

# TEXAS ESTATE PLANNING

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September 1, 2010

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## **Part I**

# **INTRODUCTION**

## **1 WHAT'S TEXAS ESTATE PLANNING? <sup>1</sup>**

Estate planning includes every aspect of your financial life. In Part I of this presentation I give you a general orientation with emphasis on the laws that apply to Texas folks. Part II of this presentation applies to everybody. Part III is mostly for folks with larger estates and tax problems.

### **1.1 Building Wealth**

The subject of building wealth is as vast as life itself. Simply put, it boils down to developing the knack of spending less than you earn and investing the rest. I will not focus on building wealth in this presentation because there are many other advisers to help you. To learn more about investments, try the non-profit American Association of Individual Investors. For information, write to AAIL, 625 North Michigan Avenue, Suite 1900, Chicago, Illinois 60611 or call 1-800-428-2244. The web site is [www.aaii.com](http://www.aaii.com).

### **1.2 Protecting your Wealth**

Just about anybody can be sued. People who own risky businesses worry about creditors. Sound estate planning, as an extra dividend, can do a lot to protect you, your family, and your retirement from creditors.

### **1.3 Retirement**

You may be retired for a long time. How can you best organize your wealth for a serene old age? This is an important subject, but I don't focus on it here because there are many other advisers to help you with this.

### **1.4 Disability**

As medical science advances, it's getting harder all the time to die. The odds are increasing that you will be disabled or rendered incompetent by accident, disease, or old age. If this happens, who will take care of you and your property? I cover this subject thoroughly because the Texas state laws are so important in planning for disability.

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## **1.5 Death Planning**

When you die, you want your property to go to your loved ones without hassle and with as little tax as possible. This gets you into many subjects, such as wills, tax-saving trusts, beneficiary designations to life insurance and retirement plan benefits, and special documents like marital property contracts and business buy-sell agreements. I focus on this subject to explain how the laws of Texas apply to your death planning.

## **1.6 Blessings**

For many, the problem is not how to get more money to the offspring, but how to keep the money from being a problem for them. At its best, estate planning deals with how to make your wealth a blessing to your family, and not a curse.

## **1.7 When Someone Dies**

This presentation focus on planning. If someone dies, see my companion presentation *Estates of Decedents in Texas*. This covers how estates of decedents work in Texas whether or not the decedent did any planning.

# **2 WHY IS ESTATE PLANNING SO HARD?**

Estate planning often seems difficult and confusing.

## **2.1 Estates are Complicated**

Estate planning is complicated because we live in the Golden Age of great wealth and good health. We own a bewildering array of properties. The laws concerning the ownership and inheritance of these properties vary in each of the fifty states in ways that are often archaic and inconsistent. The Federal tax laws, on the other hand, attempt to be all-embracing.

## **2.2 Only Change is Certain**

The laws change often. Finally, our lives are more complicated as people move about more, divorce and remarry, and live longer. As tricky as the laws can be, the people and the things they do are even more complex.

## **2.3 You're on Your Own**

Our society relies on many public and private bureaucracies for social and financial support. Organizations such as the state courts, the federal Social Security Administration, your pension plan, your banks, and your insurance companies, etc. support you in their own fields. But there's no agency to help you put it all together if you are disabled or die — here you're on your own. And it's hard for you to concentrate on an estate plan that may never be used!

# **3 HOW TO MAKE PLANNING EASIER**

## **3.1 Keep your Perspective**

Most estate plans are never used because they are replaced by something else. So you don't need a perfect estate plan if you are young and in good health. For you, something rudimentary is a good bet — just do that much and have plenty of insurance! Save your energy for sophisticated estate planning until you're older or have health problems,

## **3.2 Keep it Simple**

Strive to keep your life and your estate planning relatively simple. For example, too much emphasis is placed in estate planning on speculative attempts to save taxes. Don't go for complications unless the hoped-for tax savings seem substantial, certain, and likely to be realized soon.

