

A Guide to  
**Basic Estate Planning**

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# A Guide to Basic Estate Planning

By Glenn M. Karisch

## I. Introduction

Wills, trusts, living trusts, living wills -- estate planning has a language all its own. All too often this language can be confusing. This confusion makes it easy to postpone thinking about something that's already not much fun to think about. Many people don't think about these things until a loved one dies or becomes disabled. By then, it is too late to plan, and the family must endure difficulties and additional expense.

Estate planning is planning your affairs so that you and the people you care about are better able to deal with the problems caused by your disability or death. The techniques used to plan your estate can vary from simple, do-it-yourself steps to complex, expensive plans. Even people with little property can benefit from estate planning. It is a mistake to think that planning is only for the wealthy.

The purpose of this paper is to briefly discuss some of the basic aspects of estate planning so that you can better determine for yourself what steps you should take (if any) to plan for your disability or death. It focuses on the practical advantages and disadvantages of various estate planning tools and techniques.

This paper discusses the laws affecting Texas residents. Each state's laws regarding these matters are different. Therefore, different considerations may apply to residents of other states.

Estate planning is a complex subject, and I do not attempt in this paper to cover every legal detail and nuance. Therefore, you should consult with an estate planning professional before implementing any of these ideas.

In finding estate planning professionals to help you with your plan, remember two things. First, rarely can one person provide you with all the information, products and services you need. A good estate planning lawyer can draft your will, trust, and other documents, but he or she may not know about the latest annuity product to fit your needs. Similarly, an insurance professional specializing in estate planning may be able to recommend strategies and provide products as part of your plan, but he or she won't be able to draft your will and other documents. Estate planning often is a team effort -- lawyers, accountants, trust officers, financial planners, investment advisors, and insurance professionals may all play a role. My

focus will be on the legal aspects of estate planning, since that is the basis of my experience.

Second, there are a lot of competent lawyers, accountants, financial planners, investment advisors and insurance professionals who don't know the first thing about estate planning. Estate planning is a fairly narrow specialty. Be sure that the person you choose has sufficient experience with the subject to provide you with the right service or product. One way to help assure that the attorney you choose knows what he or she is talking about is to ask if he or she has been certified as a specialist in estate planning and probate law by the Texas Board of Legal Specialization. This certification requires experience, recommendations and passage of an exam.

## II. The probate system

To understand the pros and cons of the various estate planning techniques discussed in this paper, you need a basic understanding of how the probate court system works.

**A. The probate court.** When someone dies or becomes too ill to manage his or her own affairs, a procedure is needed for handling that person's property and for making the decisions which need to be made. For instance, a person with Alzheimer's Disease may lose the ability to take care of themselves. Who will decide where he or she will live? Who will cash their checks, pay their bills, decide on medical treatment, etc.?

Under our legal system (which evolved from the old English legal system), particular courts are given responsibility for handling problems involving death or incapacity. This responsibility is called "probate jurisdiction." Larger counties in Texas have one or more special courts that handle nothing but probate jurisdiction. These courts are called "probate courts." In smaller counties (where there is not enough business to keep a court busy full-time with probate matters), probate jurisdiction is vested in one or more of the county courts. For simplicity's sake in this paper I refer to the court having probate jurisdiction as the "probate court." Each probate court has a judge, referred to as the "probate judge."

If someone dies or becomes disabled without leaving *legally acceptable* instructions about how things should be handled, state laws apply to provide the answers. As a general rule, someone (usually a family member) is appointed by the probate judge to

handle things, and the appointed person must file periodic reports with the probate court and get the probate judge's approval before acting. This type of administration (called "dependent administration" because it is dependent on the judge's review and approval) is intended to protect the people who have an interest in the matter from fraud, incompetence and waste. By having the judge supervise the actions of the administrator, the chances of mistakes or fraud are decreased. The price one pays for this protection is, generally, a much higher cost of administration and a loss of freedom and flexibility.

**B. Guardianships.** Guardianships are created to care for the person (in other words, the physical person) and the estate (in other words, the property) of someone suffering a legal disability. The legal disability may be due to age (persons under age 18 are minors and legally cannot manage their own affairs), injury or infirmity. The person being cared for is called the "ward," and the person or persons appointed by the court to care for the ward are called "guardians." A ward may have a separate guardian of the person and guardian of the estate, but usually the court appoints one person to be guardian of both the person and estate.

All guardianships are dependent (court-supervised) administrations. Guardians are required to make periodic reports to the court and to seek court approval for many decisions. For instance, to sell property of the ward, the guardian must get the probate judge's approval.

Many aspects of guardianships are public. For instance, in the case of a mentally ill adult, a hearing is held to determine if that person is incapacitated to handle his or her affairs and to determine which person should be appointed guardian. Filings of the guardian regarding the ward's property generally are public records.

One common goal of estate planning is to avoid the need for a guardianship. Most people wish to avoid a guardianship for some or all of the following reasons: (1) expense (principally attorney's fees), (2) lack of privacy and (3) lack of freedom and flexibility.

**C. Administration of decedent's estates.** When someone dies, the property he or she owns passes to other persons or institutions in one of two ways: (1) by contract or operation of law (the "nonprobate estate"), or (2) by the probate system (the "probate estate").

**1. The nonprobate estate.** Some types of property pass by contract or operation of law. These assets are unaffected by one's will and pass to the beneficiary free of the probate system. Some of the common types of nonprobate assets are:

**a. Insurance.** Most life insurance contracts provide for payment to go directly to the beneficiary named in the policy. Unless the decedent's estate is named as beneficiary, life insurance proceeds generally are a nonprobate asset.

