FUNDAMENTALS OF ESTATE PLANNING

BY THE ESTATE PLANNING
AND PROBATE SECTION[1]
OF
CRAIN, CATON & JAMES
A PROFESSIONAL CORPORATION

[1] Larry D. George*, Sharon B. Gardner**, Helen B. Wils*, Sarah P. Pacheco*, Darlene P. Smith, C. Vance Christopher, Christopher A. Prine, Nicole B. Davis

*Board Certified in Estate Planning and Probate Law, Texas
**Fellow, American College of Trust and Estate Counsel

LARRY D. GEORGE
SHAREHOLDER
CRAIN, CATON & JAMES
A PROFESSIONAL CORPORATION
FIVE HOUSTON CENTER, 17TH FLOOR
HOUSTON, TEXAS 77010-4035
TELEPHONE: (713) 658-2323
TELECOPY: (713) 658-1921
E-MAIL: lgeorge@craincaton.com
WEB: www.craincaton.com

FUNDAMENTALS OF ESTATE PLANNING AND ASSET PROTECTION

I. INTESTACY IN TEXAS

If you die without a Will, the laws of the state of Texas will control the disposition of your property. If you permanently reside in another state on the date of your death, the laws of that state will control. Intestacy is the legal term for death without a will. Intestacy laws are rigid. They only deal with the degree of relationships and do not deal with the individual circumstances of each person's family. In addition, consider the following disadvantages:

A. If people whom you may wish to benefit are not related to you, they will take nothing if you die without a will.

B. Heirship must be established by court order. The court appoints an attorney ad litem to help determine who your heirs are. This person is paid from estate assets.

C. Heirs take shares outright, regardless of age or ability to handle money.

D. If the heir is a minor (under age 18), an expensive, time consuming guardianship may have to be established to handle the minor's share of the estate.

E. A surviving spouse may not receive an adequate share of the estate if there are children from previous marriages or if the deceased's property was primarily separate property.

F. Additional administrative expenses may be incurred because the administrator whom the court appointed will need court permission to act, a bond will be required, and guardianship fees may be necessary. An independent executor named in a will acts free of court control; an administrator appointed by the court is subject to the court's control.

G. Estate taxes may be incurred which could have been avoided through proper planning.

H. See Exhibit A for an illustration of the effect of Texas law on personal and real property if you die without a Will.

II. WILLS

Definition: A legal document controlling the disposition of your probate estate. A married person may dispose by Will of all of his separate property and his one-half (1/2) interest in all community property.

III. REASONS FOR MAKING A WILL (AND AVOIDING INTESTACY)

A. To control the disposition of your property upon your death (and avoid disposition under the Texas law) so that you determine:

- who will get what
- how they will get it
- when they will get it

B. To name an independent executor to serve without bond. Direct that no other action shall be had in the probate court for the settlement of your estate other than the probating and recording of your Will, and the return of an inventory and list of claims of your estate.

C. To create trust provisions for minors or incompetents which will avoid expensive and cumbersome guardianship proceedings.

D. To name guardians for minor children (this may also be done outside the Will).

E. Tax planning.

1. To take advantage of the unlimited marital deduction.

2. To create a bypass (credit shelter) trust for the amount of property allowed by federal law to pass free of federal estate tax (up to $1,500,000 for 2004). The tax free amount will increase as follows:

2004 $1,500,000
2005 $1,500,000
2006 $2,000,000
2007 $2,000,000
2008 $2,000,000
2009 $3,500,000
2010 Estate tax repealed
2011 Estate taxes revert back to 2002 level of $1,000,000

3. To minimize estate taxes and avoid "stacking" the estates (see Exhibit B for an example of stacking; see Exhibit C for an example of a traditional bypass trust arrangement).

