts can still serve other valuable non-tax purposes. They can provide an efficient vehicle for asset management if there are concerns about the survivor's ability to manage the assets comprising the marital deduction gift. Even if management is not a concern, the QTIP trust can provide protection for these assets from the survivor's creditors which would not be available if the assets were given to the survivor outright. Also, the first spouse to die can control the disposition of these assets at the survivor's death through the QTIP trust, rather than have the disposition of these assets controlled by the survivor's will. This may be of particular interest to those concerned about the possible remarriage of their surviving spouse.

Charitable gifts are always a good idea to consider.

The form of any charitable gifts in your will must be carefully reviewed, especially if the gift will be in a trust with non-charitable, as well as charitable, beneficiaries. Special requirements must be met to assure that the gift will qualify for a charitable deduction for estate tax purposes. If funds are available for lifetime gifts to charity, the overall tax benefits may be greater, since lifetime charitable gifts will usually generate income tax savings. Keep in mind that charitable gifts made during lifetime will normally generate income tax savings that gifts in your will do not. And even if you defer charitable gifts until death, making those gifts from retirement plans that would otherwise be subject to income taxes may be a wise planning idea.

Coordinating tax and non-tax planning.

While the impact of transfer taxes can be substantial, planning just to minimize those taxes should not be your first and only priority. And with the increased tax-free amounts we now enjoy, transfer taxes may not be a factor at all.

The most important factor in developing your estate plan is to carry out your wishes, regardless of the tax effect. Tax planning, if needed, should be coordinated with those wishes and should achieve a proper balance between those desires and reduction of transfer taxes. In other words, any tax planning devices used to reduce taxes should not interfere with the intended disposition of your property.

What are the tax advantages of lifetime gifts?

Non-taxable (annual exclusion) gifts.

Currently, you may give cash or other property valued at $14,000 annually to any number of people you desire, and the gifts will not be considered taxable gifts so long as the total value of the property given to any one person during a calendar year does not exceed $14,000, and the gift is of a "present interest." This $14,000 limit is called the "annual exclusion" and may be used each year. A present interest means that the gifts are given outright to the donee or to a special qualifying trust for the donee's benefit (see the discussion of these trusts below). In addition, any amounts paid on behalf of another (i) as tuition to certain educational organizations or for the person's education or training or (ii) as a payment for medical care to any person who provides that medical care will not be considered as taxable gifts. The exclusion for tuition and medical expenses is in addition to the $14,000 annual gift tax exclusion. Any non-taxable gifts (with limited exceptions relating to transfers of life insurance and certain other retained interests within three years of your death) will permanently remove the value of the gifts from taxation in your estate and will not be considered in computing the estate taxes due upon your death.

The annual exclusion has been indexed for inflation since 1998, moving up in minimum $1,000 increments. It reached its current value of $14,000 in 2014. Given current rates of inflation, the next increase likely won't take place until at least 2018.

In addition to outright gifts, there are two types of trusts that normally can qualify for the annual exclusion:

Twenty-One Year Trust. – One type of trust that may be used for gifts for the benefit of a minor is referred to as a twenty-one year trust[2] because the beneficiary must be given the right to receive all of the trust property at the age of twenty-one. Income earned by the property given to the trust can be distributed to the beneficiary or accumulated in the trustee's discretion prior to this time.

Annual Withdrawal Trust. – Another type of trust which allows gifts to qualify for the annual exclusion is referred to as an annual withdrawal trust[3] because it allows the beneficiary to withdraw from the trust each year an amount of property equal to the total annual exclusions available to donors who have given property to the trust that year. The beneficiary need not (and usually doesn't) withdraw the annual exclusion amounts from the trust; he or she must only have the right to do so. **This is the type of trust most often used for annual exclusion gifts.**

Taxable gifts.

Any gift (other than the payment of tuition and medical expenses) that exceeds the annual exclusion amount available for the donee (or does not qualify for the annual exclusion because the gift is not a present interest) is considered a "taxable gift." You will be required to file a gift tax return reporting any taxable gifts. However, you will be entitled to shelter any taxable gifts with your the tax-free amount for gift tax purposes ($5.49 million in 2017, indexed for inflation). Therefore, until your cumulative taxable gifts exceed this tax-free amount for gift tax purposes, you will not be required to pay any gift taxes. The value of the taxable gifts at the date of the gift will be included in computing the estate taxes due upon your estate. However, the future appreciation of the gift following the date of the gift escapes estate taxation. Therefore, taxable gifts can be an effective estate planning tool if the property has a high potential for rapid appreciation and there is a substantial period of time between the date of the gift and the date of your death.