## **3.3 Plain Language Documents**

The legal documents describing your assets, insurance, retirement plans, and the like are extremely complicated. There is little you can do about this because these documents are prepared by lawyers (working for government and financial institutions) who must deal with a vast variety of different situations in all of the states in our country.

But you can insist on having personal financial documents that you *and your survivors* can understand. True, many estate planning attorneys write wills, trusts, and other documents for individuals that are wordy, jargon-filled, and obscure. You don't have to stand for this — there are attorneys who can write plain-language documents that you can understand.

## **3.4 Coordinate Assets to Plan**

Signing your new estate planning documents usually gets you just past shortstop. To make it home for a run, you have to coordinate your assets to the plan. This means you must attend to the beneficiary designation forms for insurance, pension and retirement plans, annuities, and the like. Don't forget to see how all the bank and stock brokerage accounts are titled. And where are those blasted stock certificates for your company?

Over and over I see estate plans botched by the fact that the assets are not set up correctly. (Well, if you don't understand your planning documents, how can you coordinate the assets?) Seek a relatively simple plan, and leave yourself some time to be sure everything is in place to make the simple plan work.

### **3.5 Keep your Papers Organized**

Set up copies of all your planning papers, insurance documents, beneficiary designation forms, account reports, and the like in big 3-ring student notebooks. This makes it relatively easy to review everything and reorganize your papers as your situation changes.

### **3.6 Stay in Touch**

Call to see if there's an update of *Texas Estate Planning*. You can reach me at 972.387.1828 or 972.387.4101. My address is 7817 La Sobrina, Dallas, TX 74248. My email address is hank@mywill.com.

## **4 LOOK AROUND**

As you read this presentation, of course you will think about your own estate plan and that of your spouse. Think also about others around you:

### **4.1 Parents**

If your parents have a good estate plan, it may save you a lot of trouble as they grow older and save you taxes when they die. The older the estate owner is, the more important the planning is. When you're in your working years, your plan is of a contingent nature and is probably not likely to be used. But if you have elderly parents, their plan is what you are probably going to be stuck with.

### **4.2 Young Families**

If you have children who are starting their families, estate planning is probably a low priority. But urge them to do at least the free estate planning discussed later in this presentation.

### **4.3 Business Partners**

Has your partner done good estate planning? Or would his death foul up your business as well as his own? You have a legitimate interest in asking your partner to keep his business and personal finances in order.

## **Part II**

# **TEXAS ESTATE PLANNING FOR EVERYBODY**

## **5 TEXAS MARITAL PROPERTY LAW**

For most folks, estate planning centers on taking care of spouses and kids. You have to review the Texas marital property laws before you can understand estate planning in Texas for married persons. If you are single, you can skip this section (unless you are thinking about getting married).

### **5.1 Separate Property**

When you are single, you own separate property. After you marry, you can own separate property that you got before marriage or received as a gift (including a gift from your spouse) or inheritance while married. Also, you and your spouse can divide up community property so it becomes separate property. Consider these aspects of separate property:

#### **5.1.1 Divorce**

On divorce, your separate property cannot be awarded by the court to your ex-spouse.

#### **5.1.2 Death**

If you die while married, you can leave your separate property to anybody you wish. You do not have to leave any of your separate property to your spouse.

#### **5.1.3 Creditors**

If your spouse gets in trouble with creditors, it's difficult in Texas for his (or her) creditors to reach your separate property to collect.

### **5.2 Community Property**

Property acquired by a married person in Texas is considered to be community property unless you can prove that it is separate property.

### **5.2.1 Ouch!**

In Texas, income from separate property is community property. For example: if you inherit an apartment building, the real estate is your separate property, but the rents are community. Also, your earnings are community property.

### **5.2.2 On divorce**

The divorce court can award the community property between ex-spouses in any way which the court feels is "just and right." In an extreme case, the divorce court could award all of your community property to your ex-spouse!