4. To take advantage of the generation skipping tax laws (when making gifts or bequests to younger generations).

IV. REASONS FOR UPDATING EXISTING WILL

A. Changes in marital status

1. death of spouse

2. remarriage

B. Changes in tax law

C. Changes in children's status (age, marriage, divorce, professional liability)

D. Changes in choice of guardian for minor children

E. Child's incompetence or disability making it necessary to establish a trust for the child's benefit

F. Birth of grandchildren

G. Changes in assets requiring tax planning

H. Changes in choice of personal representative of your estate.

V. PROBATE ASSETS AND NON-PROBATE ASSETS

A. Probate Assets:

1. Generally consists of all property that you own outright unless the disposition of an asset is controlled by contract. (See V.B. below).

2. Insurance policies, employee death benefits and qualified plans where your estate is designated as beneficiary are probate assets.

3. Property owned as joint tenants with right-of-survivorship does not pass under your Will but is owned by the surviving joint tenant (e.g., some joint bank accounts and brokerage accounts). (See V.B. below).

B. Non-Probate Assets: Non-probate assets do not pass under a will. They pass in accordance with the terms of a contract which determines the legal holder of the asset.

1. Property that is frequently held by joint tenancy with rights of survivorship:

- bank accounts
- stocks
- bonds

a. The survivor owns the accounts no matter who contributed the funds and no matter what the Will says.

b. Dangers:

1. May be considered a gift to the co-tenant and a gift tax return may have to be filed.

2. If held jointly with a child, and the child dies first, the entire value of the property may be included in the child's estate and you might have to prove that the funds did not belong to the child.

3. It is difficult to establish source of contribution of funds.

4. There is no program or procedure to monitor actions of joint owner.

2. Assets where a beneficiary has been designated (and which pass outside of your Will).

a. life insurance

b. annuities

c. retirement plans including IRA's, 401(k)s, qualified plans

d. P.O.D. accounts ("payable on death to . . .")

VI. FEDERAL ESTATE AND GIFT TAXES

A. Annual Exclusion: A donor (the person making the gift) is entitled to give up to $11,000 to any person during any calendar year without filing a gift tax return or paying any gift tax. A married couple together may give up to $22,000 to another person during any calendar year without paying any gift tax.

B. Exclusions for Payments for Education and Medical Treatment: In addition to annual exclusion gifts of $11,000 per person ($22,000 per couple), an individual or couple may make direct payments for tuition at an educational institution or for medical care.

C. Exemption Equivalent Amount (Unified Credit): The exemption equivalent amount is the total amount of property which may be given to anyone during life or upon death with out incurring any federal estate tax. Under present law, the exemption equivalent is currently $1,500,000, but see III.E.2. Remember, the exemption amount is in addition to the annual exclusion amount ($11,000/$22,000 per year).

D. Federal Estate Taxes: A unified tax credit ("unified credit") is applied directly to federal estate taxes owed. The current amount of the unified tax credit is $555,800. The effect of the credit is that there is no estate or gift tax due on transfers of up to $1,500,000.

Taxable lifetime gifts reduce the unified credit available at death. For example, if you made taxable lifetime gifts (i.e., gifts above the annual exclusion of $11,000 per person per year), of $100,000, and you died in 2004, only $1,400,000 would pass to your heirs (other than a spouse) free of estate taxes at your death. For estates over the annual exclusion amount of $1,500,000, the federal estate tax rate ranges from 45% to 48%.

E. Federal Estate Tax Return: A federal estate tax return must be filed if the decedent's gross estate exceeds the exemption amount ($1,500,000) in the calendar year of the decedent's death.

The federal estate tax return is due nine (9) months after the decedent's date of death. If necessary, a six (6) month extension may be granted for the filing of the return (but not for the payment of the tax).

