Basic Texas Estate Planning and Probate Matters

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I. MAJOR GOALS OF ESTATE PLANNING

A. Eliminate, reduce or defer estate taxes

B. Eliminate, reduce or defer income taxes

C. Provide financial security for your spouse (and children)

D. Make a final gift (leave a legacy) to charity

E. Control the ultimate disposition of your estate (provide support and maintenance for one person for that person's life and then control where the remaining assets end up when that person dies–commonly done in a "second marriage" situation)

F. Protect assets from creditors

G. Reduce probate and administration costs

II. HOW ARE ASSETS TRANSFERRED AT DEATH?

A. Probate Transfers.

1. Will. A Will is a legal document that distributes a person's *probate* assets upon the person's death. A person who makes a valid Will is known as a "Testator." Probate assets are all assets in which the Testator owns an interest at death that are not distributable pursuant to a contractual arrangement entered into during life or by operation of law. Probate assets are transferred upon death by a person's Will, if there is one.

2. Intestacy Laws. The State of Texas has written a Will for those persons who die without one! This "Will" is sometimes referred to as the Statutes of Descent and Distribution or "the intestacy laws." A major change in the intestacy laws took effect for married persons dying after September 1, 1993. Prior to that time, *in all cases*, the children of a deceased spouse who died without a Will inherited the deceased spouse's one-half (½) of the community property - not the surviving spouse. The post-9/1/93 rule changes this result in cases where all of the deceased spouse's children are also children of the surviving spouse. If that is not the case, the "old" rule still applies.

B. Non Probate Transfers.

1. Non-probate Assets. A person who dies ("decedent") may own assets that will pass outside the probate process at death. These assets will not pass under the decedent's Will and, therefore, will not be distributed according to the estate plan in the Will. Thus, these assets will "avoid probate." HOWEVER, THE DECEDENT'S INTEREST IN NON-PROBATE ASSETS IS STILL PART OF HIS ESTATE FOR FEDERAL ESTATE TAX PURPOSES. The Internal Revenue Service ("IRS") does not care what method is used to transfer assets at death. ALL assets in which the decedent

owned an interest at death are part of the decedent's estate for federal estate tax purposes.

2. Three Typical Categories of Non-Probate Transfers.

   a. Beneficiary Designation Assets. This category includes life insurance policies, annuity contracts, employee benefit plans, and IRAs. Beneficiary designation assets are distributed upon death pursuant to the beneficiary designation form on file with the particular company. This can be viewed as a "contractual arrangement."

   b. Multi-Party Arrangements: Joint tenancy with right of survivorship (JTWROS), Pay on Death (POD), Transfer on Death (TOD), "Totten trust accounts" and certain other multi-party arrangements. The form of title or registration used on the account or other asset dictates what happens to the interest of a depositor or co-owner at death. Because the particular form of title or registration dictates the result at death, it can be said that the decedent's interest in the account or asset passes "by operation of law" outside the probate process. However, the Executor of the deceased account owner's estate can reach these assets if the probate assets are insufficient to pay the decedent's funeral expenses, debts, final income taxes and estate administration expenses.

   c. Revocable Living Trust Assets. If assets are actually titled in the name of the Trust settlor's Revocable Living Trust prior to his death, then those assets will be distributed according to the trust agreement upon the Trust settlor's death. On the other hand, just because a Trust settlor has executed a trust agreement does not mean that his assets will "avoid probate" upon his death. The assets must be conveyed to (i.e., titled in the name of) the Living Trust *prior to* the Trust settlor's death to avoid probate.

2. Community Property vs. Separate Property. If a decedent is married, his estate consists of his one-half (½) of the community property and his separate property, if any. Under Texas law, in the case of a married decedent, the title of the account or other asset does not tell us the owner of the account or asset–just the *manager* of the account/asset. When a marriage terminates (by death or divorce), all assets on hand are *legally presumed* to be community property, owned ½ by each spouse. To overcome this legal presumption, the person claiming that a particular asset is his separate property must prove it by clear and convincing evidence, the highest burden of proof under Texas civil law.