**b. Retirement plans.** Most individual retirement accounts (IRAs), KEOGHs and qualified retirement plans (pension plans, profit-sharing plans, 401(k) plans, etc.) which have value after the decedent's death go directly to the beneficiary named by the owner of the plan, making these plans nonprobate assets.

**c. Survivorship property.** Property held jointly with another person "with right of survivorship" passes directly to the joint owner upon the decedent's death. Common types of survivorship property include bank accounts, brokerage accounts and real estate held by spouses in other states.

**d. Trust property.** Most property held in trust passes according to the terms of the trust and not according to a person's will. Thus, trust property usually is a nonprobate asset.

**2. Probate estate.** One's probate estate is all property owned by the decedent other than nonprobate assets -- in other words, everything else. The probate estate passes according to the terms of the decedent's will or, if the decedent left no will, according to the state laws regarding intestacy. The probate estate generally falls within the jurisdiction of the probate court and is involved in a process generally known as "probate."

Often an estate planner seeks to change an asset from a probate asset to a nonprobate asset, or vice versa. For instance, a planner may suggest placing property in a trust so that it will not be subject to the probate process. While the most common goal is to eliminate assets from the probate estate (to save administrative costs), occasionally the goal is the reverse -- to make sure sufficient assets are in the probate estate to fully effectuate the plan.

**3. Intestacy.** When someone dies without a will, he or she is considered to have died "intestate." The property an intestate person owns at the time of his or her death passes according to the provisions of a state statute. In drafting this statute, the Legislature did the best job it could in trying to protect the rights and interests of the various parties involved. For instance, both a decedent's children and spouse have rights to part of the intestate person's estate, and their rights are affected by whether or not the property is separate or community property or real or personal property. While the rights of various parties may be protected, the intestacy statute rarely reflects what the intestate person would have intended if the person had expressed his or her wishes in a will.

#### **4. Dependent administration.** A

"dependent administration" is one in which the probate court supervises the actions of the administrator. Most intestate administrations (administrations of the estates of persons who die without a will) are dependent administrations. Most testate administrations (administrations of the estates of persons who left a will) are "independent administrations" (described below). A dependent administration usually results in higher administration costs because of the need for court review and approval.

**5. Independent administration.** Texas law permits persons to provide in their wills for their estates to be administered free of court supervision. If your will contains the provision required by law to qualify for "independent administration" (contained in Section 145 of the Texas Probate Code), your family may save hundreds or thousands of dollars of administrative costs and be free from interference from the probate judge. In most cases where the will specifies independent administration, only one court appearance is required. The only other involvement your loved ones will have with the probate court is the filing of an inventory of your probate estate and a list of persons who owe your estate money and the amount that they owe.

Texas law on independent administration makes probate in Texas much less expensive and much less painful than probate in many other states. Therefore, the motivation that residents of other states have to "avoid probate" is not as great for Texas residents. While some Texas residents derive real benefit from avoiding probate, for most Texans, the trouble and expense of avoiding probate is not worth it -- the cure is worse than the illness.

**6. Alternatives to administration.** By careful planning, it often is possible to avoid the need for administration. These planning techniques are described below. It also may be possible to avoid administration without planning. Texas law provides a variety of means which may be available to avoid a full-blown administration -- special rules for small estates, ways to determine heirship without a full administration, ways to have a person's will recognized as a document passing title to the beneficiaries without opening an administration, etc. These techniques may save the decedent's survivors hundreds of dollars -- if they are available. Your estate may not meet the requirements. Planning your estate is the safest way to assure that your family can settle your affairs as simply and inexpensively as possible.

### **III. Planning for death**

**A. Planning goals.** What are the goals for planning your affairs for your eventual death? Identifying these goals makes it much easier to

evaluate various options.

Some goals are obvious. (1) We want our loved ones to be taken care of. (2) We want our property to go to the persons or institutions we choose, not to those designated by state law. (3) We want our loved ones to be able to settle our affairs simply and quickly without undue expense. (4) We want our loved ones to avoid paying unnecessarily high estate taxes when we die.

Other goals depend on our particular circumstances. For instance, if you have a family member with a condition which affects his or her ability to care for himself or herself (such as a husband with Alzheimer's Disease or an autistic child), special attention needs to be given to his or her care and support. If you own a small business, your plan may need to include provisions for taking care of loyal employees, keeping the business in the family, selling the business, etc.

By articulating your particular goals, it is easier to evaluate estate planning options. For most people, relatively inexpensive "cookie-cutter" plans may work; for others, you may be doing a great disservice to those people counting on you if you fail to adopt an appropriate plan.

**B. Wills.** Wills remain the basic tool when planning for death. Most people are familiar with wills. The most familiar feature of wills is that they say who gets what when someone dies. Saying who gets what is the most basic thing a will does, but a well-drafted will can do much more than that. It lets you designate who is responsible for handling your affairs. It lets you provide for independent administration (free from excess court supervision). It lets you set up trusts for minors and other vulnerable beneficiaries so that court-monitored guardianships can be avoided. It lets you designate the guardians for your minor children upon your death. It allows you to leave part or all of your property to a church or charity. It permits you to plan your estate to save your family taxes.

For the vast majority of adults, wills are the most appropriate death-planning tool. A basic will (one that does not involve complex tax planning) is within the budget of most families and can be made flexible enough to avoid constant, costly updating.