F. Decedent's Gross Estate: Generally, all assets that the deceased owned at death is included in his or her gross estate. For example, those assets would include stocks, bonds, cash, mutual funds, mortgages, notes, jewelry, household items, real property, works of art, patents, trade marks, copyrights, business interests, limited partnership investments, a claim for an income tax refund, interest in jointly owned property, an interest in a trust, or a judgment the Decedent might have had against someone. In addition, the value of life insurance policies payable to the Decedent's estate or to an individual if the Decedent possessed an "incident of ownership" is included as an asset. An "incident of ownership" would include the right to name a beneficiary, to borrow against the cash surrender value, or otherwise control the economic benefits of the policy. Property which the Decedent transferred during his/her lifetime without adequate and full consideration is included (i.e., a bargain sale). In short, any asset in which the Decedent had an interest is included in his or her gross estate.

G. Reduction in Gross Estate: At the time of death, state and federal taxes, attorneys' fees, accountants' fees and appraisal fees will reduce the Decedent's gross estate. If the estate does not have enough liquid assets to satisfy estate obligations, including taxes, the executor will be forced to sell property at reduced prices. The executor will have to sell the property within nine (9) months of death in order to pay the federal estate tax taxes that will be due.

H. Ways to Provide Money for Estate Taxes:

1. Cash. If the estate has cash, this is the most obvious source of funds. However, often times, estates contain non-liquid real estate or business interests, and there is not sufficient cash to pay taxes and other estate costs.

2. Borrow. The money will have to be paid back with interest.

3. Sell Assets. If the estate consists of stock, bonds, mutual funds, real estate, etc., the assets may be sold to pay taxes (the funds must be raised within 9 months of the date of death).

4. Life Insurance Proceeds. Life insurance can be a good way to provide the necessary cash for estate settlement costs. If the life insurance is properly owned, for example, in a properly created irrevocable life insurance trust, the proceeds can be excluded from the decedent's estate and therefore not subject to federal estate tax.

I. Unlimited Marital Deduction:

1. Any amount of property may be given outright to a spouse or set aside in a specific type of trust for a surviving spouse, either during life or upon death, without any federal estate or gift tax consequences.

2. Qualified terminable interest trust for a surviving spouse:

a. All income must be paid to the surviving spouse for life, payable at least annually.

b. Other technical requirements must be dealt with in the trust.

c. This type of trust is useful for managing the assets, protecting the assets from a future new spouse and preserving the assets for your children in the event of a remarriage.

VII. TEXAS INHERITANCE TAX

A. A Texas inheritance tax return must be filed within nine (9) months of the decedent's date of death.

B. No Texas inheritance tax is due if no federal estate tax is due. If federal estate tax is due, Texas inheritance tax is computed as a portion of federal estate tax.

VIII. GENERATION SKIPPING TRANSFER TAX

After payment of federal estate tax liability, each person is entitled to leave (in 2004) up to $1,500,000 (i) outright to grandchildren or more remote generations, thus avoiding estate tax at any of the "skipped" generations, or (ii) in trust for the lifetime of a child or children, to be protected from death taxes at future generations for so long as the property is held in trust; at the death of all "skipped" generations, the property will pass to the younger generation undiminished by death taxes. Property held in trust has several advantages:

A. No death taxes will arise so long as the property is held in trust, no matter what the exemption amount is at the time.

B. Property held in trust should be exempt from the claims of creditors of the lifetime beneficiaries of the trust.

C. Property held in trust is not so likely to be commingled or subject to the claims of a spouse upon divorce.

D. The child or other "skipped" generation beneficiary can be given quite generous benefits from the trust without sacrificing the tax benefits such as:

1. All income.

2. Principal distributions if needed.

3. Ability to pull out up to 5% of the trust principal in any year, without regard to need.

4. The "skipped" beneficiary can be trustee of his trust.

IX. LIVING TRUSTS

You may name yourself as trustee of your own trust and provide for an alternate trustee in the event you are incapacitated or want to resign as trustee. In Texas, a trust is revocable unless the trust document specifically states it is irrevocable (i.e., you can change the trust at any time so long as you are alive and mentally competent).

A. Advantages:

1. No need for probate. In Texas, however, probate is relatively simple, inexpensive, quick, and free from court control if you have a properly drafted will.