Income tax benefits of lifetime gifts.

In some situations, a gift program may generate income tax benefits. Under current law, if you give property outright to a donee, the donee is taxed on all income generated by the property after the gift. However, if the donee is a minor under the age of 14 years, the tax on the minor will be imposed at his or her parents' rates. If property is given to a trust for the benefit of a donee, income generated by the property will be taxed (i) to the donee to the extent that the donee could have withdrawn the income from the trust, or to the extent income was distributed from the trust to the donee (but at the parents' rates if the donee is under 14), or (ii) to the trust to the extent that income was not distributed to or withdrawable by the donee. Thus, when you give property to a trust, the income generated by the property may not only be removed from your taxable income but may be split between the trust and the beneficiary. Generally, the more your income can be split, the lower the tax.

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[2] This type of trust is also known as a 2503(c) trust after the section of the Internal Revenue Code that makes gifts to this trust eligible for the annual gift tax exclusion.

[3] This type of trust is also known as a "Crummey" trust because it is patterned after the trust in the case of *Crummey vs. Commissioner*. That is the case that recognized the eligibility of gifts to this type of trust for the annual gift tax exclusion.

Unfortunately, trusts usually reach the maximum level of income taxation (currently 35% or greater) very quickly.

Sometimes, we can structure a trust so that the original donor pays the income taxes on the trust's income.[4] This payment does not constitute an additional gift to the trust, even though it, in effect, allows the trust to grow "free" of income taxes. Trusts can also be extremely beneficial if you are currently supplementing another person's income, such as an elderly parent living on a fixed income or a child or grandchild attending school. However, very little income-shifting results from gifts for the benefit of a person under the age of 14 years.

Income tax disadvantages of lifetime gifts.

One of the few tax benefits of dying is that assets includable in a person's gross estate, for income tax purposes, receives a new basis equal to its value on the date of the person's death. The potential income tax on the unrealized appreciation vanishes. This means that assets sold soon after death usually incur little or no capital gains tax. In the case of community property assets, the survivor's half of the assets also gets a new basis.

However, the "new-basis-at-death" rule only applies to assets includible in someone's estate at death. For lifetime gifts, the recipients have the same basis that the donor had. This is known as "carryover" basis. Those assets won't ever receive the benefit of the "new-basis-at-death" rule.

What are "generation-skipping trusts" and why should I be interested in them?

In general.

If you have a sizable estate, you should also consider the potential estate tax liabilities of your children. If your children will have significant estates, either through inheritance from you other others, or from their own earnings, they may benefit from replacing outright gifts to them with trusts for their benefit, designed to avoid estate taxes upon their deaths. We refer to trusts designed to avoid estate taxes in one or more younger generations as "generation-skipping" or "GST" trusts. Keep in mind that the phrase "generation-skipping" refers only to the avoidance of estate taxes in one or more generations, **not** the skipping of any younger generation members as beneficiaries.[5] These types of transfers are subject to a separate "generation-skipping transfer tax" or "GST tax." Any transfers subject to the GST tax are taxed at the highest marginal estate tax bracket (40%). However, each donor has a "GST tax exemption" equal to the tax-free amount for estate tax purposes (plus certain transfers within the annual gift tax exclusion).

Tax benefits.

Through proper planning, a husband and wife can place assets with a value equal to their combined GST tax exemptions (*i.e.*, possibly up to $10+ million) in GST trusts which can last for several generations. In Texas, the only limit on the duration of these trusts is the "rule against perpetuities," which requires all trusts to terminate 21 years following the death of all "lives in being." Usually, this means that the trusts must terminate 21 years after the death of all of your descendants who are alive at your death (or when you created the trust, in the case of lifetime gifts to irrevocable trusts). During the lifetime of the beneficiary of a GST trust, the beneficiary and his or her descendants may receive distributions for their benefit. Upon the beneficiary's death, the property remains in trust for the benefit of the beneficiary's descendants, but is not included in the beneficiary's estate for estate tax purposes.

Non-tax benefits.

