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Estate Planning

A Guide To Preserving Your Property For Your Family and Other Beneficiaries

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Estate Planning Vocabulary

Any discussion of estate planning involves the use of terms that are not part of the typical English vocabulary. In this booklet, you will find several of these terms, which have been capitalized throughout and have been defined in the section of this booklet titled "Definitions of Common Terms." If you come across a capitalized term that you do not understand, please refer to the Definitions section (pp. 18-20).

Do You Need A Will?

> Cato the Elder (ancient Roman statesman), looking back on his life had three regrets: *That he had told his wife a secret; that he had made a journey by a boat when he might have walked; and that he had lived one day without a will.*

A will is a written document describing your wishes for your property at death. The will does not transfer property until your death and until a court admits the will to probate. If you die without a will:

- State law will control the disposition of your property. Most people do not realize that in the case of a second marriage, Texas heirship law can pass a decedent's half of Community Property to the decedent's children, not to the surviving spouse. Children also inherit a share of a decedent's Separate Property.

- Custodians of your property at your death (e.g., a bank or transfer agent) generally refuse to release the property to your heirs without a court order that identifies who they are. Obtaining this court order can be expensive and time consuming.

- If both parents are dead, the court may choose a family member to serve as Guardian of your Minor children. The person selected by the court may not be the person you would have chosen.

- If your children are Minors, their inheritance must be distributed to a Guardian of the Estate. This guardianship is supervised by the Probate Court until the child reaches age 18. Court permission must be obtained to use guardianship assets for the child's support and maintenance. Guardianships of the estate are expensive and unwieldy.

- Your estate may pay more estate tax than would be due with a will incorporating tax planning.

- There are fewer options available to simplify administration of your estate. Court costs and attorneys' fees may be significantly higher than if you have a properly drawn will.

If you are married, you and your spouse each need a will. The wills may be identical, although this is not required.

Property That Passes Outside Your Will

Certain property—non-probate property—does not pass under your will; rather, it passes by operation of law or beneficiary designation. The provisions of your will thus have no effect on the disposition of this property.

An example of property that passes by operation of law is property held by two or more individuals as "joint tenants with right of survivorship" ("JTWROS"). Upon the death of a joint tenant, JTWROS property automatically passes to the surviving joint tenant(s). Although joint ownership avoids probate, it may cause adverse estate tax consequences by not fully utilizing the Estate Tax Exemption available to the first joint tenant to die.

Examples of property that passes by beneficiary designation include life insurance proceeds and employee benefits. The owner of a life insurance policy has the power to designate a beneficiary of the insurance proceeds. If no beneficiary is designated, or if all beneficiaries are deceased, the policy typically provides that the proceeds will pass to the insured's "estate." Insurance proceeds that pass to the insured's estate become subject to probate and pass to the beneficiaries named in the insured's will.

Proceeds of an employee benefit plan, such as a profit sharing plan, pension plan, or an individual retirement account ("IRA"), also pass by beneficiary designation. Unlike life insurance proceeds, which pass to the beneficiary free of income tax, employee benefits are subject to income tax when they are distributed from the plan. Generally, payment of income tax on distributions from an employee benefit plan or IRA can be deferred over the lifetime of the beneficiary. Also, if the employee's spouse is named beneficiary, she or he can "roll over" a lump sum distribution into an IRA in the survivor's name. The income tax payable on these benefits will be deferred until the spouse makes a withdrawal from the new IRA.

Minor children should not be named as primary or contingent beneficiaries of life insurance or employee benefits. The life insurance company or the administrator of the benefit plan will refuse to distribute the proceeds to the Minor, and a court-supervised Guardianship of the Minor's Estate may be required to obtain the proceeds. A better solution is to name a Trust created under the insured/employee's will or a life insurance Trust as beneficiary.

Will vs. Living Trust
(Avoiding Probate)

Texas offers the simplest probate system in the United States. A Texas resident can name an "independent" Executor to manage his or her estate. The two most significant duties of an independent Executor are to file the will for probate and prepare an "inventory and appraisement" of the decedent's property. The independent Executor must either submit the inventory to the Court or file an affidavit with the Court that the Executor has furnished the inventory to the beneficiaries of the decedent's estate. All other tasks performed by the independent Executor are free of court supervision and control.

In contrast, courts in many other states supervise Executors at virtually every stage of the probate proceeding. Such court involvement results in expense and delay that are not present in most Texas independent administrations. Further, in some states, probate attorneys receive statutory fees computed as a percentage of the value of the assets subject to the Probate Court's jurisdiction. Texas does not have statutory attorneys' fees.

Because of complicated probate laws in other states, it may make sense for non-Texas residents to structure their affairs to "avoid probate." The most common way to avoid probate is to create a revocable (sometimes called a "living") Trust during life and to transfer assets to the Trust prior to death. Assets held in the Trust at the Settlor's death pass outside the probate process in accordance with the Trust agreement. Because Texas probate administration is so simple, legal fees for preparing a revocable Trust for a Texas resident and transferring assets to it may equal the costs of preparing a will and administering the testator's assets under the Probate Court's jurisdiction. In Texas, therefore, a client typically will not save attorneys' fees or court costs by using a revocable Trust instead of a will.

Although using a revocable Trust to avoid Texas probate generally does not provide significant cost savings, it may nevertheless be appropriate in certain situations to utilize a revocable Trust as the centerpiece of an estate plan. These situations include:

- **Avoiding probate in states other than Texas.** A Texas probate court does not have jurisdiction over land located outside Texas. Thus, if a Texas resident owns real property (including mineral interests) located in another state, a separate probate proceeding will be required in each state where such property is located to transfer title to the property. Conveying the out-of-state real property to a revocable Trust prior to death will save the costs of probate in the states where the property is located.

- **Desire for privacy.** An Executor is required to file the decedent's will with the probate clerk. The clerk's records are open to public inspection and the terms of the will are therefore available to the public. In addition, the Executor must prepare an inventory of the property that passed under the decedent's will. The inventory must contain a complete description of the decedent's probate assets along with date-of-death values of this property. The inventory must either be filed with the Court (in which case it is available to the public) or furnished to the beneficiaries. In contrast, the terms of a living Trust and the property held in the Trust at the Settlor's death need not be disclosed.

- **Management in the event of incompetence.** In the typical revocable Trust plan, the Settlor also serves as Trustee. Thus, the Settlor can continue to manage the assets transferred to the Trust essentially as though the assets had not been transferred to the Trust. If the Settlor becomes unable to manage the assets, the Trust agreement can provide for a successor Trustee automatically to take control of the assets and manage them for the Settlor's benefit. This will avoid Guardianship of the Settlor's Estate.