### **5.2.3 Death**

If your spouse dies, you as the surviving spouse are entitled to one-half the community property. This (together with your right to live in the homestead for life) is the main protection you get under Texas law because you were a spouse. Your deceased spouse does not have to leave you his or her share of the community property in his or her will. In other words, in Texas you are not required to do anything in your will for your spouse. You can leave your half of the community (and part or all of your separate property) to your mate if you like, but the law does not require this. (Well, if the community property happens to be in a retirement plan set up under federal laws, the plan doesn't go through your will and you normally have to leave a benefit for your spouse from that plan.)

## **5.3 Marital Property Agreements**

With a written agreement, you and your spouse can identify your separate and community property. You can change the rules and arrange your marital property almost any way you like. For example, you can divide your community property so that you and your spouse will have separate property. You can also go the other way and convert separate property into community.

### **5.3.1 Getting married?**

If you are thinking about getting married, you might consider a pre-marital agreement. The agreement will identify your separate property and explain what separate and community property you and your future spouse will have in the marriage. This is especially important if you already have children from an earlier marriage who expect to eventually inherit from you.

### **5.3.2 Spouse in a risky business?**

Marital property arrangements can't be used to defeat existing creditors. But a lot can be done to protect you from creditors your spouse might have later. So you might want to use a marital

property agreement to create separate property for a spouse that would be safe from the creditors of the other spouse.

### **5.3.3 Records**

If you sell separate property and reinvest the proceeds, the new property is also separate. But remember, if you've married, everything is considered community unless you can prove it is separate. So if you have a marital property arrangement, you have to back it up day-by-day with good records.

## **5.4 How to Title Your Separate Property**

Suppose you are married, you don't have a marital property agreement, and you want to keep your separate property intact. What do you do?

- ▷ Make sure to title all your separate accounts something like this: "Mary Lamb Separate Property." If an account is titled "Mary Lamb Account," the law assumes it is community.
- ▷ You should from time to time transfer any income earned by your separate property out of the separate property account to a community account. This tends to keep the separate property from being tainted with community earnings. If too much mingling of funds happens, you may reach the point where you can't successfully identify what is your separate estate. Then the presumption takes over that the property is community and you have lost your separate property.
- ▷ Finally, have a bookkeeper set up a complete record of everything you do with your separate property. You are allowed to reinvest your separate all you like. But the trick is to be able to clearly trace your holdings back to the original assets that were separate.

## **6 DEATH WITHOUT WILL**

### **6.1 Intestate Succession**

When you die, your property instantly passes to someone else. If you don't say to whom through your will or some other arrangement, the law awards the property to its new owners — your heirs — by "intestate succession." If you allow property to pass by intestate succession, you may leave the survivors with legal problems ranging from an expensive nuisance to a complete disaster.

#### **6.1.1 Pitfall**

What happens if a Texas husband dies with community property, children, and no will? The answer depends on who is the mother of the kids! The wife gets her half of the community property

regardless. If the wife is the mother of the kids, she gets her husband's half of the community also. But if the husband has a child who is not the child of the wife, then hold the phone. The husband's share of one-half of the community goes not to the wife, but to the husband's kids! (In this step-child situation, the husband's kids also get one-half of the community property earned by the wife as well as one-half of the husband's community property.)

### **6.1.2 Different pitfall**

What happens if our Texas husband dies with separate property, children, and no will? Two-thirds will go to the kids and only one third to the wife, even if the wife is the mother of the kids! This is probably not what the poor guy had in mind. Many Texas spouses have separate property, especially when the couple has moved to Texas recently from a common law state. Moral: If you are married, be sure your husband or wife has a will!

## **6.2 Will Substitutes**

Some folks (usually with smaller estates) may be able to pass all their property to others as they wish without a will. These folks can use life insurance, special bank accounts, government bonds, IRAs, and annuities, etc., to pass property when they die. This is usually done by correctly filling out the appropriate beneficiary designation forms. These ways of leaving property to others are called "will substitutes." If you have real property or a larger estate with a variety of kinds of assets, it's probably not practical for you to rely on will substitutes alone.

