ESTATE PLANNING TODAY

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Multi-Generational Estate Planning

One goal of estate planning is to transfer wealth from one person to another, either during life or at death. This transfer may be made by a Will leaving one spouse's property to the other, or to children or other loved ones. Having a Will and powers of attorney not only makes your family's life easier in the event of your death or disability, but also ensures that your property passes exactly as you intend at the time of your death. Few clients intend to benefit the IRS or the creditors or ex-spouses of their loved ones. Therefore, trusts play a vital role in estate planning, since they can protect inherited property from estate taxation, creditors and divorce courts. Once they realize the benefits that trusts offer, many of our clients ask about extending these protections in two logical directions: How can I get my parents to undertake estate planning to protect any potential inheritance I might receive? How can I get my adult children to focus on the need for estate planning?

The Benefits of Trust Planning

Before you can have a productive conversation with a family member about estate planning, you need to have a few fundamentals in mind. Because most estate planning benefits involve the use of trusts, we begin with a summary of the benefits of trust planning.

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 2001, 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 Tax Free 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."

Also In this Issue...

*As this issue went to press, Congress was considering estate tax reform that would increase the exemption to $1,000,000 in 2002, slowly increasing to $3,500,000 in 2009, culminating in repeal of the estate tax in 2010. We will provide a detailed analysis of any changes as soon as they are finalized.

The Bypass Trust. 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, 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. The Bypass trust may also permit distributions to children, parents, or other loved ones. The surviving spouse is sometimes given a testamentary "power of appointment" over the Bypass Trust (described below), which enables the spouse to name the recipients of the Bypass Trust assets remaining at his or her death. In summary, the Bypass Trust can give the surviving spouse use of and substantial control over trust property during his or her lifetime. 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" estate taxation in the estate of the spouse.

The Marital Trust. 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 spouse's 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 may be made to the surviving spouse (but not others during the spouse's lifetime) to provide for his or her health, support and maintenance in accordance with his or her accustomed standard of living. 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.

Second Generation Trusts. 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. The trustee is required to provide for the health, support, maintenance and education of the children and their descendants during their lifetimes. So long as the trust continues, 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 ages you select. Each child may also 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.
- 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.

Flexibility Through Powers of Appointment. A "power of appointment" enables the beneficiary of a trust to decide to whom the trust's assets will pass. A "testamentary" power of appointment means that the power may be exercised in the beneficiary's Will. Powers of appointment may be "limited" so that the group of people to whom the property may be given is restricted, or "general" so that the beneficiary may give the trust property to his or her estate, and thereby, to anyone named in his or her Will. Granting powers of appointment allows beneficiaries at each generational level to decide not only who receives the trust property, but also whether that property should pass outright to one or more individuals or in further trust.

Benefitting from Second-Generation Planning.

Clients who understand the benefits of second generation planning for their children often realize that those same benefits would be welcome for any property that they might inherit in the future from their parents or other family members. They sometimes ask whether they can place the property that they inherit from their parents into such a trust. Unfortunately, the benefits of second-generation planning are not available if you create a trust for yourself. Instead, the trust must be created by someone else. Therefore, clients whose parents are still living and who have more than a very modest amount of wealth might ask their *parents* to do some sophisticated estate planning, so that they can receive any inherited property in trust for their benefit. With properly drawn trusts in their parents' Wills, they can have access to and control over the inherited property, while property that they don't need may remain in the trust (exempt from their creditors and federal estate taxes).

Talking to Your Parents About Estate Planning

How does one go about talking to his or her parents about estate planning? In some families, it is an easy and natural conversation. For many people, however, it is awkward to broach the subject. Many people feel uncomfortable talking with their elders about their eventual death, let alone the disposition of property afterward. It is virtually taboo in our culture to say "I love you, and want you to be with me forever, but eventually you will die, and when you do, some of your property will pass to me." Will your parents perceive you as greedy or callous if you talk

about what you might expect to inherit? Obviously, the topic requires considerable tact.

There is no "right" way to broach the subject. Every family and every relationship within a family is different, and requires its own unique approach. However, one of the following approaches might work for you, or at least give you a starting point for beginning a dialogue.

Often, the conversation can evolve naturally by letting your parents know that you have talked to your attorney about your own estate planning, and that in the process you learned a lot about how trusts work to minimize taxes and protect inherited property. You might ask whether your parents have reviewed their estate plan recently and whether their attorney talked to them about lifetime trusts for the children. (For a variety of reasons, many lawyers talk about bypass and marital trusts, but don't mention second-generation planning, so be sure to be specific).

You might begin by asking your parents whether they have made plans to take care of themselves if they become incapacitated, and whether they have signed living wills, and financial and medical powers of attorney. It is a legitimate question and it may be viewed as less materialistic since this type of planning benefits them and not you. Once the discussion begins, it is natural to progress from there to a broader discussion of their overall estate planning.