A married couple who wishes to utilize a revocable Trust plan typically creates a single revocable trust which disposes of each spouse's property at the spouse's death. Both spouses can serve as co-Trustee or one of them can serve as sole Trustee.

Although a revocable Trust may be advantageous in certain estate plans, it does not save income tax and does not offer any greater estate tax savings than a properly drawn will. A revocable Trust also will not protect your assets from claims of your creditors. Even if you establish a revocable Trust, you should execute a will to dispose of property you do not transfer to the Trust during your lifetime.

Do You Need Tax Planning?

While everyone needs a will, not all clients need tax planning. In general terms, you need tax planning if any of the following apply:

- You are single and the net value of your property exceeds the Estate Tax Exemption. The Estate Tax Exemption is $5,000,000 (reduced by certain large lifetime gifts), indexed for inflation. As a result of indexing, the Estate Tax Exemption is currently $5,340,000.

- You are married and the total net value of your property and your spouse's property exceeds the Estate Tax Exemption.

- You wish to leave property to your children, but they have substantial estates of their own.

- You have substantial retirement benefits or life insurance.

- You wish to make gifts to your children and grandchildren in excess of "normal" holiday and birthday gifts.

- You are an owner of a closely-held business.

Before deciding that none of the above categories applies to you, you should realize that the face amount of life insurance and the current fair market value of property held in employee benefit plans and IRAs are part of your estate for estate tax purposes.

Estate And Gift Tax Rules In A Nutshell

Estate and gift taxes are a concern for less than 10% of the population. But, if these transfer taxes apply to you, you must take care in arranging your affairs because your applicable transfer tax rates can approach 40%.

To understand how these transfer taxes may affect you, you should be familiar with some general concepts:

Gift Tax

- During your life, you may make outright gifts of up to $14,000 (indexed annually for inflation) per year, per donee without any transfer tax consequences. You will not need to file a gift tax return to report these Annual Exclusion gifts.

- You may make gifts of unlimited amounts by paying tuition (but no other school expenses) and medical expenses of another individual (referred to below as Tuition/Medical Expense Gifts). For instance, you could pay your grandchild's

$45,000 college tuition and also give your grandchild $14,000 for room and board, books, and other college expenses. It is important to note the gift tax benefit described in this paragraph is available only if the payments are made directly to the school or provider of medical services. You will not need to file a gift tax return to report these Tuition/Medical Expense Gifts.

- During your life or at your death, you may give unlimited amounts to your spouse without paying transfer taxes. Gifts to your spouse pass tax free due to the unlimited Marital Deduction.

- During your life or at your death, you may give unlimited amounts to charity without paying gift tax. (Such gifts may not be fully deductible for income tax purposes, however.) These gifts pass tax free due to the Charitable Deduction.

- You may make lifetime gifts to individuals in excess of the $14,000 Annual Exclusion Amount, but not exceeding a cumulative total equal to your Gift Tax Exemption, without paying gift tax. Like the Estate Tax Exemption, the Gift Tax Exemption is $5,000,000, indexed for inflation. The Gift Tax Exemption is currently $5,340,000.

- If your total Taxable Gifts exceed the Gift Tax Exemption, then future lifetime gifts will be taxable unless the gift is made to your spouse or to charity.

- Lifetime gifts often produce greater tax savings than if the same gift were made at death. Lifetime gifts, unlike gifts made at death, qualify for the $14,000 Annual Exclusion and the unlimited Tuition/Medical Expense Gifts exception. In addition, if property you give away during life appreciates in value following the date of the gift, the appreciation will escape gift and estate tax. Further, income generated by the gifted property will benefit the donee instead of augmenting your estate.

Estate Tax

Planning for your spouse and family at your death typically involves a combination of tax benefits:

- In many cases, the unlimited Marital Deduction preempts the use of the Estate Tax Exemption. This means that if your will leaves everything outright to your spouse, all of your property will pass tax free at your death, but your Estate Tax Exemption may be wasted. Only your spouse's Estate Tax Exemption may be available to shelter the survivor's property from estate tax at death. As outlined below, Congress recently enacted legislation to avoid this result for some couples, but unfortunately the legislation does not benefit everyone.

- You can take advantage of your Estate Tax Exemption and provide for your surviving spouse at the same time in one of two ways. First, you may alert your spouse that he or she should file an estate tax return for your estate and elect to carry over your Estate Tax Exemption, as permitted by recent legislation. Unfortunately, this option is problematic for several reasons. Most importantly, a person can carry over Estate Tax Exemption only from his or her last deceased spouse. Thus, if you die and your spouse later remarries, your Estate Tax Exemption may be lost. Also, your spouse may carry over only the original amount of your Estate Tax Exemption, without regard to later growth in asset values.

  Second, and more reliably, you can take advantage of your Estate Tax Exemption and provide for your surviving spouse at the same time by creating a Bypass Trust for your spouse under your will. Your Adjusted Estate Tax Exemption will pass to the Bypass Trust and the remainder of your property in excess of your Adjusted Estate Tax Exemption will pass to your spouse and qualify for the unlimited Marital Deduction. No tax will be due at your death. The property transferred to the Bypass Trust under your will is not taxable at your spouse's death, regardless of its value at that time. Your spouse's Adjusted

Estate Tax Exemption still will be available to shelter that amount of property at her or his death. For instance, if both spouses die when the Estate Tax Exemption is $5,340,000, as much as $10,680,000 may be protected from estate tax by incorporating Bypass Trust planning. This translates to a tax savings of over $2,136,000 on a $10,680,000 estate. These concepts are illustrated by the charts on pages 10 and 11.

- Your spouse can be the Trustee of the Bypass Trust and may receive all the income from this Trust and principal if needed for her or his health, maintenance, and support. Your children can be co-beneficiaries with your spouse of the Bypass Trust.

- You can obtain the benefits of the unlimited Marital Deduction by leaving property either outright to your spouse or to a special type of Trust known as a qualified terminable interest property ("QTIP") Trust. Your spouse will receive all the income from the QTIP Trust and can receive principal, if you desire. Unlike property owned outright by your spouse, which may be freely transferred by your spouse, property held in a QTIP Trust will pass as provided in your will at your spouse's death. An important advantage offered by utilizing a QTIP Trust is that the trust property will be protected from claims of your spouse's creditors and from claims of a future spouse.