### **6.2.1 Car titles**

Car titles in Texas can now be filled out in the name of two persons with title to pass on the death of one to the other by right of survivorship.

### **6.2.2 Financial accounts as will substitute**

Accounts at a bank, credit union, stockbroker, etc. are often used as will substitutes in Texas. If you set up one of these accounts, be sure you talk to an experienced person at the institution who knows how to use the different kinds of accounts correctly.

**6.2.2.1 Joint tenancy with right of survivorship** JTWROS is a popular will substitute. Certain magic words should be present in a Texas joint tenancy with right of survivorship. An example would be: "On the death of one party to this joint account, all sums in the account on the death vest in and belong to the surviving party as his or her separate property and estate." Without such words, the money in the account may pass to the estate of the party who dies, and not to the survivor of the account.



**6.2.2.2 Contrast to agency account** Joint tenancy with right of survivorship should be contrasted with an agency account. An agency account is similar to joint tenancy with right of survivorship in that at least two people can sign to take money out of the agency account. But with an agency account, the property on death passes through the estate of the owner of the account (either by his will or by intestacy) and nothing passes to the agent. An agency account is usually intended when an old person wants a younger relative or a friend to be able to write checks. The old person wants his property on his death to pass to his relatives and not to the agent. All too often in this situation, the parties mistakenly use the wrong form and establish a joint tenancy with right of survivorship. When the old person dies, the agent walks off with the money and the other heirs get nothing.

**6.2.2.3 POD account** Would you like to leave money in a bank account to someone else when you die, but be the only person who can sign on the account while you are alive? For this you can use what is called the POD (pay on death) account. (Caution: don't try to use a POD account with community property.)

### **6.2.3 Problems with will substitutes**

You should never use a will substitute to leave property to a minor, i.e., a person under age 18. As I explain in more detail later, if there's a minor in your estate plan, you should set up some sort of trust (usually in your will) for the minor. Then you would make property for the minor payable to the trustee under the will. Similarly, you should be particularly cautious about using will substitutes if you have a lot of debts or there will be taxes due at your death. In this situation, there will be an executor (or administrator) of your estate to pay the bills. If you leave property through will substitutes to the wrong persons, your executor may have to chase after the beneficiaries to collect from them their fair share of the debts and taxes. This sort of mess can keep an estate tied up in litigation for years.

## **6.3 Community Property with Right of Survivorship**

In other parts of the United States, it's popular for married persons to own property with right of survivorship. This is another example of a will substitute; on death, the surviving spouse automatically owns the account. This survivorship idea clashes, however, with the basic notion of community property that only half of the property goes to the surviving spouse at death. Still, in 1987, Texas voters approved a constitutional amendment that allows spouses to agree that community property shall pass on death to the surviving spouse by right to survivorship. This form of ownership has now become popular with Texas married couples.

### **6.3.1 Checking accounts with survivorship**

It is easy now to establish convenience checking accounts in Texas that pass on death to the surviving spouse. I recommend you have a moderate size account set up this way so your surviving spouse can have quick access to cash if you die.

### **6.3.2 When is right of survivorship appropriate?**

If you are married, should you own substantial properties with the right of survivorship? Well, it depends. Property titled this way passes automatically to the surviving spouse. If you have an estate plan with a tax-saving trust or other special features, you should avoid survivorship because it may foul up your planning.

### **6.3.3 No good for real property**

In many other states, special deeds are used to convey real estate to husband and wife so that when the first spouse dies, the survivor inherits the entire property by right of survivorship. This should be possible in Texas (since 1987), but it is almost unheard of. Real estate law, rooted in medieval concepts, is slow to change. A Texas lawyer who would try a real estate deed with survivorship would be at least as brave as that first man to eat an oyster.