A more direct method of broaching the subject may be simply to give your parents a copy of this newsletter. Please feel free to do so. Call or e-mail us if you would like to have extra copies or if your parents would like to be added to our mailing list.

Estate Planning for Your Children

Clients with adult children, especially children who have families of their own, often project the estate planning process down to their children. Do your children have Wills (not to mention powers of attorney and other documents that protect them in the event of disability)? Here again, the conversation can be awkward. However, because most parents don't expect to receive an inheritance from their children, the emotional issues that can interfere with the discussion about estate planning are usually not a problem.

Generally, well meaning advice is appreciated, so long as it is not seen as critical or interfering. Again, many clients begin the conversation by saying that they recently reviewed their own estate plans. The discussion may contain a suggestion that it is never too early for adult children to obtain Wills, appoint guardians for minor children, and sign powers of attorney, particularly when the children have children, even if they have not yet developed substantial assets of their own.

Ethical Issues

In the context of multi-generational estate planning, we are often asked by our clients to do estate planning for their parents, children or other family members. The canons of ethics that apply to attorneys allow us to perform estate planning for more than one generation of family members so long as certain important safeguards are in place. These safeguards are designed to protect each of our clients in the important areas of attorney confidentiality and loyalty.

Initially, when we prepare your estate plan, you are our only client; neither your parents, your children, nor any other relatives are our clients. As and when you ask us to do so, we may discuss your estate plan with your family members and answer questions they may have, but this is always at your request and in our capacity as your lawyers.

If we are asked to do estate planning for your parents, children, or other family members, we can do so, even if their interests are adverse to you, if we have your and their permission to represent you both. We obtain this permission as a matter of course when we do estate planning.

When we undertake estate planning for your parents or someone that you expect to inherit from, it is vitally important that you understand that, as to that engagement, they, and not you, become our client. This means that we will take instruction only from them, and will maintain their communications as confidential, even from you, unless we are authorized by them to do otherwise.

We frequently receive requests from individuals to draft a Will for a parent leaving property to them. Naturally, in drafting any Will, we must ensure that the Will reflects the wishes of the person who signs the Will, and not merely the hopes of one of the recipients.

Multi-generational representation can often be a very efficient way to co-ordinate estate planning. In the context of clients who wish to pass property from the grandparents' generation down to grandchildren and beyond, having a single attorney involved at all generational levels serves to ensure that each family member is informed of the overall plan, and can act to accomplish their own specific objectives in the context of that plan. Nevertheless, each client's wishes and goals are unique. It is essential that the family agree beforehand that confidentiality will be maintained in accordance with each family member's wishes, and that each person be allowed to accomplish his or her own individual objectives.

Post-Death Trust Funding

The discussion above highlights a number of benefits available to clients who utilize trusts in their estate plans. In many cases, however, the trusts that provide these benefits are dormant during the lifetimes of our clients. Bypass and Marital Trusts are simply words on paper in a Will or revocable trust agreement until one spouse dies. Second generation trusts are not created until both spouses have passed away. Most clients are more than pleased to essentially ignore their estate plan once the documents are signed. Once death occurs, however, it is essential that the executor obtain appropriate advice to fund the trusts

described in the plan. **You may have the best Will in the world, but it is ineffective unless the trusts it describes are actually *funded after death*.**

In most estates, the administration process is undertaken in three phases. The first and simplest phase is "probate." Although probate is widely misunderstood, the process in Texas is quite simple. Taken from the Latin word meaning "prove," probate is simply a matter of proving to the satisfaction of the local court that the decedent has passed away leaving a valid Will, and that the person named in the Will to administer the estate is available and eligible to do so. The required court documents are straightforward, and hearings typically last less than two minutes.

The second phase of the process is the "administration" of the estate. Administration includes matters like filing a final income tax return for the decedent, protecting assets, preparing and filing an estate tax return, selling assets to raise the cash needed to pay debts and taxes, and actually paying the debts and taxes that prove to be due.

The final phase of the process is known as "funding." Funding involves distributing assets to those who are entitled to them. When assets pass to individuals, they insist upon receiving their inheritance. When the recipient is a trust, however, it is surprising how often the executor fails to implement this last critical step of funding the trusts described in the Will or revocable trust agreement.

Trust funding involves filing deeds, opening trust bank and brokerage accounts, transferring assets, and *documenting* distributions. Until assets are conveyed, the trust's benefits cannot be realized. While some corrective measures to fix improper funding can be taken long after the administration is complete, they are often costly and complex. Failure to fund is frequently a source of expensive and contentious litigation. The benefits of trusts are best preserved if the executor gets appropriate tax and legal advice to complete trust funding in a timely manner.

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