ESTATE PLANNING TODAY

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An Estate Planning Toolbox

Modern estate planners have dozens of planing techniques available in their "toolbox." However, almost every client's estate plan begins with some basic techniques. For some clients, these basics are only the first step in their estate plan; for other clients, no additional estate planning is necessary. This issue describes some of the basic techniques that for the core of a sound estate plan.

Estate Planning 101–The Bypass Trust and The Marital Trust

Estate tax planning for married couples with taxable estates usually involves preparing Wills which divide the estate of the first spouse to die into two shares. One share is the portion of a deceased person's estate that is exempt from estate tax ($675,000 in 2000, scheduled to increase to $1,000,000 by 2006). This amount is sometimes referred to as the "Tax Free Amount." The balance of the estate, i.e., the amount that exceeds the exemption amount in the year of death, passes to the surviving spouse (or to a Marital Trust) to defer estate tax. This excess amount is referred to as the "Marital Deduction Amount."

A Bypass Trust is a trust designed to hold the Tax Free Amount. Although the terms of the Bypass Trust must be spelled out by including them in your Will prior to death, the trust is not actually established or funded until after the death of one spouse. The surviving spouse or any other qualified person or entity may serve as trustee of a suitably drafted Bypass Trust. The Bypass Trust typically permits distributions to be made for the health, support and maintenance of the surviving spouse in accordance with his or her accustomed standard of living. Distributions can also be made to children and other descendants from the Bypass Trust, as "secondary" beneficiaries. The surviving spouse is sometimes given a testamentary "power of appointment" over the Bypass Trust, which empowers the spouse to name the recipients of the Bypass Trust assets remaining at his or her death. In summary, the Bypass Trust gives the surviving spouse the use of trust property during his or her lifetime, and perhaps control over the disposition of the property at death. Despite this access and control, the assets in the Bypass Trust will not be subject to estate tax at the second spouse's death, regardless of their value at that time. As a result the assets in the Bypass Trust are said to "bypass" the estate tax.

The portion of a spouse's estate in excess of the Tax Free Amount (the "Marital Deduction Amount") will be subject to estate tax at the first death unless it passes to the surviving spouse, or to a second qualifying trust. Property that passes to the surviving spouse or to a qualified Marital Trust is deducted from the taxable estate of the first spouse to die, effectively deferring estate tax on this property until the second spouse's death. As with the Bypass Trust, the surviving spouse or any other qualified person or entity may serve as trustee of a suitably drafted Marital Trust. Under the terms of the Marital Trust, all income must be distributed to the surviving spouse. Distributions of principal can be made to the surviving spouse to provide for his or her health, support and maintenance in accordance with his or her accustomed standard of living. Again, the surviving spouse may be given a power of appointment over the property to determine who will receive any property remaining in the Marital Trust at the time of the surviving spouse's death. When the surviving spouse passes away, the assets in the Marital Trust (on which tax was deferred), as well as the surviving spouse's individual assets, will be taxed to the extent the total exceeds his or her Tax Free Amount.

Also in this Issue...

Taking the Next Step: Second-Generation Planning

Married couples with children are frequently concerned not only with providing for each other, but also with ensuring that property passes to the second generation (their children) in a way that will be of the most benefit to them. For couples with young children, using a trust as a recipient of the property enables management of the assets by a trusted family member, friend or professional trustee until the children reach an age when they are mature enough to manage their own financial affairs. While the property is held in trust, it is managed by the chosen trustee. The trustee is required to provide for the health, support, maintenance and education of the children and their descendants during their lifetimes. In addition, the trust property is exempt from attachment by the child's creditors (including a child's ex-spouse in a divorce). Parents looking for a way to maintain the protections afforded by a trust, even after the children are able to handle their own financial affairs, may include provisions in their Wills which create lifetime trusts for the benefit of the children and their descendants.