Chart I

How To Eliminate Federal Estate Taxes With A Bypass Trust

$10,680,000 Community Property Estate
(assuming both deaths occur when the Estate Tax Exemption is $5,340,000 and surviving spouse is unable to carry over first spouse's exemption due to remarriage or other reasons)

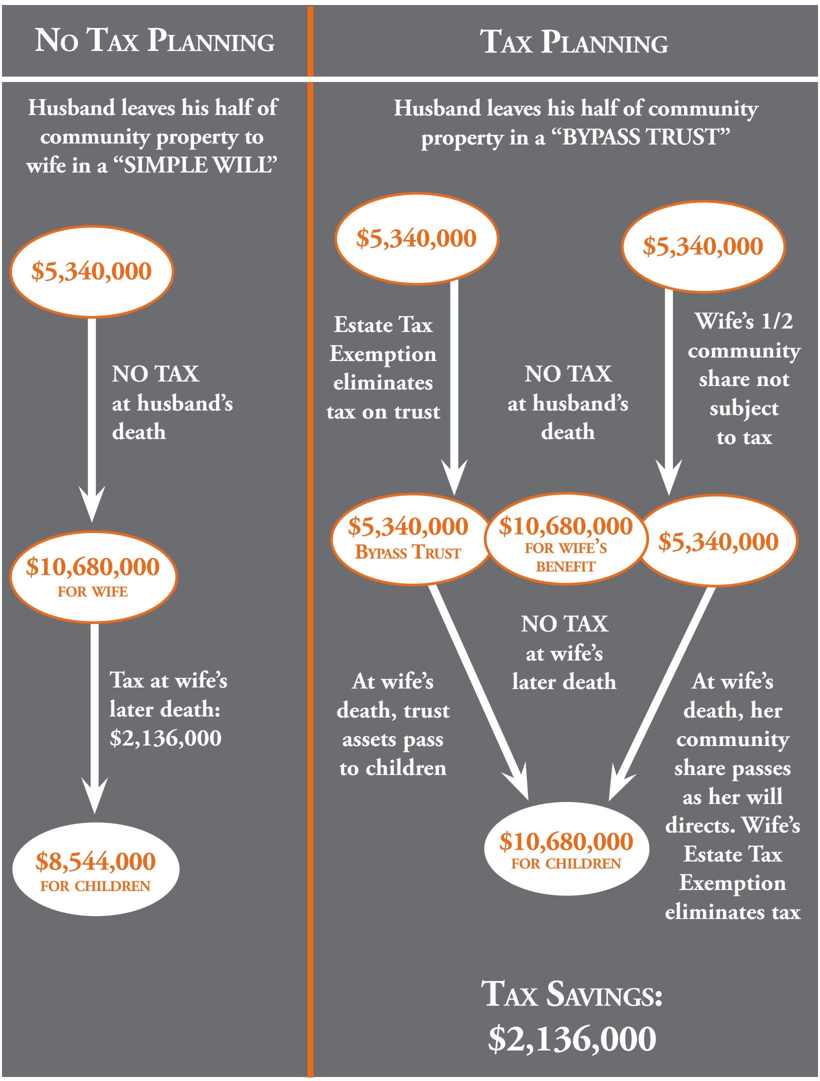
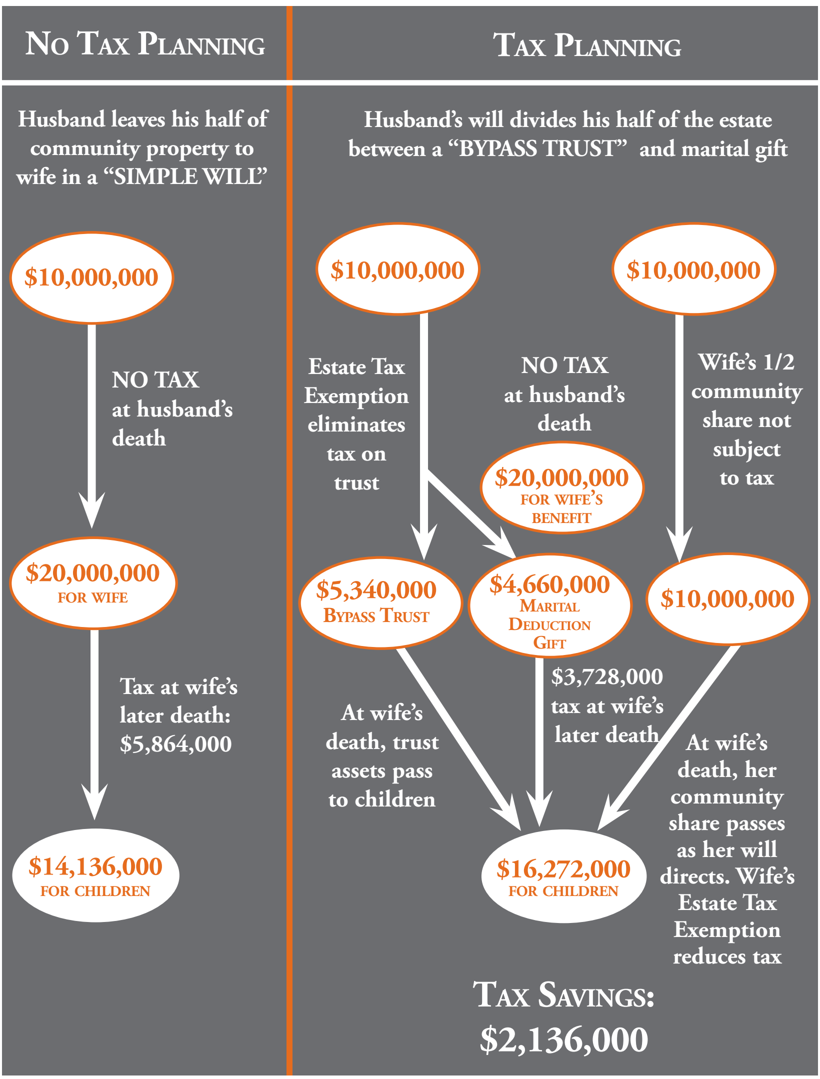


Chart II

How To Reduce Federal Estate Taxes With A Bypass Trust

$20 Million Community Property Estate
(assuming both deaths occur when the Estate Tax Exemption is $5,340,000 and surviving spouse is unable to carry over first spouse's exemption due to remarriage or other reasons)



Selection of Fiduciaries

Fiduciary: *One who holds a relationship or acts in a position involving confidence or trust.*

Estate planning necessarily involves the selection of fiduciaries. Fiduciaries include Executors, Trustees, Guardians, and attorneys-in-fact under powers of attorney. In some cases, we can select our own fiduciaries and in other cases they may be selected for us. For example, a person can name an Executor in his will, but if he fails to do so, a court may appoint an administrator to administer the assets. Similarly, a Minor cannot name his or her own Guardian, but the Minor's parents can designate a Guardian to care for the child if they are both deceased. If the parents fail to name a Guardian, the court may name one. If a person includes a Trust in his or her will to save estate taxes or to administer property for a Minor or other individual incapable of managing finances, a Trustee must be selected.