Wills must be prepared and signed in a way that meets specific legal requirements. There are no standard will forms contained in the Texas statutes. There are a number of do-it-yourself will kits available. While it is possible to have a valid do-it-yourself will, do-it-yourselfers run several risks. First, the will may not be valid. Second, it may not be "self-proving" (adding expense to the administration process). Third, it may not take advantage of

particular provisions of Texas law (such as independent administration), resulting in greater administrative expense. Fourth, it may not adequately deal with the interests of minors. Fifth, it may fail to deal with a unique circumstance in your life that an experienced estate planner would identify and address in a professionally prepared will. Finally, you don't get a second chance with a will -- if your self-done will misses the boat on a key point or two, you can't go back and do it again.

Wills have several disadvantages. First, while they may make probate less expensive by providing for independent administration, they do not avoid probate entirely. Second, while the up-front cost of a will generally is less than that of other options (notably a living trust), it still may be more than you care to pay. Finally, wills offer no help in the event you become disabled before your death -- wills only become effective on your death.

**C. Living trusts.** Living trusts, also known as revocable inter vivos trusts, have become quite popular in the past ten years. To understand living trusts, you need to know what a trust is. A trust is created when a person (called a "Trustor," "Settlor" or "Grantor") gives property to someone (called a "Trustee") with instructions to manage the property for the benefit of one or more persons or institutions (called "Beneficiaries"). Trusts may be revocable (meaning that the Trustor can cancel the trust and get the property back) or irrevocable (meaning that the Trustor loses control of the property once it is given to the Trustee). Except in rare cases, trusts operate free of court supervision and control. Trusts often are the source of fear and confusion to people who are unfamiliar with them, but they are a basic estate planning tool with many potential benefits.

A living trust is a trust created by someone when they are living and, generally, for estate planning purposes. In the classic case, the Trustor creates a revocable trust by giving part or all of his property to the Trustee with instructions to take care of the Trustor and his spouse until they die and then to give the property to the Trustor's children. The Trustor usually is the initial Trustee of the trust, with others named to take over as Trustee if the Trustor dies or becomes disabled. Living trusts are very flexible, and there are infinite variations on this pattern, but this classic case is useful in illustrating the pros and cons of a living trust.

The first thing to realize is that creation of a living trust usually has little effect on the day-to-day lives of the Trustor and his or her spouse. This is because the creator of the trust (the Trustor) also is the Trustee and the primary beneficiary of the trust. Typically there are no income tax consequences to creation of a living trust. Thus, while certain legal technicalities must be followed, life for the Trustor goes on pretty much as

before creating the trust. The benefits of the living trust come into play when the Trustor becomes disabled or dies.

If the Trustor becomes unable to handle his own affairs, he is replaced as Trustee by the person the Trustor has chosen -- usually his wife, child or other loved one. The new Trustee then manages the trust property to care for the disabled Trustor. The new Trustee is aided in this task by the trust itself, which makes it more convenient to deal with third parties on the Trustor's behalf and contains provisions regarding how the Trustor is to be cared for. In most cases the need for a court-supervised guardianship is avoided.

When the Trustor dies, he is replaced by the backup Trustee he has chosen, and the new Trustee administers the trust property in accordance with the trust document. In the simplest case, this involves terminating the trust and splitting up the trust property among the rightful recipients. In many cases, the trust continues to take care of a surviving spouse, young children or grandchildren, etc.

The advantages of living trusts include: (1) excellent disability planning; (2) increased privacy; and (3) reduced risk of a court battle over your property and affairs.

Living trusts offer the same estate-tax planning opportunities as wills -- no more and no less. Therefore, while estate tax planning is possible in a living trust, it offers no advantages in this regard over wills.

Unfortunately, living trusts also have drawbacks. The principal disadvantage is the high up-front cost. Living trusts cost more to draft. Also, to be fully effective, it is necessary to transfer your property into the trust. This usually means legal fees to prepare deeds to your house and other property and lots of legwork to transfer brokerage and bank accounts, cars, etc. into the trust. These up-front costs can be reduced if you delay putting all of your property into the trust. However, failing to have all of the property in the trust before your death or disability reduces the benefits of the trust.

Some assets cannot be transferred to the trust without adverse consequences. For instance, many investment partnerships prohibit transfers to trusts without permission of the other partners. Also, transferring real property into the trust may reduce your title insurance policy coverage. Finally, use of a living trust may reduce the exemptions available to you and your family in the event of bankruptcy.

Living trusts usually must be backed up by a will and a property power of attorney to cover property which you may own which is not placed into the trust prior to your death or disability. This will and power

of attorney can be simple "pour-over" documents (they pour your assets over into your trust) which are relatively easy and inexpensive to prepare.

Living trusts avoid probate only to the extent that they are fully funded with all of the Trustor's property. If the Trustor fails to (or chooses not to) transfer property to the trust before his or her death, probating the back-up "pour-over" will may be necessary to get the missing property into the trust. Still, this simple probate of a minor part of the Trustor's estate is likely to be less expensive than the probate of the Trustor's entire estate. Even if the trust is fully funded and probate is completely avoided, a number of steps will still be necessary after the Trustor's death. For instance, a federal estate tax return must be prepared and filed (unless the Trustor's estate is small enough to be exempt from the filing requirement). Thus, as a practical matter, the savings in post-death administrative costs rarely justifies the increased up-front cost of the living trust. Unfortunately, many non-lawyers (and some lawyers) promote living trusts as a money-saving device (you've got to avoid probate, right?) when there is little or no savings in legal expenses and administrative costs in most cases.