2. No need for probate administration in other states if you own property outside of Texas.

3. May be less vulnerable to challenge than a will especially the if the trust has been in existence for some time.

4. Competent management can be obtained through a professional trustee.

5. Continuous trust administration after your death.

B. Disadvantages:

1. Legal title to all of your assets must be transferred to the trustee. If all assets are not transferred to the living trust, the assets outside the trust will be subject to probate (i.e., you will have paid twice; once for creating the trust to avoid probate and again for the unintended probate).

2. If a corporate trustee is used, a fee will be charged for their services.

3. A trustee must maintain separate bank accounts for the trust.

4. Attorney, legal, and accounting expenses will be incurred in establishing and maintaining the trust and in filing trust tax returns.

5. The assets in a revocable trust are subject to your creditor's claims even if trust has a spendthrift clause.

6. **Note: A living trust does not change or reduce the federal estate tax liability when compared to a properly drafted Will.**

X. OTHER COMMONLY USED ESTATE PLANNING DOCUMENTS

A. Life Insurance Trust:

1. While life insurance is exempt from income tax, it is not exempt from estate tax. Life insurance is treated the same as any other asset for estate tax purposes.

2. If life insurance is left directly to the surviving spouse, the surviving spouse's estate will be "stacked" such that his/her estate will be larger and perhaps taxable, on his/her death.

3. If the ownership and control of the life insurance is transferred to an irrevocable trust which you do not control, it is possible to avoid estate tax on the death of both spouses. The insured (i.e., you) must not have any "incidents of ownership" in the insurance policy.

This means that you cannot retain the right to change the beneficiary, borrow against the policy or pledge the policy as collateral for a loan.

4. Advantages of using an irrevocable life insurance trust:

- life insurance proceeds can be protected from creditors and future spouses
- depending upon your choice of trustees, more sophisticated management expertise can be obtained or more seasoned judgment can be used to control the assets
- the life insurance proceeds can be used to pay any estate taxes that might arise after both spouses are deceased; i.e., it can provide liquidity without being subject to estate taxes
- if any of the life insurance proceeds end up in the hands of your children, the provisions of the trust can provide the circumstances under which the children will receive the money

5. A summary of a typical irrevocable life insurance trust which owns insurance on the life of only one spouse is attached as Exhibit D.

B. Durable Power of Attorney:

1. This is a document by which you appoint someone to act on your behalf regarding your personal financial matters.

2. You can name any competent adult that you choose though many people first appoint their spouse and, in many instances, will appoint one or more of their adult children or a trusted friend or relative as a successor to the spouse.

3. The person you name to act on your behalf is considered a "fiduciary". The person you appoint has significant and substantial power and control over your financial affairs so that it is critical that you appoint someone that is totally trustworthy and honest.

C. Medical Power of Attorney:

1. This is a document in which you appoint someone to act on your behalf regarding medical treatment decisions.

2. This document may only be used if you are unable to competently discuss your medical treatment with your attending physician.

3. In most cases, the other spouse is first appointed to act on your behalf. While the successors or alternates can be the same persons mentioned above under the Durable Power of Attorney, sometimes the skills needed to make financial and business decisions are not the same as those required to make medical decisions. Thus, the alternates or successors may differ from above.

D. Directive to Physicians and Family or Surrogates:

1. This document is more frequently called a “living will”.

2. This document sets forth your decisions concerning life sustaining treatment in the event you have an “irreversible condition” or a “terminal condition” as defined by the Texas legislature.

3. Most persons choose their spouse to make decisions under this document. You may also name alternate or successor persons to make the decision in the event your spouse has predeceased you or is unable to make the decision

E. <u>Declaration of Guardian</u>:

1. This document allows you to name the person who would manage your assets and be in charge of your personal well being should you ever need a court appointed guardian.