## **7 BASIC ESTATE PLANNING**

### **7.1 Free Will**

Everybody should have a will. Do you think this recommendation is self-serving coming from an attorney? Well, let me show you how Mortimer Schnerd wrote his will for free. He took a piece of paper, and in his own handwriting, said the following:

“I, Mortimer Schnerd, give all my property when I die to my wife, Modine Schnerd, and she will be my independent executor to serve without bond. [Signed] Mortimer Schnerd on January 1, 2010.”

(Modine wrote a will just like it leaving all her property to Mortimer.)

#### **7.1.1 Legal will**

Mortimer’s will is legal in Texas because it is entirely in his handwriting. It would be hard to forge this much writing, so the court will accept it even though there are no witnesses.

#### **7.1.2 Better than nothing**

A handwritten will might be all that’s needed for someone who has a modest estate or who is using will substitutes to get most of his property to his loved ones. If you are married and there are step-children or you have separate property, this simple estate plan would get all the property to your surviving spouse and avoid the pitfall of the children inheriting too soon. A handwritten will may not be perfect, but it’s usually better than not having a will at all.

### **7.1.3 What are disadvantages of a handwritten will?**

A handwritten will seldom says everything that it ideally should. For example, a well-written will should name one or more backup executors if the main executor can't serve. If you try to write your own will, you're likely to miss this and other important points. A handwritten will should normally not be used where minor children are likely to inherit. A trust should be set up in a will for minor children, and this is too complicated to do in handwriting.

## **7.2 If Both Spouses Die**

What if both Mortimer and Modine should die leaving minor children as orphans? This calls for a will with a trust for orphans. This is the most common type will used in Texas, so I will call it the John and Jane Doe estate plan. In John's will, everything goes to Jane. If something happens to both John and Jane, the will has a trust for the orphans until the youngest child is, say, age 25 and the children are ready (hopefully) to get their inheritance. The wills also name a trustee for the trust and a guardian for the orphans. If your children are grown, your will could be simpler. It would leave everything to your spouse; or if you are the second to die, to the children outright in equal shares.

## **7.3 Special Wills**

Here are some other common situations that call for a professionally-written will:

### **7.3.1 Several families**

If you have remarried, there may be step-children. If there are children from your new marriage, you have even more obligations! If you are in this situation, you probably need a thoughtfully-developed will coupled with a good insurance program.

### **7.3.2 Elderly parents**

If your parents need help, you should probably have a trust for them in your will.

### **7.3.3 Charities or friends**

If you want to do something for folks other than your blood relatives, you usually need a will.

### **7.3.4 Gifts to numerous beneficiaries**

The more people you name in your will, the greater the risk of some sort of disagreement or dispute. When you have numerous beneficiaries, it's especially important to say which of them will have their gifts reduced by the payment of debts, expenses, and taxes of your estate.

## **7.4 Independent Administration**

The word "probate" has both a narrow and a broad meaning in estate planning. The narrow meaning of the word is the legal process of having a decedent's will accepted by the probate court. The broad meaning of probate is the whole process of collecting the decedent's assets, paying the bills, dealing with tax authorities, and eventually distributing the decedent's property to beneficiaries. In this section I speak of probate in the narrow sense of dealing with the probate court. I use the word "administration" to describe the general process of settling a decedent's estate.

### **7.4.1 Avoid probate?**

High court costs and attorneys' fees associated with dealing with the probate court in many parts of the United States have given the probate process a much-dreaded reputation. In many states, costs and fees associated with the probate court in a substantial estate (valued at, say, one million dollars) can be more than \$25,000. In Texas, probate fear-and-loathing is rarely justified. For a Texas estate of equal value, probate costs might be something like \$1,500.

### **7.4.2 Texas independent administration**

Perhaps you are wondering why Texas probate is so reasonable. The engine of this drastic cost-differential is named: Texas independent administration. If your will calls for independent administration, all your executor has to do in the probate court is appear at one hearing (to prove that the document offered is your true will) and file an inventory of your estate later (done by mail). Your executor will receive from the court a document called "Letters Testamentary." Then your executor will handle the rest of the administration of your estate without any further involvement of the probate court. In many other parts of the United States, you can save substantial amounts of money for your heirs by setting up your estate in a living trust (discussed in detail later in this presentation) to avoid probate. But because the probate of a will in Texas is so simple, there is seldom an advantage in Texas in "avoiding probate" through the use of a living trust. In Texas, the costs of setting up a living trust will normally be more than the expected savings from avoiding probate.