The popularity of living trusts arose in states other than Texas that have substantially higher probate costs. For years, most Texas lawyers told their clients that they didn't need living wills because of inexpensive Texas probate. As a result, many Texas lawyers have developed a prejudice against living trusts which is only partially justified. It is true that living trusts are appropriate in fewer situations in Texas than in other states, but there are cases in Texas where the living trust may be the best planning tool.

Living trusts may be particularly attractive for the following:

1. Persons worried about their own incapacity or the incapacity of a spouse or loved one. Living trusts are the best incapacity planning device. Generally speaking, the risk of incapacity increases with age. Therefore, older persons are more likely to benefit from a living trust than younger persons.

2. Persons who own real property in more than one state. If a Texan also owns real estate in another state (such as a vacation home in Colorado), a will-based plan may mean that two probate proceedings are necessary -- one in Texas to handle most things, and another in the state where the real property is located to pass title to that asset. Placing the out-of-state real estate in a living trust can avoid the need for the probate proceeding in the other state.

3. Persons concerned with privacy. If a person puts all of his or her property into the trust prior to death or disability, public disclosure of that person's property is more easily avoided. Generally, no

inventory of trust assets must be filed in court as a public record.

4. Persons whose financial affairs are stable. After retirement, a living will might be an excellent estate planning choice, since there are likely to be fewer assets acquired and disposed of. On the other hand, persons in their 30s, 40s and 50s are likely to be acquiring and disposing of many assets prior to death; trying to assure that all these assets are bought and sold by the trust is likely to be a huge headache.

5. Persons concerned about a court fight over their property. In some cases, it is harder to challenge a living trust than to challenge a will. Persons who believe a court fight over their property is likely should consult with an attorney and consider a living trust.

There is no statutory form for a living trust. While there are several books about living trusts, most suggest that you get an attorney to draft the trust. This is good advice, since living trusts are complex.

**D. Survivorship property.** Property owned jointly "with right of survivorship" passes directly to the joint owner upon death and is not affected by the decedent's will. This offers both an estate planning opportunity and a trap. The opportunity is for avoiding probate. The trap is that survivorship rights may keep the property from going where it needs to go for the estate plan to work.

In small estates, the need for an administration may be avoided if care is taken with certain assets. For instance, a husband who wishes to leave all of his property to his wife may avoid the need for probate if assets like his bank accounts and automobiles are held jointly with his wife "with right of survivorship."

Until recently it was difficult for spouses to own community property jointly with right of survivorship in Texas. However, an amendment to the Texas Constitution makes it clear that survivorship rights can be created between spouses, if the legal formalities are met. The requirements for survivorship agreements between spouses are found in Section 452 of the Texas Probate Code. Generally speaking, the legal formalities are met if there is a written agreement signed by both spouses specifying which property is covered. Most banks offer account holders survivorship options. A law passed by the Texas Legislature in 1993 encourages banks and savings and loan associations to use a standardized form for account designations, and this may make it easier to select a survivorship designation for bank accounts. A state statute permits automobiles to be registered with right of survivorship.

Survivorship property is not favored in Texas. Thus, the courts are likely to throw out a survivorship

arrangement that does not meet the letter of the law. A large percentage of survivorship accounts at financial institutions are subject to attack because the forms either do not contain the proper language to create a survivorship arrangement or are not filled out correctly.

A change to the Texas Probate Code in 1997 makes it clear that stocks, bonds and other securities may be held in survivorship form.

It is dangerous to rely on survivorship arrangements to solve estate planning problems without expert help. For example, many widows and widowers use joint bank accounts with an adult child "with right of survivorship" as an inexpensive way to plan their estate. This arrangement may have adverse tax consequences. Also, when the widow or widower dies, the child named in the account legally owns all of the money on deposit, to the exclusion of his brothers and sisters. This often creates tremendous hard feelings. Even if the child named in the account shares the wealth, hard feelings may continue, and there may be gift tax consequences to the child sharing the wealth. Survivorship agreements also may cause problems in larger estates where the property subject to the survivorship agreement is needed to fund a trust or other gift -- if it goes outright to a spouse or other person, it is not available to fund a trust, which could have a terrible effect on a carefully planned estate.

**E. Life insurance and retirement plans.** Life insurance and retirement plans generally are nonprobate assets -- the proceeds pass to the beneficiary named in the contract and not according to the decedent's will. This is great, so long as these proceeds are coordinated with the overall plan.

A standard planning technique for parents with minor children is to prepare a will which leaves everything to the surviving spouse and then into a trust for the kids if both parents are dead. This trust is used to prevent the need for a court-supervised guardianship for the minor children. If the husband names his wife as the primary beneficiary in a life insurance policy, this plan is not disturbed -- his wife gets the insurance money directly and quickly, and she gets everything else under the will. However, if he names his children as secondary beneficiaries on the policy, the carefully-drawn trust in the will fails to work properly -- his minor children get the insurance money outright, necessitating an expensive, court-supervised guardianship. To properly coordinate life insurance proceeds with the estate plan in this example, the secondary beneficiary should be the husband's estate or the trustee of the children's trust.

#### **IV. Planning for disability**

**A. Planning goals.** The possibility of becoming mentally unable to manage one's affairs often is more

frightening to people than the certainty of death. Americans are living longer, and the chance of becoming incapacitated prior to death is growing. For years, many lawyers faithfully prepared wills for their clients but did nothing to prepare for their possible incapacity. This has changed markedly in recent years, and most estate planning lawyers also offer disability planning tools as a part of the basic estate plan.