Since the beneficiary does not directly own the property in the GST trust, the property should not be subject to the claims of the beneficiary's creditors. The beneficiary may be in a high-risk profession (*e.g.*, malpractice suits against a doctor or lawyer), or may face

[4] This type of trust is often known as an IDGT (pronounced "I-dig-it"), which stands for **i**ntentionally **d**efective **g**rantor **t**rust.

[5] This is similar to the use of the term "bypass" trust for a trust that avoids estate taxes in a surviving spouse's estate while providing benefits to that spouse.

large potential debts (*e.g.*, liability on real estate loans). The GST trust can provide a "nest egg" against unforeseen adverse economic situations which might wipe out the rest of the beneficiary's estate. Through proper planning, the beneficiary can protect these assets from creditors, and still maintain a significant degree of control over the assets as trustee of the GST trust. This same feature of the trust may keep the assets in the GST trust from becoming "marital property" subject to division in the event of the beneficiary's divorce. The GST trust may also provide a means of centralizing the management of certain family assets in a limited number of trustees while spreading the economic benefit of these assets among a large number of family members.

What about my retirement plans?

Income taxes.

While most inherited assets are distributed to beneficiaries free of income (as opposed to estate) taxes, beneficiaries will usually have to pay income taxes on any benefits they receive from retirement plans, such as 401(k) plans and IRA's. However, a surviving spouse may be entitled to "roll over" any retirement plan benefits into his or her own IRA, and defer taxation of those benefits until they are withdrawn. Certain minimum distributions must usually be taken out of a retirement plan once the participant reaches the age of 70½.

Distribution planning.

Retirement plan benefits do not pass under the provisions of your will. Rather, the beneficiary designations you sign in connection with the plans control the disposition of these benefits at your death. Proper planning may allow you to minimize the income taxation of these benefits. However, because many of our clients have a higher and higher percentage of their estates in their retirement plans, overall estate planning for those clients has become much more complicated.

And life insurance policies?

The advantages of life insurance trusts.

Many of our clients are under the mistaken impression that life insurance benefits automatically pass free of estate taxes. While life insurance proceeds generally are paid to the beneficiaries free of **income** taxes, those proceeds will normally be included in the insured's estate for **estate** tax purposes. If you have a substantial amount of life insurance which you intend to keep until your death, you may wish to consider taking certain actions to prevent the proceeds from the policies from being taxed in your estate.

Assume that the husband is heavily insured. Through proper planning, it may be possible to prevent the inclusion of the proceeds from insurance policies on the husband's life in either his estate or his wife's estate. One such planning device is for the husband to create an irrevocable life insurance trust for the benefit of his wife and/or his descendants to own the policies.

If the husband does not wish to create an irrevocable insurance trust, he could incorporate an insurance trust into his wife's will to receive all of his wife's interest in the policies on his life in the event that his wife predeceases him. This would prevent the proceeds with respect to his wife's interest (which would be held in trust at the time of the husband's death) from being includable as a portion of the husband's estate.

Coordination of beneficiary designations.

As noted above, since insurance proceeds are payable in accordance with a beneficiary designation instead of your will (unless the proceeds are payable to your estate or a trust created by your will), your insurance beneficiary designations should be reviewed to coordinate with the dispositive plan contained in your will. This review will not only assure that the intended beneficiaries will receive the insurance proceeds but also that the proceeds will be received in a manner that coordinates with the tax and non-tax planning incorporated into your will.

Won't probating my estate be complicated and expensive?

Probably not.

Texas law allows you to appoint an executor who will have authority to act independently of any court supervision. This is known as "independent administration." In those cases, the probate court must still determine that (i) your will is valid under Texas law, was not revoked and was filed in the correct county, and (ii) the independent executor named by you is not disqualified under Texas law. This takes place at a relatively informal hearing before the probate judge, usually two or three weeks after the will was filed. After the probate hearing, the executor is required to notify the beneficiaries that the will was probated. the only required filings in the probate court are (i) an affidavit that a notice to creditors was published in a local newspaper notifying them of the appointment of your independent executor, (ii) an affidavit or certificate that the beneficiaries were properly notified, and (iii) an inventory of all assets passing under the will. If you have a "living trust" and all of your assets are already held in the name of the trust, then this "probate" portion of your estate administration may be avoided. The "probate" portion of an estate administration typically costs about $250 in filing fees and $1,000 to $2,000 in attorney fees (through the initial probate hearing).