You can appoint a Guardian of the Person of your Minor child to serve in the event of the death of both you and your spouse. You may not deprive the child's natural parent (e.g., your former spouse) of the right to serve as Guardian of the child's Person. In selecting a Guardian of the Person, you should choose the person best qualified to act as a parent to the child. The Guardian may be the same person selected as Trustee to manage the child's finances, but need not be.

We are often asked whether we recommend using an individual or corporation to serve as Executor or Trustee. Both kinds of fiduciaries are appropriate in certain circumstances.

Individual fiduciaries are often viewed as more flexible and attuned to particular family situations. Family members or business associates may be familiar with family properties and businesses. Many feel that a carefully selected individual Trustee can more accurately reflect the desires of the Settlor in a particular situation. In many cases an individual may serve for little or no compensation, resulting in substantial savings to the family.

There are potential drawbacks to individual Trustees, however. An individual may not have the required characteristics to serve as Trustee or, due to age or infirmity, may not continue to have them. Effective asset management may be gained by specifically permitting the individual Trustee to delegate investment authority to a competent agent. An individual may have a potential conflict of interest with the beneficiaries of the Trust, such as when the individual Trustee is a co-owner of property held in the Trust. A Trustee who is also a beneficiary of the Trust may face adverse tax consequences.

Corporate Trustees offer particular advantages. They are stable and have professional staffs qualified in asset management and record keeping. All professional fiduciaries are subject to regulation by state or federal authorities. If errors occur, the institution is answerable.

Many situations require a corporate Trustee because of the duration of the Trust, the unavailability of qualified individuals to accept the responsibility, or the potential for conflict among beneficiaries of the Trust.

Corporate Trustees are not inexpensive, so the institution's fees should be discussed in detail at the time the plan is developed. Some corporate trust institutions are unable or unwilling to handle small Trusts or estates. If you are considering naming a corporate fiduciary, you should meet with a representative of the corporate fiduciary to discuss the proposed appointment in detail.

All wills and trust instruments should provide for succession of fiduciary duties, either by naming successor Trustees and Executors or by providing for a simple and workable mechanism for appointment of successors. If you name a corporate Trustee, you should consider whether to give family members the power to remove the fiduciary and appoint another so that satisfactory administration can be assured if there is a change in circumstances.

We often recommend the appointment of co-fiduciaries, either an individual with an institution or two or more individuals. Co-fiduciaries can provide desirable checks and balances and can bring different skills to their tasks.

An unqualified fiduciary can defeat the best estate plan. Individual fiduciaries should have three important qualifications:

- they should be trustworthy;

- they should have the ability to administer the assets entrusted to them; and
- they must have the time to devote to managing the assets.

The selection of a fiduciary should not be made lightly. Affection or admiration for a person does not make that person a good choice as a fiduciary. Further, although many consider being named Trustee or Executor an honor, it is, in fact, a serious and important job. A fiduciary who is unable or unwilling to carefully and completely carry out his duties may frustrate the desires of the person who established the Trust and may be subject to legal liability.

A Trustee must manage Trust assets in the same way that a prudent person would manage his or her own assets, not with a view to speculation, but rather for the production of income and the preservation of principal. The Trustee must deal in an even-handed manner between different beneficiaries and keep full and complete records. Failure to carry out these duties may make the fiduciary liable to the Trust beneficiaries.

What Your Attorney Needs To Prepare Your Will

You should disclose fully to your attorney all pertinent facts concerning your property and your family. Before meeting with the estate planning attorney, you should consider generally who should manage the property after you are gone. The following is a checklist of information your attorney needs to properly plan your estate:

1. The legal names for you and your spouse.
2. Are you and your spouse United States citizens?
3. Permanent address and, if you have more than one residence, the location of each other residence.
4. If you have been married previously, your attorney will need information regarding the former spouse. If your former spouse died while you were married, bring a copy of the will, and if applicable, the estate tax return filed in that spouse's estate. If you are divorced, bring a copy of your divorce decree and property settlement agreement.

5. Bring a copy of a premarital or postnuptial agreement if you and your current spouse have signed one.

6. List the names, ages, and addresses of your children and other beneficiaries of your estate. If charitable beneficiaries will be named, please try to ascertain and give the correct name and specific division of the organization (e.g., name "the Dallas Chapter of the American Cancer Society;" otherwise, your gift would pass to "the American Cancer Society," the national organization, and not to the local division). Remember that many charities have similar names, so be certain that you supply the correct name of your chosen organization.

7. If you want your attorney to prepare a Medical Power of Attorney, HIPAA Release and Authorization, or Appointment of Agent to Control Disposition of Remains, provide the name, address, and telephone number of each agent you plan to name.

8. If you are a beneficiary or Trustee of a Trust or if you have a power of appointment under a Trust, bring a copy of that Trust agreement to the meeting.

9. Have you ever filed gift tax returns? If so, bring copies of the returns with you.

10. Name, address, and telephone number of your accountant.

11. Information regarding insurance policies on your life and your spouse's life. This information should include the name of the insurer, face amount of the policy, cash value of the policy, the owner of the policy, and the beneficiary.

12. Do you have an employment contract, buy-sell agreement, or stock purchase plan?

13. Are you entitled to a pension, profit-sharing benefits, stock options, or other employment benefits? Do you have an IRA? Who is the beneficiary of these assets? What is the approximate current value of each plan or account?

14. Provide a list of your assets and the approximate market value of each asset and a list of your debts and the approximate amount of each debt. These lists can be in the form of a financial statement or balance sheet.

15. Do you and your spouse own assets as "joint tenants with rights of survivorship" or as "tenants by the entirety"? If so, which assets?

16. Have you been a Texas resident during your entire marriage? If not, please try to determine which of your assets were acquired prior to your move to Texas.

17. Who should serve as Guardian of the Persons of your Minor children? Who should serve as successor Guardian?

18. Who should serve as Executor and successor Executor of your estate? Who should serve as Trustee and successor Trustee of any Trust created under your will?

19. If a Trust is created for your children, how old should each child be prior to receiving his or her inheritance? Suggestions include giving the entire share to a child at a specified age (most clients require their children to be at least age 30 before receiving the assets outright); splitting the child's inheritance (e.g., half at age 30 and the remainder at age 35); and holding all children's inheritance in Trust until the youngest child reaches a specified age (e.g., 25), when the Trust will split into a share for each child. (See, however, Item 21 below and the discussion at pages 21-22, relating to generation-skipping tax planning.)

20. If you, your spouse, your children, and all of your other descendants are deceased, where should your property pass? Common choices include the "Heirs at Law" of each spouse or specified charities.