Some of the goals of disability planning are: (1) inexpensive, simple management; (2) care for the disabled person; (3) privacy and dignity; (4) making known wishes which cannot be expressed after incapacity.

**B. Living trusts.** Living trusts, described above, are the best disability planning devices. They offer the most efficient management, the most privacy, the most certainty of success, and the greatest opportunity to express wishes. The drawbacks of a living trust in this regard are the trouble and expense of setting it up. This increased trouble and expense means that living trusts are more desirable for persons whose disability is more likely (due to age, infirmity, etc.) and less desirable for persons whose disability is less likely.

**C. Powers of attorney.** If a living trust is not used, a good alternative is the use of powers of attorney. Powers of attorney are documents in which the person signing (called the "Principal") gives someone else (called the "Attorney" or "Agent") the authority to act for the Principal. Even though the person named is often called an "Attorney" or "Attorney-in-Fact," he or she does not have to be a lawyer; usually the Agent is the spouse or other loved one.

In most cases, proper use of powers of attorney can avoid the need for a guardianship. Living trusts are more effective in avoiding guardianships because it is easier to get third parties to deal with the trustee of a trust than with the Agent under a power of attorney. If the power of attorney doesn't cover a decision which needs to be made, or if a third party won't accept the power of attorney, a guardianship may be necessary.

Powers of attorney are like blank checks. They give the Agents tremendous authority, but typically they give little guidance on how the authority is to be used. Living trusts give authority and guidance; powers of attorney just give authority. Therefore, the Principal places a great deal of trust in the hands of the Agent.

Powers of attorney must meet specific legal requirements. There are different requirements for powers of attorney authorizing the Agent to deal with property and powers of attorney authorizing the Agent to make health care decisions. These two types of powers are discussed below.

Powers of attorney are fairly standardized and, therefore, relatively inexpensive. Many attorneys will prepare powers of attorney at the time they prepare wills for little or no extra cost.

**1. Durable powers of attorney for property.** Property powers of attorney give the Agent the authority to deal with the Principal's property. Typically, the Agent is given the authority to buy and sell property, pay bills, invest property, cash in investments, etc.

In 1993 the Texas Legislature adopted a standard form for property powers of attorney. The form, called a "Statutory Durable Power of Attorney," permits the Principal to give the Agent authority to act in a wide range of transactions. The statutory form permits the Principal to choose whether or not the Agent has the authority to act immediately or only if and when the Principal becomes disabled.

The statutory form was amended in 1997 to make it easier to use. The new form became available September 1, 1997.

Keep the following in mind regarding durable powers of attorney for property:

- Powers of attorney signed before September 1, 1993, which meet the requirements of Texas law when they were signed continue to be effective. However, Agents may find it easier to get banks and other third parties to accept the new statutory durable power of attorney forms.
- Banks and other third parties are entitled to rely on sworn statements made by the Agent that the power of attorney has not been revoked and, in cases where the power of attorney becomes effective only upon the disability or incapacity of the Principal, on sworn statements made by the Agent that the Principal is in fact disabled or incapacitated. Thus, the Principal must trust the Agent, since a dishonest Agent may be able to move assets to institutions where the Principal cannot find them.

The requirements for durable powers of attorney for property are found in Sections 481-506 of the Texas Probate Code.

**2. Medical powers of attorney.** Medical powers of attorney permit the Agent to make health care decisions for the Principal, but only during times when the Principal is unable to make the decisions.

The statutory form and requirements for a medical power of attorney are found in Chapter 166 of the Texas Health and Safety Code.

**D. Living wills.** A living will (also called

"Directive to Physicians and Family or Surrogates" and not to be confused with a living trust) is a document in which the signer indicates his or her wishes about dying a natural death. In a living will, you may declare that life-sustaining treatments be withheld if you have a terminal condition or an irreversible condition. You also may designate someone to make treatment decisions for you if the need arises.

Living wills are not as broad as medical powers of attorney. Persons designated in a living will can only make life-or-death type decisions (decisions to withhold treatment, etc.). Agents acting under medical powers can make life-or-death decisions and most other health-related decisions. Thus, in some ways the living will is superfluous. However, a written declaration of your intention for withholding life-sustaining treatment may give the person you designate greater peace of mind in deciding to withhold treatment.

The statutory form and requirements for living wills are found in Chapter 166 of the Texas Health and Safety Code.

**E. Declarations of guardian.** Hopefully, through the use of a living trust and/or powers of attorney, a court-supervised guardianship can be avoided. However, if a guardianship ever is needed, you have the right to designate the person(s) who you want to serve as your guardian(s). While the probate court is not required to appoint the person you designate, it is likely to do so. Also, if there is someone who you absolutely do not want to be your guardian, you are permitted to disqualify that person, making him or her ineligible to be your guardian.

The form approved by the Texas Legislature for the declaration of guardian can be found in Section 679 of the Texas Probate Code.

**F. Joint accounts.** Often joint accounts are used as a way to manage an incapacitated person's money. Powers of attorney are preferable to joint accounts because they offer much greater flexibility. However, joint accounts may present a practical solution to some problems. Care should be taken that the joint accounts don't cause more problems than they solve. In most cases, if a joint account is used for disability planning purposes, it should *not* be a survivorship account. A "convenience account" generally is best. (See the discussion of survivorship property above.)

**G. Nursing home planning.** By some accounts, more than 40% of 65-year-old Americans eventually will enter a nursing home. The high cost of nursing home care wipes out the estates of many lower and middle class Americans. Long term care insurance is growing in popularity, but the policies available today are not standardized and are confusing to the consumer

and the insurance agent alike. Consumer groups urge you to use extreme caution in buying long term care coverage.