### **7.4.3 How do you get it?**

To have independent administration of your estate, you should have a will which requests it. Mortimer Schnerd's will simply says that his wife will be the independent executor, and that is enough. The typical language that you will see in a typewritten Texas will is as follows: "No other action shall be had in the probate court in which this will is probated . . . than the probating and recording of this will and the return of an inventory . . . ." (Your will should also say that the independent executor will serve without bond.)

#### **7.4.4 Costs of administration**

Probate costs in Texas are much lower than in other parts of the United States. The costs of administering an estate generally are about the same in Texas as in other places. The work involved in collecting assets, paying bills, settling with the tax man, and changing the titles of properties over to the names of the beneficiaries is the same everywhere regardless whether the estate went through probate or is handled with a living trust.

#### **7.4.5 Who gets the credit?**

Is Texas independent administration a product of modern law making? Nope. It was passed by the Congress of the Republic of Texas in 1843. Texas was a frontier, lawyers were treated like horse thieves, and the court was far away. Our forebears knew what probate was like back East and wanted no part of it. Texas independent administration is even today the model for reformers around the nation!

### **7.5 What Jobs are in the Will?**

Your will should name an independent executor and maybe a trustee and guardian.

#### **7.5.1 Executor**

The executor oversees the administration of the estate. He collects assets, continues operation of any business, pays the bills and taxes, deals with all the problems of the estate, and finally disburses the property to the beneficiaries. This can be a big and confusing job. The executor's tasks can be over in a few months or can go on for several years.

#### **7.5.2 Trustee**

The will may establish one or more trusts to save taxes or protect money for beneficiaries, etc. When the executor is finished, he turns the property over to the trustee of each trust. The trustee is then charged with oversight of the property left for the beneficiary named in the trust. This arrangement continues until the trust reaches the end of its term as provided for within the trust itself. The work of the trustee is usually less intense than that of the executor. But a trust can last for decades and present the trustee with onerous and exhausting duties.

#### **7.5.3 Guardian**

Finally, if there are minor children and both parents die, the responsibility of raising them until they are 18 belongs to the guardian. You can appoint the guardian in your will.

#### **7.5.4 Burden of being fiduciary**

Each executor, trustee, and guardian is called a "fiduciary." A fiduciary is burdened with a long-term responsibility, involved obligation, and the highest mandate of honesty, loyalty, and skill known to the law. Being appointed fiduciary in a will is no honor— it's a difficult and sometimes thankless job.

#### **7.5.5 Who is qualified?**

Texas fiduciaries usually operate without the active supervision of any court. If a Texas fiduciary is lazy or dishonest, it is *hard* to correct the situation. When making appointments in the will, you must plan for the worst and avoid wishful thinking. If there is any question in your mind about a person's integrity or business judgment, you cannot name him as fiduciary in your will. Also, your candidate for a fiduciary role should not be too old, too far away, or too busy. One person for each job is usually best. But at times co-fiduciaries or even a committee should be appointed, especially when there is a business to manage.

#### **7.5.6 Corporate fiduciary**

If you have relatives and friends who can serve as fiduciaries, you are lucky. But if an individual fouls up an estate or trust, the results can be catastrophic and there is seldom any practical way of undoing the damage. When in doubt, you should include a bank trust department or a trust company in your plans as corporate fiduciary. A corporate fiduciary provides vast experience in the administration of estates and trusts (normally lacking by individuals no matter how honest or capable), objectivity, and expert investment advice. And even if relatives and friends are appointed as the primary fiduciaries, most estate plans should include a corporate fiduciary as backup in case the individuals cannot serve.