21. Are you interested in leaving property in Trust for your children's lifetimes? If you and your spouse have an estate exceeding your combined GST Exemptions (currently $5,340,000 per spouse) (see discussion on pp. 21 and 22), the attorney will discuss with you the generation-skipping transfer tax.

22. Do any beneficiaries have special needs and, if so, is it important that such beneficiary qualify for government assistance?

Other Estate Planning Documents

In addition to having a will prepared, clients often are interested in executing the following estate planning documents (sometimes called "ancillary" estate planning documents):

- **Directive to Physicians** ("Living Will") states your request that you not be kept alive by artificial means.

- **Durable Power of Attorney** designates another individual as agent to handle your financial affairs if you become incapacitated. This document can grant your agent immediate authority or can postpone the agent's authority until a physician deems you mentally incapacitated.

- **Medical Power of Attorney** names an individual to make health care treatment decisions if you are unable to do so.

- **HIPAA Release and Authorization** grants your agent access to your medical records. Although the Medical Power of Attorney technically is sufficient to give your agent this access, most medical providers are more comfortable releasing information to an agent if presented with the statutory HIPAA form.

- **Declaration of Guardian** allows you to specify an individual to act as Guardian of your Person or Estate if you become incapacitated and need to have a Guardian. This document also allows you to prohibit specified individuals from being appointed your Guardian.

- **Appointment of Agent to Control Disposition of Remains** names an agent who is authorized to make funeral, burial, and other arrangements on your behalf.

If you would like your attorney to prepare these documents for you, you will need to provide the names, addresses, and telephone numbers of the agents and guardians you would like to appoint.

Definitions of Common Terms

Adjusted Estate Tax Exemption: See "Estate Tax Exemption" below.

Annual Exclusion Amount: The amount of property that may be given, tax free, during life to persons other than one's spouse. Typically, when an Annual Exclusion gift is made, no gift tax return must be filed, and the gift does not reduce the donor's Gift Tax Exemption or Estate Tax Exemption. By statute, the Annual Exclusion Amount is $10,000, indexed for inflation. The Annual Exclusion Amount is currently $14,000. Thus, a husband and wife can annually give up to $28,000 tax free to as many donees as they wish.

Bypass Trust: A trust to which an individual's Estate Tax Exemption passes.

Charitable Deduction: The gift or estate tax deduction available for gifts made to charity. An unlimited gift and estate tax deduction is available for such gifts. The income tax Charitable Deduction is not unlimited and depends on a variety of factors.

Community Property: All property owned by a husband and wife during marriage while they reside in Texas except the following, which is "Separate Property":

- property one of them owned prior to marriage
- property received as a gift or inheritance
- recoveries for personal injuries, except recoveries for loss of earning capacity
- property acquired while the spouses resided in a non-community property state

- property agreed to be separate property of one spouse in a premarital or postmarital agreement
- mutations or changes in form of separate property

Community Property includes all wages earned by either spouse while the spouses reside in Texas, income from both community and separate property, and property acquired using such wages or income.

Estate Tax Exemption: The amount that can pass free of estate tax to persons other than the decedent's spouse (to whom the decedent can give unlimited amounts). By statute, the Estate Tax Exemption is $5,000,000. The Estate Tax Exemption is indexed for inflation and is currently $5,340,000. The decedent's Taxable Gifts reduce the decedent's Estate Tax Exemption, leaving less exemption to shelter gifts made at death. This reduced amount is referred to in this booklet as the Adjusted Estate Tax Exemption. For example, a gift to your child of $114,000 will, after subtracting the $14,000 that qualifies for the Annual Exclusion, be a "taxable" gift of $100,000. If you have not made prior Taxable Gifts, no gift tax will be payable as a result of this gift, but your Estate Tax Exemption will be reduced from $5,340,000 to $5,240,000 and your Gift Tax Exemption similarly will be reduced from $5,340,000 to $5,240,000.

Executor: The person appointed to wind up a decedent's affairs. In Texas, an Executor may be "independent" and may serve without bond. The independent Executor thus serves free from supervision and control of the Probate Court. The Executor's duties include collecting the decedent's assets, paying the decedent's bills, filing tax returns, and distributing assets to beneficiaries.

Gift Tax Exemption: The cumulative amount, in addition to the Annual Exclusion Amount and the amount of Tuition/Medical Expense Gifts, that an individual can give tax free during his or her lifetime to persons other than the donor's spouse. The Gift Tax Exemption currently is $5,340,000.

Guardian of the Estate: The person or institution appointed by the Probate Court to manage a Minor's or incapacitated person's assets.

Guardian of the Person: The person appointed by the Probate Court to have physical custody of a Minor or incapacitated person and who has the right to make decisions regarding the ward's health and custody. A parent's will may name a Guardian of the Person of Minor children, although one parent cannot deprive the child's other natural parent from serving as Guardian. In Texas, a husband and wife (but not two unmarried individuals) may serve as co-Guardians of the Person.

Heirs at Law: The persons who inherit your property if you have no will. These include your spouse and your descendants. If you have no spouse or descendants, your parents inherit first, followed by siblings and descendants of a deceased sibling.

Marital Deduction: The estate and gift tax deduction available for gifts during life or at death to one's spouse. This deduction is unlimited, so unlimited amounts of property can be given tax free between spouses.

Minor: In Texas, a person under age 18.

Separate Property: See "Community Property" above.

Settlor (also called a "Grantor"): The person who creates a Trust.

Taxable Estate: An estate is a Taxable Estate if its net value exceeds the Estate Tax Exemption (taking into account the decedent's Taxable Gifts).

Taxable Gifts: Lifetime gifts other than Annual Exclusion Gifts and Tuition/Medical Expense Gifts.

Trust: A property interest held by one person or institution (the "Trustee") for the benefit of another (the "beneficiary"). A Trust established in a will is known as a testamentary Trust, and a Trust established by a living person is known as a living or inter vivos Trust.

Trustee: The person or institution who holds legal title to property for the benefit of others (the "beneficiaries"). Texas Trustees can act without court supervision and control unless the instrument creating the Trust provides otherwise.

Tuition/Medical Expense Gifts: Payments made during life directly to a school for a donee's tuition (but no other educational expense) or to a provider of medical services to the donee. Tuition/Medical Expense Gifts do not reduce the donor's Gift or Estate Tax Exemptions.

The typical client needs a will (or a revocable Trust) utilizing the client's and his or her spouse's Estate Tax Exemptions. Most clients also opt to have some or all of the ancillary estate planning documents described on page 17 prepared. Beyond the basic estate planning documents discussed in the preceding pages, most clients also have an interest in one or more of the topics discussed below. Please note that implementing certain of these techniques will require you to file a gift tax return, so you should be certain to advise your accountant if you enter into any lifetime estate planning transactions.