3. The Post-Death Process: The Probate Process vs. The (Estate) Administration Process. Most lay people (and even some attorneys) fail to distinguish between that portion of the post-death process that consists of the probate matters and the portion of the post-death process that consists of

"administration" and federal tax matters. Even if a decedent's estate is able to "avoid probate" completely, it will not avoid the need for post-death administration and post-death federal tax "due diligence." The person in charge of the decedent's estate (either the Executor under his Will or the successor Trustee under his Living Trust Agreement) has responsibilities relating to the handling and distribution of the assets, the payment of debts, taxes and expenses, and federal tax "due diligence." Federal tax *due diligence* includes the handling of all outstanding and ongoing federal tax matters, which includes federal estate tax, gift tax, GST tax and income tax matters, to the extent applicable, and also federal income tax basis matters.

4. Avoiding Probate vs. Avoiding Estate Taxes. Some people are so concerned with "avoiding probate" that they overlook doing the necessary planning to avoid estate taxes. When the federal estate tax applies, the amount payable is significantly greater than the costs related to probate.

C. Requirements for a valid Will in Texas. It is fairly easy to satisfy the requirements for having a valid Will under Texas law. Thus, there is no valid excuse for *not* having a Will.

III. WHAT HAPPENS IF THERE IS NO WILL?

A. Intestacy Laws Apply to Probate Assets

B. Increased Probate/Administration Costs and Delays

C. Guardianships of ESTATES of Minors: If the Decedent dies without a valid Will and any minor (person under age 18) is entitled to a share of the Decedent's estate, a Guardianship for the minor's Estate may need to be created in the Probate Court - even if the minor is the Decedent's child and the spouse (who is the minor's parent) survives him. Guardianships are expensive, time consuming and cumbersome.

IV. WHEN SHOULD A WILL BE CHANGED?

A. Financial situation has changed

B. Personal situation has changed (e.g., single before and now married or vice versa)

C. Persons named in fiduciary positions have died or moved far away or are no longer appropriate

D. You move to another state

V. IMPORTANT RELATED ESTATE PLANNING DOCUMENTS

A. Statutory Durable Power of Attorney (property and financial matters)

B. Medical Durable Power of Attorney (health care decisions)

C. Directive to Physicians (Living Will)

D. HIPAA Authorization

E. Designation of Guardian for Minor or Incapacitated Child(ren) by Parent

F. Declaration of Guardian (for self) in Event of Later Need

G. Proper Beneficiary Designations for Life Insurance Policies, Employee Benefit Plans, Annuities and IRAs

H. Revocable Trusts ("Living Trusts") - Optional in Texas, but even Texas residents should consider creating a Living Trust if they own real property or minerals outside Texas and titling their non-Texas property in the name of their Trust before death

I. Irrevocable Trusts (usually created to achieve transfer tax savings)

J. Uniform Transfers to Minors Act (custodial arrangement for gifts to minors)

J. Marital Property Agreements (very important for "second" marriages)

VI. BASIC FEDERAL ESTATE AND GIFT TAX CONSIDERATIONS

A. Transfer Tax System - **SEE EXHIBIT A**.

B. Annual Exclusion Gifts (for 2014: $14,000 per donor per donee)

C. Charitable Deduction (unlimited at death; percentage limitations apply during life)

D. Unlimited Marital Deduction (for gifts to a spouse who is a US citizen)

E. Federal Tax Exclusion Amount (estate, gift and GST tax)–per ATRA, $5 million, indexed for inflation (for 2014: $5,340,000)

F. <u>Common Misconception</u>: Married Couples do NOT automatically get two (2) Estate Tax Exclusion Amounts–they must DO something to get two (2) Estate Tax Exclusion Amounts:

1. Create and fund a Credit-Shelter Trust (a/k/a Bypass Trust) or

2. Elect Portability on the first spouse's death or

3. Both!

EXHIBIT "A"