Medicaid is available to pay for nursing home care for persons meeting government poverty limits. If no planning steps are taken, the property of the person confined to a nursing home must be "spent down" until he or she qualifies for Medicaid.

Some families seek to protect part of the family's wealth from the cost of nursing home care. This effort usually involves taking steps to retain certain assets within the family's ownership and control while qualifying the infirm person for Medicaid.

Medicaid planning is controversial. Many feel that it is inappropriate for families to take advantage of a government program for the poor while preserving assets which could be used to pay nursing home costs.

Medicaid planning also is complex. Government regulations on qualifying for Medicaid are complex and change frequently. Planning usually involves working with an attorney or other person who is familiar with Medicaid issues.

If you want to consider Medicaid planning, consult with someone experienced in the area. An important thing to remember is that it is best to act well in advance of entry into a nursing home. Under current regulations, transfers of property may disqualify the applicant from Medicaid coverage. In addition, there are criminal penalties in some cases.

#### **V. Planning for people who are single or who have children from a prior marriage**

Single people and people who have remarried but have children from a prior marriage face different planning issues. Single people without children often think that their planning situation is simpler than that facing a married couple. Actually, planning for a single person usually is more complex (and expensive) because there is no "standard" plan. Most married couples with children have the same planning goal -- leave everything to the surviving spouse and then to the kids. This means that a planner can develop a standardized approach and only make slight variations to this basic theme. There is no standard plan for single people. Singles may want to leave their property to their parents, to siblings, to nieces and nephews, to friends, to charity, or to some combination of these. The lack of a standard plan means more attorney time in meeting with the client and in drafting the customized plan. It also means that addressing the needs of single people in a paper of this type is difficult.

The lack of a standard plan does not mean that singles should avoid planning. In many ways,

planning is more important for singles -- especially disability planning. Because of the community property system in Texas, and because of society's acceptance of marriage, a disabled married person with an unplanned estate is more likely to avoid the trouble and expense of a guardianship than a disabled single person. Picking the people who will take care of you and giving them the right tools is extremely important for single people. Also, there are a number of exciting planning opportunities for singles, especially in the charitable area, since singles usually do not have the same familial commitments as married people with children.

The problems of having no standard plan apply with even greater force in the case of persons who have remarried but who have children from a prior marriage. Balancing the interests of the new spouse with the interests of the children is difficult. Since second marriages are so common, planners have developed a number of ways to address the problem. Some common ways are prenuptial agreements, placing specific assets (often life insurance) in trust for the children and careful monitoring of separate and community property (with separate property going to the children and community property going to the new spouse). Unfortunately, there is no clearly fair solution. It is important to come up with a plan, because to do nothing virtually guarantees not only additional trouble and expense, but also hard feelings.

#### **VI. Picking people to represent you**

Often the hardest part of the estate planning process is picking the people who will act for you if you become disabled or die. Many of my clients put off finalizing their plans because they cannot decide who should take care of their minor children if they die before their kids grow up. It is crucial not to put off the whole process while trying to come up with the perfect choice. The perfect choice rarely exists. Having an adequate choice in a completed plan is better than having no plan at all.

Picking your representatives is a very personal task, but there are general guidelines. The representatives you pick either must be adults, properly chartered trust companies or banks with trust powers. Your estate planning professional should be able to recommend a bank or trust company if you want an institutional trustee or executor. Many people pick family members or friends as representatives, especially in smaller estates. In larger estates, in complex estates and in estates involving possible disputes among beneficiaries, a trust company or bank with trust powers can be an invaluable choice.

As a general rule, adults from any state may serve -- representatives need not be Texas residents. Nevertheless, if you have a will, choosing a local person to be executor (administrator) of your will is

likely to work smoother and save administrative costs.

The people you choose should be young and healthy enough to fulfill their duties. If you have young children, the person you choose as trustee of their property and guardian of their persons may have to serve for several years. Always name one or two alternates to serve in case the person you name dies, becomes ill or otherwise fails to serve.

You are not required to ask the people you choose in advance if they are willing to serve, but it is a good idea to do so. Your representatives do not have to be given a copy of your planning documents, but they should know where to find the documents should the need arise.

It is not unusual to have seven or eight different tasks for which you need representatives. For instance, you may need an executor for your will, a guardian for your minor children, a trustee to care for your minor children's property, a trustee of a tax bypass trust, an agent for your property power of attorney, an agent for your health care power of attorney, a guardian for your declaration of guardian, and a person to make life-or-death decisions for you in your living will. You can choose different people for each position, but most people pick the same persons to serve each capacity.

Estate planning documents tend to be cold and impersonal. There are several reasons for this (greater flexibility, documents need to be changed less frequently, greater customization results in greater cost, etc.). If you want to give your representatives more personal advice and instruction than your estate planning documents permit, you can write a letter or memo to your representatives and leave it with your estate planning documents. This method works great, so long as you make it clear in the letter or memo that it contains advisory instructions only and does not change the will or other official document. You must be careful not to accidentally revoke your estate planning document by giving conflicting instructions to your representatives. Ask your estate planning professional about using a letter or memo to personalize your plan.

## **VII. Charitable giving**

Charitable giving is an important part of estate planning. Many people wish to make a gift to their church or to another charity when they die, but unless they make a provision for the gift in their will or living trust, the gift will not be made. If you wish to make a gift to your church or favorite charity in your will or living trust, be sure to mention it to the attorney helping plan your estate so that a proper provision may be included.