Generation-Skipping Planning

The country's wealthiest families have preserved their wealth through many generations by creating generation-skipping Trusts. That is, the founder of the family's wealth transferred it to a Trust that continued for the lifetime of his children and more remote descendants. Gift or estate tax may have been payable when the Trust was first created; thereafter, however, no transfer tax was payable even though each successive generation received liberal benefits from the Trust. In contrast, had the founder left his property outright to his children, who left it outright to their children, and so on, estate tax would have been payable as each generation died. The benefits of this type of generation-skipping planning were greatly reduced in the mid-'80s with the enactment of the generation-skipping transfer tax ("GSTT"). The GSTT applies to transfers directly to the transferor's grandchildren or more remote descendants or to a Trust which benefits any of these individuals. If a "generation-skipping" transfer is made, the transferred property will be taxed as though the property were transferred outright to each successive generation at the highest estate tax rate. Each individual, however, has a "GST Exemption" that can be used to protect property from GSTT. The GST Exemption is presently $5,340,000. The tax benefits of utilizing the GST exemption in connection with many of the techniques discussed in this booklet can be significant.

> **Example**. Paul's will creates a Bypass Trust for his wife, Pamela. Following Pamela's death, the Bypass Trust will continue for the lifetime of their son, Chip. At Chip's death, the property will pass to Chip's children. Paul died on January 1, 2014, never having made any lifetime gifts in

excess of the Annual Exclusion Amount. Pamela, as Executor of Paul's estate, transfers Paul's Estate Tax Exemption ($5,340,000) to the Bypass Trust and also directs that Paul's GST Exemption (also $5,340,000) apply to the Bypass Trust. (Note that use of Paul's GST Exemption does not increase the amount Paula can transfer tax free to the Bypass Trust but simply protects the Bypass Trust property from tax at Chip's death.) When Pamela dies, the Bypass Trust assets have grown from $5,340,000 to $7,000,000. No estate tax or GSTT is payable when these assets pass in trust for Chip's benefit. At Chip's death, the trust assets are worth $15,000,000. All of these assets pass to Chip's children tax free. In contrast, if Chip had received the Bypass Trust assets outright at his mother's death, his taxable estate would have been increased by $15,000,000.

Lifetime Giving

Making gifts during life offers several advantages:

- Property given away during your life will not be subject to tax at your death.

- You can take advantage of your $14,000 Annual Exclusion Amount, which is not available to shelter gifts made at death. The recipient of a lifetime Annual Exclusion gift is not required to pay gift tax on the gift.

- Unlimited Tuition/Medical Expense Gifts can be made during life. This benefit is not available following the donor's death.

- Appreciation in value of the gifted property between the date of the gift and the date of your death will escape estate tax.

- Income earned with respect to the gifted property will be taxed to the recipient and thus will not increase your Taxable Estate.

- If taxable lifetime gifts exceed your Gift Tax Exemption, gift tax paid with respect to future lifetime taxable gifts will be excluded from your gross estate if you live three years after making the gift. (In contrast, if you made no lifetime gift, the estate tax will apply not only to the property you wish to transfer at death but also to the assets which will be used to pay the estate tax on the transferred property.)

- Opportunities exist to give property away during life but retain certain limited rights to the property, such as the right to manage the property.

- Opportunities exist to discount the value of gifted property by contributing the property to a family limited partnership or other closely-held entity and giving away interests in that business.

Gifts to Minors

It is generally unwise to make a gift directly to a Minor because the Minor is legally unable to manage the property. Four common methods for making gifts to Minors are:

- **Gift under Texas Uniform Transfers to Minors Act**. To make such a gift, you can designate a relative or other person or institution, known as the "custodian," to hold the property for a beneficiary under age 21. The custodian has broad powers to manage the property and to use it for the beneficiary's benefit. At age 21, the recipient is entitled to receive the property outright.

- **Gift to "Minor's" Trust**. A gift to a Trust generally does not qualify for the Annual Exclusion from gift tax, forcing the donor to utilize some of his or her Gift Tax Exemption to shelter the gift from gift tax. The "Minor's" Trust is an exception to this general rule: gifts to such Trusts qualify for the Annual Exclusion. The beneficiary is entitled to receive the Trust property at age 21; if the beneficiary reaches age 21 and does not request distribution of the Trust property, the Trust will continue until the beneficiary reaches such later age as is specified in the Trust instrument.

- **Gift to "Crummey" Trust**. A "Crummey" Trust (named for the taxpayer who first created this type of Trust) is another exception to the rule that gifts in Trust do not qualify for the Annual Exclusion. A gift to a Crummey Trust qualifies for the

Annual Exclusion because the Trust beneficiary has a limited right to withdraw up to the Annual Exclusion Amount of each contribution made to the Trust. Unlike a Minor's Trust, a Crummey Trust can be created for an adult as well as a Minor and, other than the right of withdrawal when a contribution is made to the Trust, the beneficiary need have no future right of withdrawal.

- **Gift to Qualified State Tuition Program**. Many states sponsor "Qualified State Tuition Programs" (also known as "Section 529 plans") to promote saving for education. These programs permit parents, grandparents, and other individuals to accumulate funds for a specified beneficiary. Contributions to the program grow tax free, and distributions are tax free if used for the beneficiary's "qualified higher education expenses." Contributions also qualify for the Annual Exclusion – in fact, a donor may elect to use future Annual Exclusions (up to four additional years) to shelter a current gift. However, it may be more appropriate from an estate tax perspective to use the Annual Exclusion to fund other expenses and use the unlimited tuition exclusion to pay the beneficiary's tuition directly at the appropriate time.

Insurance Planning

Many clients do not realize that insurance proceeds are subject to estate tax and must be included in the calculation of a person's gross estate. If the surviving spouse is named beneficiary, of course, the insurance proceeds will qualify for the Marital Deduction at the insured spouse's death and will therefore not be taxable at that time. But, the proceeds remaining at the death of the surviving spouse will be includable in that spouse's Taxable Estate. Through careful planning, insurance proceeds can be removed from taxation in both spouses' estates. The most common plan involves a Crummey Trust, which owns the life insurance policy and to which the insured spouse makes contributions to permit the Trustee to make the premium payments. At the insured's death, the policy proceeds pass to the Trust free of estate tax. If estate tax is payable in the insured's estate or the surviving spouse's estate, the Trust (which has received the insurance proceeds tax free) can lend cash to the particular estate to pay the tax. Crummey insurance Trusts are often used to own a "last-to-die" insurance policy, a relatively inexpensive type of life insurance which pays at the death of the surviving spouse to enable that spouse's estate to pay estate tax.