### **7.6 Coordinate Assets not Controlled by Will**

In the old days, a will controlled all of a person's property at death. Think about what Benjamin Franklin owned: a house, printing press, books, horse and carriage, and pennies saved. These old-fashioned assets all passed by Ben's will, and they would still normally pass by a will today. Lawyers call these properties "probate assets." Think now about all the new-fangled assets that people own today: pension plans, life insurance, government bonds, IRAs, annuities, etc. These "non-probate" assets (which were also called "will substitutes" earlier in this presentation) pass at death by the instructions in a beneficiary designation form which you sign, and not by your will. So do not think your estate plan is done just because you have signed a new will! Your beneficiary designations have to be coordinated to the will to be sure that the plan works well.

### 7.6.1 Insurance

Insurance is paid to the party you name on your beneficiary designation form. For private insurance, this is usually filled out when you apply for the insurance. For group insurance where you work, you usually name your beneficiary on a form in the office of your firm benefits administrator.

- ▷ A common mistake is to make insurance payable to a minor. An insurance company cannot give money to a minor, and a court-supervised guardianship may result. If you want to leave insurance for a minor, you should set up a trust in your will to receive the insurance for the benefit of that child. Such a trust will be far more flexible and economical than a guardianship. Also, you can provide in your will that the trust will run on for a child until he is, say, age 30 and mature enough to receive the money. If a guardianship is set up for insurance money, the child would receive the money at age 18, which is often too young.
- ▷ Ordinarily, insurance should also not be made payable to the "estate" of the insured. It's better, normally, to make an individual or a trust the beneficiary of the insurance. A Texas law says that insurance proceeds are not available to the creditors of the decedent. If you pay the proceeds to individuals or a trust, you stay clear of any trouble. But what if the proceeds are paid to the decedent's estate? If the estate is the primary beneficiary, the insurance may be available to creditors. If the estate receives the proceeds as the secondary beneficiary, the exemption from creditors of the insured probably will hold up.
- ▷ When I write a will with trusts, I usually recommend that the beneficiary designation of life insurance be "the trustee under my will." I then provide special provisions in the will to make sure the insurance gets to the right places. If the will is changed later, it's usually not necessary for the client to change his insurance beneficiary designation forms again.

### 7.6.2 Retirement plans

In the old days, you were lucky if you had a pension. The pension paid money each month to you in your retirement and maybe to your spouse if he or she survived you. After you both died, the pension was over and your kids inherited the house and furniture. Today, a few people still have pensions, but most of us have what I will call "retirement plans."

- ▷ Retirement plans here means arrangements where you have control over a fund for retirement. If money is left over after you and your spouse (or other beneficiary) have died, it can go to other members of the family. Examples of this kind of retirement plan include the IRA, 401(k), and Keogh Plan.
- ▷ The downside to all this is that you have complete responsibility for managing your retirement plans. This responsibility includes figuring out who inherits the plans. This typically do this by filling out beneficiary designation forms.
- ▷ For many years, the government did a poor job of explaining the rules of how money would be distributed from retirement plans. In 2002, the government finally came out with simplified regulations. Generally, the new rules allow you to take less money each year out of your

retirement plans than before. If you don't need the money to live on, you can try to preserve the plan to be inherited by your heirs. The new rules also make it easier for your heirs to continue the benefits of the plan for themselves. Everyone with a retirement plan should learn how the new rules apply to his or her situation and how to make out the beneficiary designation form to best advantage.

- ▷ Most people know that a surviving spouse usually can “roll over” a retirement plan she inherits so that it will be treated as if she made the money herself. This is a valuable right for most surviving spouses. Rollover has never been available to children or other non-spouses who inherit retirement plans. But recently, Congress gave non-spouses who inherit retirement plans some new tools (completely effective in 2010) to “stretch out” the required distributions and thereby preserve the valuable tax shelter of the retirement plan. (This has been incorrectly called a “non-spouse rollover.” The new provisions work quite differently from a rollover.) If you are involved with a retirement plan passing to a non-spouse, get expert advice.