ESTATE TAX SYSTEM

I. What Assets are Included in Your Gross Estate?

A. Home (primary residence)
B. Other real estate of all types
C. Oil, gas and other mineral interests
D. Stocks and bonds (including tax-exempt bonds)
E. Mortgages due you, notes receivable, cash, checking accounts, savings accounts, money market accounts and CD's
F. Life insurance proceeds payable on your death and your interest in life insurance policies insuring the lives of living persons
G. Partnerships, LLCs, S corporations, proprietorships and other business interests
H. Collections (coins, stamps, guns, etc.).
I. Annuities (commercial and qualified employee benefit annuities, such as 403(b) plans)
J. Qualified retirement benefits (401(a) and 401(k) plans, profit-sharing plans, thrift plans, IRAs of all types, IRA rollovers and other qualified employee benefit plans)
J. Deferred compensation plans and non-qualified employee benefit plans
K. Tangible personal property (vehicles, household furnishings, art, jewelry, etc.)
L. General powers of appointment (powers over trusts)

NOTE: a married decedent's interest in the community property is ½ the total value

II. How are Assets Valued for Federal Estate Tax Purposes?

A. Fair market value (may need appraisals for "hard to value" assets)
B. Valuation date - either date of death or 6 months after date of death, if later date would lower estate taxes payable

III. What Deductions are Allowed Against Your Gross Estate?

A. Unlimited marital deduction (if spouse is a U.S. citizen; must use a QDOT for gifts to non-citizen spouse to obtain marital deduction)
B. Funeral expenses
C. Executor commissions
D. Attorney fees
E. Accounting fees
F. Appraisal fees
G. Mortgage and liens due at death
H. Miscellaneous debts owed at death (outstanding credit card bills, property taxes, income taxes, etc.)
I. Bequests to charity (unlimited deduction at death)

NOTE: don't forget about community obligations (decedent's estate only owes ½ the amount)

IV. How is the Taxable Estate Determined?

A. Step 1: The total amount of the allowable deductions is subtracted from the total value of the gross estate.

B. Step 2: The total value of all *adjusted taxable gifts* is added back to the figure obtained in Step 1 to produce the Taxable Estate. The estate tax is calculated based on the Taxable Estate. In this way, adjusted taxable gifts are part of the tax base at death.

An adjusted taxable gift is a gift made after December 31, 1976 that had a value exceeding the annual exclusion from the federal gift tax in the year when made. In general, the total value of all gifts made by the donor to a particular donee in a particular year must be determined, and if that total value exceeds the gift tax annual exclusion amount for that year, the excess amount is a *taxable gift*. The total of all post-12/31/76 taxable gifts made during life (i.e., adjusted taxable gifts) becomes part of the estate tax base at death upon which estate taxes are calculated. The current gift tax annual exclusion amount is $14,000 per donor per donee.

V. How is the Estate Tax Calculated?

A. Once (i) assets are listed and valued, (ii) the total amount of allowable deductions is subtracted, and (iii) the amount of the adjusted taxable gifts (if any) is added back (i.e., all steps described above have been taken), the tax rate is then applied to the Taxable Estate. For decedents who die in 2014, the estate tax exclusion amount is $5,340,000. Note that married couples who rely exclusively on the unlimited marital deduction to avoid estate taxes on the first spouse's death (and don't elect portability) will "waste" the first spouse's estate tax exclusion amount. As a result, otherwise avoidable estate taxes could be payable on the second spouse's death.

B. As a result of the American Taxpayer Relief Act of 2012 (ATRA), passed in January 2013, the estate tax rate for 2014 is 40%. The same 40% tax rate also applies for GST and gift tax purposes.

C. Simple Example: Death in 2014:

SINGLE PERSON (could be the surviving spouse)

Total Gross Estate	$6,800,000
Less: Total Allowable Deductions (assumed amount)	< 50,000>
Taxable Estate	$6,750,000
Taxable Estate	$6,750,000
Less: 2014 estate tax exclusion amount	< $5,340,000>
Amount subject to Estate Tax	$1,410,000
Estate Taxes Payable (40% Tax Rate)	$564,000