Charitable Gifts

If you are charitably inclined, there are many ways for you to make gifts to charity during your life and at death.

- **Outright Gifts**. Outright gifts, of course, are simple to make and can provide income tax benefits if made during life. More sophisticated techniques include making a gift to a private foundation you create during your lifetime. In addition to qualifying for an income tax deduction, a gift to a private foundation can be held by the foundation virtually free of tax until those in control of the foundation (which can include you as the founder) determine how to utilize the foundation's assets to make charitable gifts, subject to certain limitations.

- **"Split-Interest" Gifts**. A "split-interest" gift is a gift that results in you or some other individual owning an interest in property (usually in trust) while a charity owns an interest in the same property. If you structure the gift properly, you generally will receive a charitable income tax deduction for the portion of your gift equivalent to the value of the charity's interest in the gift. The value of the charity's interest is determined under actuarial tables published by the IRS. These tables take into account the noncharitable beneficiary's age (or the length of the term interest) and the interest rate at the time of the gift. Examples of split-interest gifts include:

  Gift of Remainder Interest in Personal Residence. You can receive a charitable income tax deduction by making a lifetime gift to charity of the right to receive your home following your death (a "remainder" interest), while you retain the right to live in the home during your lifetime. It is possible to compute the present value of the remainder interest by using IRS tables which take into account (i) your age and (ii) the Federal interest rate in effect when you make the gift.

  Charitable Remainder Trust. A charitable remainder trust ("CRT") is a Trust under which the Settlor or another individual has the right to receive an annual payment for a set number of years or for the Settlor's or individual beneficiary's lifetime. If the annual payment is a fixed amount, the CRT is called a charitable remainder annuity trust ("CRAT"); if the annual payment is a percentage of the value of the CRTs assets, determined annually, the CRT is a charitable remainder unitrust ("CRUT"). Upon the end of the trust term, the assets remaining in the trust are distributed to charitable organizations. As with the gift to charity of a remainder interest in a residence, it is possible to compute the present value of the annual payments during the term of a CRT by using IRS tables which take into account (i) the age of the noncharitable beneficiary or the number of years over which the noncharitable beneficiary will receive distributions from the trust, (ii) the amount of the annual payment to the noncharitable beneficiary, and (iii) the Federal interest rate on the date the CRT is created. Subtracting this present value from the total value of the property transferred to the CRT determines the amount of the Settlor's gift to charity, which can then be deducted on the Settlor's income tax return.

> **Example**. John and Jane, both age 76, contributed assets worth $1,000,000 to a CRAT on January 1, 2014, retaining the right to receive $50,000 per year for their joint lifetimes and for the lifetime of the survivor. When both spouses are deceased, the CRAT property will pass to ABC Charity. Under the IRS tables, the charitable remainder interest is worth $409,500 on January 1, 2014. Subject to the charitable income tax rules, John and Jane may claim a charitable income tax deduction of $409,500 in 2014.

If the Settlor is not the individual beneficiary of the CRT, the present value calculated as described above will be the amount of the Settlor's taxable gift. Note that a gift to a CRT can provide significant benefits to the contributor beyond the income tax Charitable Deduction. For example, if you own highly appreciated property that does not produce a satisfactory return, you could contribute the property to a CRT and receive the following benefits: an income tax deduction based on the appreciated value of the property; no capital gains tax when the Trust sells the property; and a fixed rate of return payable to you from the sales proceeds of the property.

Charitable Lead Trust. A charitable lead trust ("CLT") is the reverse of a CRT in that a charity (or charities) has the current right to receive distributions from the CLT, and one or more individual beneficiaries (such as children or grandchildren) (the "remainder beneficiaries") receive the assets remaining in the Trust upon the expiration of the charity's income interest. The lead interest of the charity is for a fixed period of time, such as 10 or 15 years, or for a term measured by the lifetime of a specified individual, and the trust instrument specifies how much the charity is to receive each year. If the charity receives a fixed payment, the CLT is a charitable lead annuity trust ("CLAT"); if the payment is a fixed percentage of the CLT's assets, valued annually, the CLT is a charitable lead unitrust ("CLUT"). Subtracting the present value of the charity's interest from the value of the property contributed to the CLT determines the taxable amount of the grantor's gift to the CLT.

> **Example**. Mary contributed assets worth $1,000,000 to a CLAT on January 1, 2014. The CLAT will pay $70,000 to ABC Charity for 15 years, at the end of which the CLAT property will be distributed to Mary's children. Mary made a 2014 gift to her children equal to $100,000. If the CLAT property appreciates (or earns) exactly 7% per year, Mary's children will receive $1,000,000 on January 1, 2029. And, if the CLAT assets appreciate (or earn) 10% per year, the children will receive $1,950,000 in 15 years, but Mary's gift reportable on a gift tax return will still be only $100,000.

As illustrated in the Example above, the CLT is a good technique when the asset transferred to the CLT is expected to perform better than the Federal interest rate used to determine the amount of the grantor's gift – the IRS tables will value the gift to the remainder beneficiaries less than what these beneficiaries will receive if the asset performs as projected. Unlike a gift to a CRT, which always offers the donor an opportunity to claim a charitable income tax deduction, a gift to a CLT does not necessarily result in an income tax deduction. If the donor wants to claim an income tax deduction in the year he or she creates the CLT, the transaction must be structured so that the donor is taxed on all of the Trust's income during the time the charity receives payments from the CLT.

Leveraging the Gift Tax Exemption

The amount of a gift for gift tax purposes is the property's value in the hands of the donee. The following transactions allow a donor to reduce the amount of his or her gift, for gift tax purposes, by retaining an interest in the transferred property.

- **Grantor Retained Annuity Trust**. A grantor retained annuity trust ("GRAT") involves a gift of property (usually assets believed to have the potential for substantial appreciation) to a Trust where the donor retains the right to receive an annual payment for a term of years, at the end of which the GRAT assets pass to the donor's children or other beneficiaries (the "remainder beneficiaries"). The donor to a GRAT makes a gift to the remainder beneficiaries on the date the GRAT is created; however, because the donor retains an annuity interest, the amount of the donor's gift to the remainder beneficiaries is determined by subtracting from the value of the property transferred to the GRAT the present value of the donor's interest (determined in the same manner as the donor's charitable deduction for a gift to a CRT (described above) is calculated). By manipulating the term of the GRAT and the amount of the retained annuity, a GRAT can be established where the actuarial value of the remainder interest (and therefore the amount of the donor's gift) is only a nominal amount. When the donor's retained term interest ends, the GRAT terminates and all assets are distributed either outright to, or in trust for, the remainder beneficiaries. If the GRAT assets have outperformed the interest rate set by the Treasury for the month the GRAT is created, the remainder beneficiaries will receive, tax free, property equal to the accumulated excess yield.