If you are considering making a gift to a church or

charity at your death, you may wish to consider the benefits of making a split-interest charitable gift during your life. A variety of techniques with uninviting, legalistic names (charitable gift annuities, charitable remainder unitrusts, charitable remainder annuity trusts, etc.) are available which remove the property you give away from your estate for estate tax purposes, give you a current income tax deduction, pay you income for your lifetime, and leave the rest to charity. These techniques are particularly attractive if you have highly appreciated property, such as stock options or real estate.

Most professional estate planners are familiar with these techniques, although they may refer you to a specialist for the actual implementation of these plans. Most large charities have officers who will be happy to consult with you about the availability of these techniques.

## **VIII. Estate tax planning**

**A. The estate and gift tax system.** The unified federal estate and gift tax is part of the Internal Revenue Code. A tax is imposed on the value of a decedent's estate that is subject to tax. Lifetime gifts are taxed as well. Just about everything you own at death is taxed -- your house, real estate, investments, business assets, life insurance proceeds, etc. The property is valued as of the date of your death (or in some cases six months after your death).

The vast majority (more than 90 percent) of estates are not large enough to be taxable. For persons dying in 2005, estates of less than \$1,500,000 (after taking into consideration taxable lifetime gifts) are not taxed. For estates exceeding \$1,500,000, the tax bite is severe. Estates of more than \$1,500,000 are taxed at rates of 45% to 47%.

The 2001 tax bill increases the tax-free amount over the next several years -- \$2,000,000 for persons dying in 2006, 2007 and 2008, \$3,500,000 for persons dying in 2009 and eliminates the estate tax entirely for persons dying in 2010. However, the tax-free amount drops back to \$1,000,000 for persons dying in 2011 or beyond. Most estate planners think Congress will change the law in the next few years, either fixing the tax-free amount at some level (perhaps \$1,500,000 or \$2,000,000) or eliminating the estate tax entirely. In the meantime, persons with estates of \$1,500,000 or more need to consider taking steps to protect their estates from taxation.

One way to reduce estate taxes is to remove assets from your estate or keep them from ever becoming part of your estate. Two of the basic techniques for accomplishing this -- the bypass trust and gift-giving programs -- are discussed below. There are a number of other techniques which estate planners employ to keep assets out of your estate. For instance, life

insurance proceeds may be kept out of the decedent's estate for tax purposes if the policy is owned by a trust or by someone other than the insured. These techniques often are quite complex and full of traps for the unwary. An in-depth discussion of the advanced techniques is beyond the scope of this paper.

**B. Three keys to basic estate tax planning.** The federal estate and gift tax system is too complex to discuss in detail in this paper. Instead, I would like to focus on these three keys: (1) the unlimited marital deduction; (2) the applicable exclusion amount; and (3) the \$11,000 per donee per year gift tax exclusion.

**1. Unlimited marital deduction.** A husband is given an unlimited deduction for estate tax purposes for qualified property left to his wife, and vice versa. Therefore, a husband can leave all of his estate to his wife, or a wife can leave all of her estate to her husband, regardless of the size of the estate, without any estate tax being due upon the death of the first spouse to die. This has only been the case since 1981. Federal tax policy now is to tax property as it passes from generation to generation, but not to worry about taxing property passing from spouse to spouse. Special rules apply to spouses who are not United States citizens.

Because of the unlimited marital deduction, the estate tax savings we discuss is a savings in tax *when the second spouse dies*. Thus, for most couples, we are talking about saving your children money years from now when the last spouse dies, not saving you or your spouse money in your lifetimes.

**2. The applicable exclusion amount.** As mentioned above, estates of persons dying in 2005 which are under \$1,500,000 are not taxed. In effect, the IRS allows each person to give away during their lifetimes or leave at their deaths up to \$1,500,000 *to any person* (not just their spouse) without paying tax.

For small estates, the applicable exclusion amount means there's no reason to worry about estate taxes. For large estates, the exclusion is an opportunity to leave property to someone other than the surviving spouse (or to place property in a trust benefitting the surviving spouse) without any tax being due. The applicable exclusion amount forms the basis for the bypass trust planning technique described below.

**3. \$11,000 per donee per year gift tax exclusion.** With certain exceptions, gifts made during a person's lifetime count against the \$1,000,000 applicable gift tax exclusion amount and result in gift tax being due if the gifts exceed the exclusion amount. Therefore, if someone gave \$100,000 worth of property in nonexempt gifts during his lifetime, he or she would use up \$100,000 of his \$1,000,000 applicable gift tax exclusion amount, leaving only \$900,000 to be used later in life and adversely

affecting the applicable exclusion amount available at death.

Congress recognizes that people give each other gifts for birthdays, Christmas, etc., and that it would be ridiculous to try to tax these gifts. Therefore, the tax law permits each person to give any other person up to \$11,000 worth of gifts each year with no gift tax consequences. (Until a few years ago the amount was \$10,000. However, an inflation adjustment made the gift tax exclusion \$11,000 beginning January 1, 2002.) If a spouse joins in making a gift, that amount doubles to \$22,000 worth of gifts per donee per year with no gift tax due and none of the \$1,500,000 exemption equivalent used up. (Gifts of separate property in excess of \$11,000 in which spouses join require the filing of a gift tax return, but no tax is due and no credit is used up if the joint gift is less than or equal to \$22,000. If the gift is of community property, spouses may make a joint gift of up to \$22,000 without being required to file a gift tax return, and no tax is due and no credit is used up.)