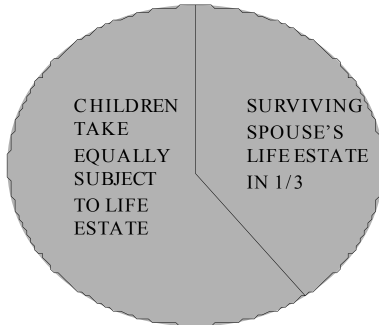
2. Most persons choose their spouse to make decisions under this document. You may also name alternate or successor persons to make the decision in the event your spouse has predeceased you or is unable to make the decision

EXHIBIT A

TEXAS DESCENT AND DISTRIBUTION
(THE LEGAL EFFECT OF NOT HAVING A WILL)

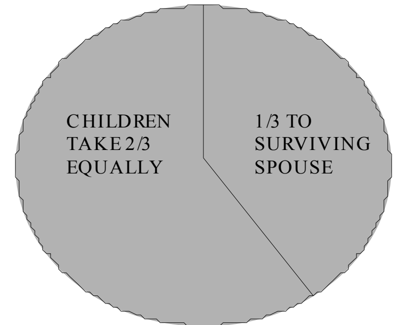
MARRIED PERSON WITH CHILD(REN)

A. SEPARATE PROPERTY REAL ESTATE



ALL REALTY IS OWNED BY DECEDENT'S CHILD(REN) WHEN SURVIVING SPOUSE DIES.

ALL OTHER PROPERTY



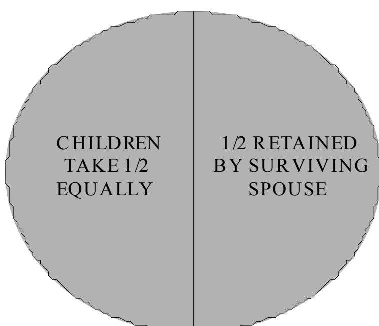
B. COMMUNITY PROPERTY REAL ESTATE

ONLY APPLIES IF

ALL SURVIVING CHILD(REN) AND DESCENDANTS OF DECEDENT ARE ALSO CHILD(REN) OR DESCENDANTS OF SURVIVING SPOUSE.

ALL OTHER PROPERTY

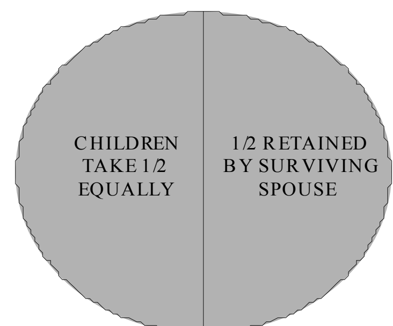
B. COMMUNITY PROPERTY REAL ESTATE



ONLY APPLIES IF

THERE ARE CHILDREN FROM OUTSIDE OF THE EXISTING MARRIAGE ON THE DATE OF DEATH OF THE DECEASED. CHILD(REN) OF DECEASED CHILD(REN) TAKE THEIR PARENTS' SHARE SUBJECT TO ADVANCEMENTS.

ALL OTHER PROPERTY



COMPLIMENTS OF
JUDGE RUSSELL AUSTIN
HARRIS COUNTY PROBATE COURT 1

┌EXHIBIT

Stacking Estates

A. Husband's and Wife's Assets (all community property)

Cash	$ 50,000
Real Estate (home)	350,000
Securities	50,000
Sale of Interest in Company	500,000
Retirement Plans	500,000
Life Insurance	250,000
Total Combined Estate	$1,700,000