Each child can be given the right to become a co-trustee or sole trustee of his or her trust at designated ages. Additionally, each child may be given a power of appointment to designate the recipient of the property in that child's trust upon his or her death. If the child does not exercise this power of appointment, any remaining trust property typically passes to the child's children, in further lifetime trusts for their benefit, on essentially the same terms as the child's lifetime trust. There are a number of advantages to using lifetime trusts for children and other descendants:

- The trust assets will not be subject to claims of a descendant's creditors, so that a large judgment in a lawsuit will not result in the descendant losing the benefits of these assets;
- The assets will remain clearly segregated as a descendant's separate property, which is generally beyond the reach of Texas divorce courts;
- Management assistance can be provided for each descendant who is under a specified age through a trustee or co-trustee;
- There may be potential income tax savings available through distributions directly to grandchildren, who may be in low tax brackets; and
- Up to $2,000,000 per married couple (adjusted for inflation each year after 1998), plus any growth on the property between the death of the parents and the death of the children, can pass free from estate tax at the child's death when property passes from the children's trusts to grandchildren or other descendants.

Selecting Guardians

For parents of young children, money management is often of secondary importance. They are frequently more concerned about deciding who will raise the children and undertake the parenting responsibility for the kids. The person who is charged with caring for minor children is referred to as a "Guardian." In Texas, children are treated as minors until they reach the age of 18. Guardians may be named in the Will, or in a separate instrument entitled "Declaration of Guardian for Minor Children." A guardian may be appointed for the "person" of the minor, for the "estate" of the minor, or both. A guardian of the person is responsible for making parental decisions regarding the minor's upbringing, education and welfare. A guardian of the estate manages funds that belong to the minor (but not funds that are placed into trust for the minor, which are managed by the trustee of the trust). The same person may be named to serve as both the guardian of the minor's person and estate. This person may, but need not, be the same person who serves as the trustee of any trust created for the minor's benefit. One or more alternate Guardians are usually named. Co-Guardians may be named as well, but if two persons are named as the Co-Guardians of the person of a minor, those persons must be married to each other.

Impaired Judgment Documents

Wills are an effective tool to determine how assets are managed and disposed of upon a person's death. Sound estate planning will also seek to ensure that if the client becomes disabled, important personal and financial decisions can be made without the need to appoint a court-supervised guardian. Several tools are available to protect against disability.

Statutory Durable Powers of Attorney. A Power of Attorney enables you to appoint someone to act on your behalf during your lifetime regarding financial matters. Many people appoint their spouse or another trusted family member to serve as their "agent." Frequently, one or more alternate agents are named. These documents can be made effective immediately, or can be structured for use only in the event you become incapacitated. The Texas Legislature has created a form known as a Statutory Durable Power of Attorney. That instrument also allows you to grant the agent authority to undertake one or more specific financial tasks. It also allows you to empower your agent to make gifts on your behalf.

An agent is a "fiduciary." As a result, the agent must act with the utmost honesty in carrying out you wishes. While a Power of Attorney may appoint an agent to serve for a limited purpose or for limited period of time, most Powers of Attorney give broad authority to the agent. Third parties are entitled to rely upon information and instructions given to them on your behalf by your agent. For example, if your agent signs a check on your account, and the bank has received a copy of the Power of Attorney from you or from the agent, the bank is entitled to honor the check as though it were signed by you. As you can see, naming someone to serve as your agent vests that person with substantial power over your financial affairs. As a result, careful thought should be given to the person or persons that you select to serve as your agent.

Medical Powers of Attorney. As its name implies, a Medical Power of Attorney enables someone to act on your behalf during your lifetime regarding medical treatment decisions. Again, many people appoint their spouse or another trusted family member to serve as their "agent." One or more alternate agents are often named. The agent can make medical treatment decisions only if you are incapacitated and unable to make treatment decisions on your own behalf. Even after you have signed this document, you have the right to make health care decisions for yourself as long as you are able to do so and treatment cannot be given to you or stopped over your objection. Texas law requires that you read and sign an information statement attached to the Medical Power of Attorney.