> **Example**. Tom, age 60, transferred assets worth $1,000,000 to a GRAT on January 1, 2014, retaining the right to receive $50,000 per year for five years. Tom made a gift of $766,000 to his children in 2014. If the GRAT instead paid Tom $100,000 per year for ten years, Tom's gift would be reduced to $111,000.

If the income generated by the assets held in the GRAT is insufficient to pay the donor's retained annuity, a portion of the GRAT's assets will be returned to the donor in satisfaction (or partial satisfaction) of the retained annuity interest. Also, if the donor does not outlive the retained annuity term, some or all of the GRAT assets will be included in the donor's gross estate. The result of either of these scenarios is that the donor may be in the same position economically and tax wise as if the GRAT had never been established.

- **Qualified Personal Residence Trust**. The qualified personal residence trust ("QPRT") is a Trust to which the Settlor transfers a residence while retaining the right to use the property for a fixed period of time. Upon the termination of the fixed term, the QPRT generally provides that the property passes to the Settlor's children. If desired, the Settlor could then lease the property from the beneficiaries, passing additional assets to them without gift tax consequences. The amount of the Settlor's gift for tax purposes is the value of the residence when it is transferred to the QPRT minus the actuarial value of the Settlor's right to use the residence for the specified term. The effect is that the residence passes to the remainder beneficiaries at the end of the fixed term at a fraction of its actual value for gift tax purposes.

> **Example**. Tina, age 63, transferred her residence worth $1,000,000 to a QPRT on January 1, 2014, retaining the right to live in the residence for ten years. Tina made a gift of $656,000 to her children in 2014. If Tina instead retained the right to live in the home for 15 years, her gift to her children would be reduced to $483,000.

The planning technique works particularly well with vacation property so that the grantor does not have to transfer his or her primary residence. As with a gift to a GRAT, the death of the grantor prior to the end of the fixed term will undo the tax benefits of the QPRT.

Installment Sale to Grantor Trust

Another sophisticated estate planning technique involves the sale of assets to a Trust in exchange for an installment note. First, an irrevocable Trust is created containing provisions giving the Settlor certain powers that cause all of the assets of the Trust to be treated as if personally owned by the Settlor for income tax purposes. A Trust of this kind is known as a "grantor trust." Often, the Trust will be drafted so that the "grantor trust" powers can be rescinded in the future, resulting in the Trust thereafter being treated as a separate taxpayer and liable for its own taxes. While the grantor trust should be ignored for income tax purposes, it is structured so that the Settlor does not own the trust assets for gift and estate tax purposes. Accordingly, property held in the grantor trust at the Settlor's death should not be included in the Settlor's taxable estate.

After the grantor trust is created, the Settlor (i) makes a gift to the Trust (generally equal to between 10% and 20% of the value of the assets which the Settlor plans to sell to the Trust) and (ii) sells assets to the Trust in exchange for an installment note equal to the fair market value of the transferred assets and bearing a rate of interest approved by the IRS. If this transaction is properly structured, the value of the note (if not previously repaid by the Trust) and the note payments which the Settlor did not spend during his or her lifetime are included in the Settlor's estate at the Settlor's death, but the property held in the trust should not be included in the Settlor's estate. This technique essentially "freezes" the value of the assets sold to the Trust at their value on the date of sale. Any future appreciation of the transferred assets should occur outside the Settlor's estate and escape transfer taxes.

While a transfer to a GRAT (described above) is considered to be relatively safe planning from an audit standpoint because the structure of the GRAT is governed by statute, an installment sale to a grantor trust is generally considered to be a more aggressive form of tax planning. Steps can be taken to minimize the risks of an audit or an adjustment upon audit, but clients should be aware that this technique is somewhat riskier than other types of planning. That said, the benefits from this transaction can be quite substantial if the transaction is structured properly.

Family Limited Partnership

A family limited partnership is an estate planning vehicle that enables individuals under appropriate circumstances to transfer assets out of their estates to their descendants during their lifetime while (i) maintaining a level of control over the partnership assets, (ii) providing significant protection of family assets from the claims of creditors of family members, and (iii) possibly obtaining discounts from the fair market value of the transferred assets for federal transfer tax purposes.

Because the family limited partnership often has centralized management through a corporate general partner or limited liability company, and because the partnership will often have restrictions on the transfer of partnership interests, the donor who transfers assets to the family limited partnership may help ensure that the underlying partnership assets will continue to be properly managed for the benefit of the donor's family after the donor has relinquished economic ownership.

During the donor's lifetime, the donor can make gifts of limited partnership interests to the donor's descendants. Because a limited partner's rights in the family limited partnership will be severely limited or nonexistent with respect to distributions from the partnership, management of the business, and liquidation, it is believed that the value of the limited partnership interest for gift tax purposes can be discounted (perhaps substantially) from its pro rata share of the liquidation value of the partnership.

Upon the donor's death, all of the partnership interests that the donor has retained will be included in the donor's estate for estate tax purposes. Often, because of the structure of the partnership, the donor's estate will be able to make a strong argument for a discount in the valuation of the partnership interests owned by the donor, providing substantial estate tax savings.

Retirement Planning

If you name your spouse as beneficiary of qualified retirement benefits or an IRA, your spouse may roll a lump sum distribution from the plan or account into her or his own IRA and continue the income tax deferral you enjoyed. In some cases, this may not be the best plan. An IRA is the primary asset of many clients. If such a client names his or her spouse as beneficiary, the client may fail to take full advantage of the Estate Tax Exemption, thereby causing more property to be subject to estate tax when the surviving spouse dies. Alternatively, a client may want his or her spouse to receive the retirement assets during life but not to have the power to designate a beneficiary of the remaining account balance at the spouse's death. Thus, it may be appropriate to designate a Bypass Trust as beneficiary instead of your spouse, despite the fact that designating the Bypass Trust may accelerate the income tax payable on the retirement assets.

Asset Conservation

The term "estate planning" encompasses not only planning to save tax but planning to protect assets from an individual's potential creditors with the goal of maximizing the amount of property available to the individual's family. Planning for asset conservation does not take place in a vacuum: it necessarily involves traditional estate planning, such as utilizing Trusts to make gifts to children. Other techniques may be available, depending on the situation. Even though you may not believe your assets are at risk from a creditor, it may be that your children's assets are at risk. For example, is one of your children a physician in a high-risk practice? If so, you may want to consider putting that child's inheritance in a spendthrift Trust as opposed to leaving property outright to the child. Family limited partnerships are often integrated into estate plans when asset conservation is a consideration.

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