B. Death of First Spouse (with simple Will)

Taxable Estate	$ 850,000
Estate Tax	-0-

C. Death of Second Spouse

Taxable Estate	$1,700,000
Estate Tax	90,000

D. Excess Estate Tax Paid $ 90,000

EXHIBIT C

BYPASS TRUST WILL

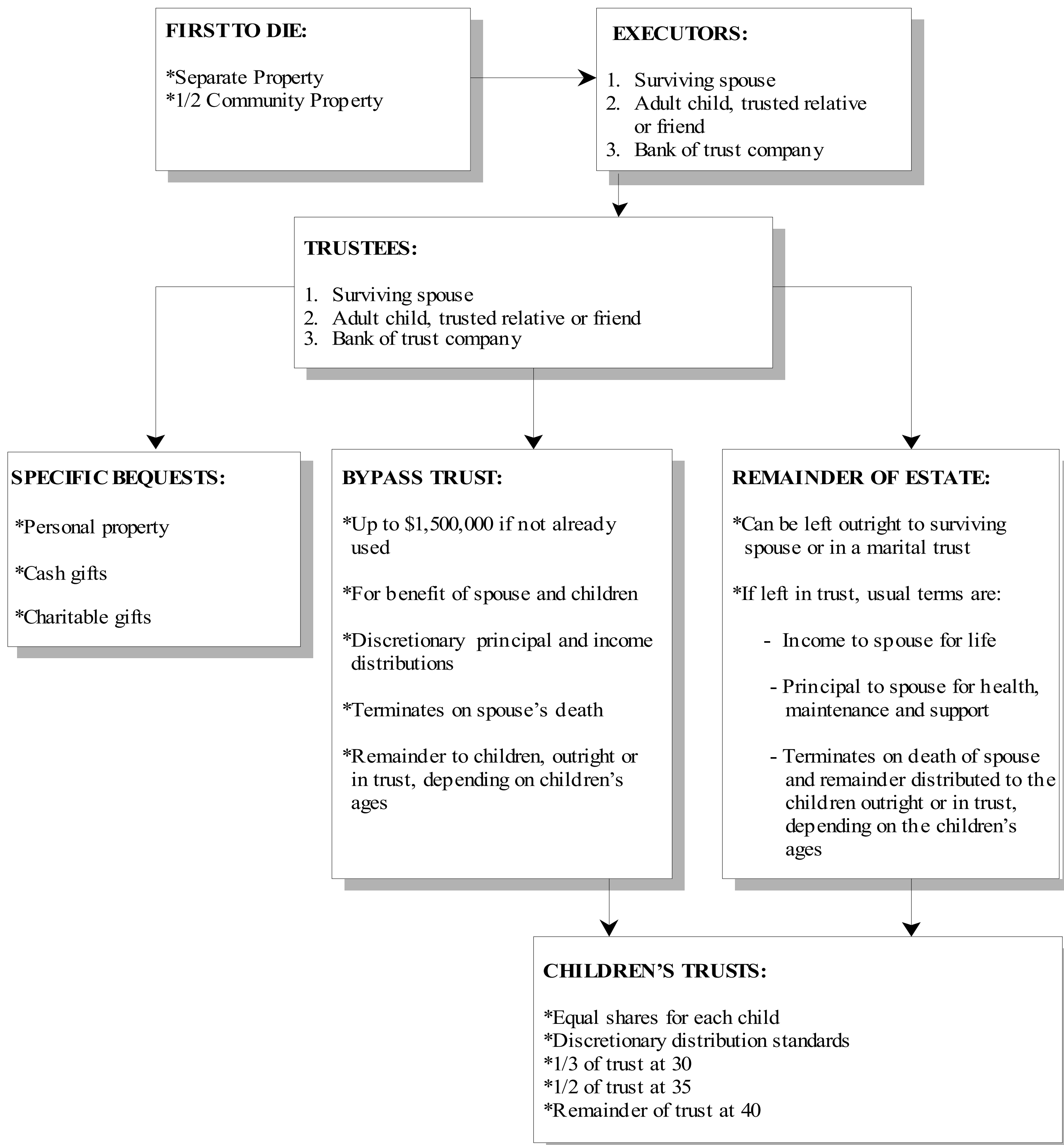


EXHIBIT D

TYPICAL LIFE INSURANCE TRUST