The remainder of your estate administration will be similar whether you have a "living trust" plan or a will plan. The executor (or the trustee of your living trust) is responsible for identifying, collecting, and valuing all of your assets and paying your liabilities. The executor/trustee is personally responsible for filing all federal and state tax returns for you and your estate and paying all taxes due. This includes your final individual income tax return, any gift tax returns that should but haven't been filed, income tax returns for your estate during the estate administration, and a federal estate tax return if the value of your assets equals or exceeds the "tax-free amount."

After the executor/trustee has identified and valued all of your assets, paid all of your liabilities that are currently due, paid all of your tax liabilities, and filed all tax returns that are due, your remaining assets may be distributed to your beneficiaries in accordance with your will (or living trust). Since the executor/trustee can be personally liable for your tax and other liabilities, most do not distribute assets to beneficiaries until all of the liabilities have been paid. However, since the Internal Revenue Service has three years from the filing date of any tax return to audit and assess additional taxes, executors/trustees often make partial distributions to estate beneficiaries during the estate administration.

The executor/trustee has authority to hire an attorney and an accountant to assist in the estate administration process. The fees charged by these professionals are typically on an hourly basis. In our firm, we have determined that much of the assistance the executor/trustee requires can be provided by our legal assistant under the supervision of one of our attorneys. Typically, we provide the executor/trustee a checklist of items that must be completed and the executor/trustee determines which items will be completed by us, which items will be completed by the accountant, and which items will be completed by the executor/trustee. Under Texas law, an executor or trustee is entitled to reasonable compensation but provisions in the will (or trust) control whether executor/trustee compensation is authorized, and, if so, on what basis it is to be determined.

A few words about potential conflicts between spouses.

Potential conflicts, and each spouse's right to dispose of his or her property.

If we are representing a married couple, both of you are our clients, and we may ethically represent you both as long as your interests are not in conflict. However, each of you has the absolute right to arrange your business affairs and to dispose of your property, including your separate property and one-half of your community property, as you see fit. While the existence of a conflict may seem remote, the possibility always exists. If a conflict does arise between the two of you that may affect your estate planning, you have an obligation to advise us as soon as possible, and we may be required to step aside and let each of you hire separate, independent attorneys to advocate your respective positions.

Communications from spouses.

In addition, you should be aware that, in general, any information that either of you shares with us will be shared with both of you. While we will maintain the confidentiality of your information from any third parties, we cannot keep any information that one of you shares with us confidential from the other if we represent both of you.

A few words about fees.

How we charge for our services.

The principal factor in billing for our services is the time and effort and the hourly rates of the attorneys and legal assistants involved. Our hourly rates are based on years of experience, specialization and training in practice, and level of professional attainment. While charges for estate planning services may vary from case to case, our experience indicates that after our initial meeting, we can often provide a "flat-fee" estimate for most standard estate planning packages. Keep in mind, however, that if you change your mind regarding any estate planning decisions after we begin preparation of documents, the fees may increase. If we encounter anything that would cause a significant variance from our estimate, we will let you know in advance.

When we bill for our services.

Our general practice is to bill our clients on a regular basis, normally each month, for both fees and expenses. However, for most standard estate planning services, we often wait until all of our services have been completed prior to sending a bill. (The most common exception would be if there is a significant delay in that completion that is caused by the client.) We expect payment within 30 days of our statement. If you ever disagree with the amount of our fees, please call us. Usually, any disagreements are resolved to the satisfaction of both sides with little inconvenience or formality.

Complaints.

The State Bar of Texas has a toll-free "800" number for information relating to the attorney grievance process. The State Bar investigates complaints of professional misconduct by Texas attorneys. Although not every dispute with a lawyer involves professional misconduct, the State Bar Office of General Counsel can provide you with information about how to file a complaint. For more information call 1-800-932-1900.

How often should I review my estate planning documents?

Once we have completed an engagement, you should be aware that changes in tax, property, probate and other laws may affect your estate plan. We do not review each client file to determine the impact of court cases, rulings and other changes. In addition, there are likely to be changes in your own family circumstances or estate planning goals that could impact your estate plan. There can always be future changes to the tax laws, but we cannot anticipate what form those changes may take. You should therefore have your estate plan reviewed on a regular basis. We will not unilaterally undertake any review of this type in the future unless and until you request us to do so. We will charge a reasonable fee for the review.

(April, 2017)