The annual gift tax exclusion covers Christmas and birthday gifts with room to spare for most families. This exclusion forms the basis of the gift-giving technique for reducing estate taxes described below.

**C. Using a bypass trust to save \$555,000+ in estate taxes.** This paper discusses two basic techniques for reducing estate tax. The first of these techniques is called the bypass trust. It is available in cases where the husband and wife are both living.

If taxes were not a factor, most husbands would leave everything to their wives when they die, and most wives would leave everything to their husbands. (This is not always the case, of course, such as when there are children from a prior marriage.) If a wife leaves everything to her husband, the first \$1,500,000 passing to her husband escapes tax two ways -- first, it qualifies for the unlimited marital deduction, and second, it uses up the applicable exclusion amount. Because it escapes taxation two ways, one of these ways (the applicable exclusion amount) is wasted. This results in stacking the wife's entire estate on top of the husband's estate, subjecting more property to taxation.

The purpose of the bypass trust is to keep from wasting the annual exclusion amount when the first spouse dies. By using a bypass trust, both spouses utilize their applicable exclusion amount, permitting them to pass \$3,000,000 or more tax-free to their family -- a savings of \$555,800 or more in estate tax.

Here is an oversimplification of how a bypass

trust works:<sup>1</sup> each will provides that \$1,500,000 worth of property goes into a trust (called the "bypass" trust because it bypasses taxation in the estate of the second spouse to die) and all of the rest of the property goes to the surviving spouse in a way that qualifies for the unlimited marital deduction.

In most cases the surviving spouse is named as the trustee of the bypass trust (although another individual or institutional trustee also can be the trustee) and the surviving spouse is the beneficiary of the trust. (The trust also can be used for other purposes, such as caring for a parent or for the children of a prior marriage.) Thus, in the typical case, the surviving spouse manages the money as trustee and gets the benefit of the trust for his or her lifetime as beneficiary. However, the trust is set up in a way that makes it escape taxation in the estate of the second spouse to die. Instead of being taxed in the surviving spouse's estate, it passes free of tax to the children.

The result of using a bypass trust is illustrated as follows. It works the same regardless of which spouse dies first, so in this example let's assume the wife dies first: no tax is due when the wife dies; the husband manages the bypass trust as trustee and benefits from the bypass trust as beneficiary for his lifetime; when the husband dies, the \$1,500,000 previously placed in the bypass trust *plus any appreciation in value of the trust* passes to the children free of estate tax; \$1,500,000 of other property owned by the husband passes to the children when the husband dies free of estate tax; only that portion of the husband's property which exceeds \$1,500,000 is taxed; the family saves \$555,800 or more in estate taxes.

**D. Using a gift-giving program.** Full utilization of the \$11,000 per donee per year gift tax exclusion can dramatically reduce the size of the taxable estate, especially in the case of large families. The savings is effectively doubled if a gift-giving program is used while both the wife and husband are living, since \$22,000 per donee per year can be given.

To whom may gifts be given? Anyone. Children, grandchildren, sons- and daughters-in-law are all possible recipients. You choose who to include in the program. Obviously, the more persons receiving maximum gifts, the quicker the estate can be reduced.

Gift-giving is permanent and irrevocable. Therefore, it must be undertaken with caution and with an understanding of the risks. Once you've given it away, it's gone. Make sure you don't need the property

being given away. If you give it to a spendthrift child or an uncooperative child, it may be lost to the family. Also, the divorce or bankruptcy of a child could frustrate your intentions.

Generally speaking, four types of property are good for gift-giving programs. First, easy to value property is good to use because you can easily stay within the gift limits. You may have to hire an appraiser for difficult to value property. (Always give slightly less than \$11,000 or \$22,000 per year so that Christmas presents and birthday presents don't put you over the limit.) Second, property which is likely to appreciate is a good choice, since the appreciation in value after the gift also escapes taxation. Third, property which you know you want to stay in the family is a good choice. Fourth, property which is difficult to sell (such as undivided interests in the family farm or vacation home) is a good choice if you are worried that the donees may be tempted to convert the gift into cash for spending. Obviously, these four categories are somewhat inconsistent with each other (for example, easy to value property usually is easy to convert to cash and spend), so pick the type of property that best fits your situation.

Only gifts of "present interests" in property qualify for the gift tax exclusion. You cannot keep a life estate in your house and give away the remainder interest if you want it to qualify for the gift tax exclusion. For most purposes, this means that the gift must be made without a retained interest -- you really have to "give it away" to qualify. One exception to the present interest rule is for gifts to persons under age 21. Gifts to persons under age 21 qualify for the gift tax exclusion if they receive the property outright at or before age 21. Gifts to minors can be made in one of two ways -- gifts under the Uniform Transfers to Minors Act (in which a custodian is named to care for the property until the child reaches age 21) or gifts to a trust which terminates at age 21.

**E. An estate tax planning example.** Stan and Jennifer have a \$4 million estate. Their current wills leave everything to each other, and on the death of the surviving spouse, their three children split everything equally. If Stan died in 2005, followed by Jennifer in 2006, with no estate tax planning (ignoring appreciation and expenses), the children's tax bill would be \$780,800 (19.5% of the estate).

**1. Using a credit shelter trust.** By using a credit shelter trust (ignoring appreciation and expenses), the children's tax bill will be \$155,800 (3.9% of the estate) -- a savings of \$625,000.

**2. Using a gift-giving program.** Stan and Jennifer have three children and three grandchildren. By

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<sup>1</sup> This example ignores inflation and the increase in the applicable exclusion amount, both of which should further enhance the estate tax savings of using a bypass trust.