Directives to Physicians and Family or Surrogates. A Directive to Physicians and Family or Surrogates (sometimes called a "Directive" or "Living Will") evidences your intentions whether to withhold or continue life sustaining treatment in the event you have an "irreversible condition" or a "terminal condition." However, if you want the agent named in your Medical Power of Attorney to control the decision to either withhold or continue life sustaining treatment, you do not need a Directive. This is because, whenever you do not have a Directive, Texas law gives this authority to the agent under your Medical Power of Attorney. If you do not want your Medical Power of Attorney agent to have the authority (and you want to specify your preferences in writing), you *do* need a Directive. The Directive applies only if you are otherwise unable to communicate your wishes. It may be revoked by you at any time. The statutorily required information statement attached to the Directive provides additional details as to its purpose and effect.

Irrevocable Life Insurance Trusts

Life insurance death benefits are generally exempt from income tax. However, life insurance is subject to estate tax if the insured person owns or controls the life insurance contract. Therefore, estate planning for life insurance often involves having the insured part with all "incidents of ownership" in the policy. "Incidents of ownership" include all rights to benefit from or control the insurance policy. For example, they include the right to change the beneficiary; the right to borrow against the policy; the right to surrender the policy for its cash value; and the right to pledge the policy as collateral for a loan.

If someone other than you buys the insurance policy and holds all incidents of ownership over the policy, the death benefits will be completely excluded from your gross estate for federal tax purposes. In other words, third-party ownership of life insurance makes the death benefits estate tax free. Some people select their adult children to serve as owners. Frequently, however, the third party selected to own the insurance is an "irrevocable life insurance trust" ("ILIT").

Using an ILIT to own the insurance offers some significant advantages over ownership of the policy by the insured's children. For example:

- If you intend for your spouse to benefit from the life insurance, an ILIT can be used to provide for the surviving spouse, with any balance remaining at the spouse’s death passing to the children.
- An ILIT can be structured to continue after your death as a vehicle to manage and preserve wealth for your children (and/or grandchildren). The ILIT would include second-generation trusts for your children, which would ensure that the insurance proceeds would be afforded the same benefits that those trusts provide in a Will (see page 1).
- With an ILIT, you can control the future beneficial ownership of the insurance (for example, you might provide for trusts that last for your children’s respective lives and then continue for their children); however, if your children own the insurance directly, they can sell and/or Will their interest in the policy to whomever they please.
- With an ILIT, you can provide a source of cash to the executor of your estate for the payment of estate taxes. (Generally, an ILIT will be coordinated with your Will to facilitate this.) However, if your children own the insurance directly, it may not be possible to force them all to apply their share of the benefits towards the payment of estate taxes.

If you transfer an existing life insurance policy to a third party, you must survive for at least three years after the transfer date in order for the insurance to be estate-tax free; otherwise, the insurance will be treated as if you had never parted with it. On the other hand, if someone other than you is the initial purchaser of the insurance, the three-year rule does not apply. Therefore, if you are planning to purchase a new insurance policy on your life and you want that policy to be owned by an ILIT, you should establish the ILIT before you acquire the policy, and then let the ILIT actually purchase the insurance as the original owner.

If an ILIT owns the policy, you will have to transfer cash to the ILIT each year so that it can pay the premium. Every transfer that you makes to the ILIT will be treated as a gift, which is potentially subject to gift tax. A properly drafted ILIT can usually avoid gift tax by taking advantage of the $10,000 per year "present-interest exclusion." Gifts to trusts usually do not qualify for the present interest exclusion; however, by giving each beneficiary the present right to withdraw the amount of any gifts made to the ILIT up to $10,000 per year, ("withdrawal rights"), gifts to the ILIT *will* qualify for the exclusion, and will not be subject to gift tax.

In Our Next Issue . . .

The next issue of *Estate Planning Today* will focus on planning for retirement plans. The assets in these plans represent an enormous amount of wealth which passes to family members at the participant's death. These plans present unique problems, since they are frequently subject to both income and estate tax, and are governed by competing state and federal laws.

Contact Us:

If you have any questions about the material in this issue, or if we can be of assistance to you in your estate planning, feel free to contact us by phone, fax or traditional mail at the address and phone number shown below. You can also reach us by e-mail addressed to:

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