### **7.6.3 Community property with right of survivorship**

This new form of ownership (discussed earlier) will also pass outside the will. If you have a will with tax-saving or other special features, be careful not to put too much of your property into survivorship form; there might not be enough left in your estate to fund the gifts in your will.

## **8 DISABILITY DUE TO ACCIDENT, ILLNESS, OR OLD AGE**

### **8.1 The Problem**

What would happen if you passed into a coma for a long time due to an accident or illness? Is anyone in your family faced with a chronic illness or the increasing feebleness of old age? Who would take care of business and medical decisions in these situations for the afflicted person? There are six important tools available now in Texas for helping deal with the problems of disability:

- ▷ The durable power of attorney for property.
- ▷ The revocable living trust for property management.
- ▷ The medical power of attorney.
- ▷ The HIPAA authorization (allowing loved ones to have your medical information).
- ▷ The directive to physicians (or living will).
- ▷ The declaration of guardian in event of need.



## **8.2 Durable Power of Attorney for Property**

A power of attorney is a document which one person, called the principal, gives to another, called the agent, allowing the agent to handle business or personal matters for the principal. The agent is also called an “attorney-in-fact.” (The attorney in fact is not to be confused with a lawyer whose job is to work as an “attorney-at-law.”) Ordinarily, a power of attorney expires when the principal becomes incompetent, because the principal is no longer able to supervise the agent. This rule would make a power of attorney useless in planning for the risk of a disability. So, in recent years, all the states have passed laws saying that a power of attorney can continue even though the principal becomes incompetent — a “durable” power of attorney.

### **8.2.1 Texas form**

The Texas Legislature has been busy in recent years trying to make the durable power of attorney for property workable for Texas folks. All you have to do is to sign the correct form before a notary public to create a comprehensive and strong power of attorney. Also, you can sign a power of attorney that will only go into effect after you have become legally disabled (a “springing” power of attorney).

### **8.2.2 Advantages of durable power of attorney:**

- ▷ The agent under a durable power of attorney has great flexibility to do what the principal wants.
- ▷ The durable power of attorney is simple; you don’t have to change the title to your assets.
- ▷ A single durable power of attorney document covers all assets that the principal owns at the time the power is signed and acquires thereafter.

### **8.2.3 Disadvantages of durable power of attorney:**

- ▷ Tremendous power is concentrated in the hands of the agent. There have recently been cases where agents stole money from principals. (The Texas legislature in 2001 passed a new law requiring an agent acting under a power of attorney to account to the principal. The legislature also beefed up criminal statutes that apply to agents.) On the other hand, the agent has no duty to do anything, so an agent may disappoint the principal by doing nothing.
- ▷ The agent with a power of attorney deals with financial institutions and other third parties to help manage the assets of the principal. But the law doesn’t require a third party to do anything when requested by the agent. In other words, the power of attorney is only as good as the third party is willing to believe it is good. If you are an agent trying to act for a principal, it sure helps if the third party you face already knows and trusts you.

- ▷ Some third parties like real estate title companies, banks, and stock brokers may not be happy with the customary Texas power of attorney form. They may insist on the use of their own forms.
- ▷ The law of durable powers of attorney is relatively new, so there are unanswered questions. Also, no fees for the agent are provided by law. For these reasons, a professional fiduciary would normally refuse to accept a durable power of attorney.
- ▷ A Texas durable power of attorney may not be well received in other states, because the law might be different there.

## **8.3 Revocable Living Trust for Property Management**

The other major tool for dealing with property during disability is the revocable living trust for property management, which I sometimes call simply the "living trust" in this presentation. The living trust competes with the durable power of attorney as a management tool. The living trust also competes with the will as a tool for leaving property to your loved ones after you die. In this section, I will focus on the advantages and disadvantages of the living trust. In the next section, I will briefly discuss when an estate plan should be based on a living trust and when it should be based on a durable power of attorney for property and a will.

### **8.3.1 Trusts in general**

A trust is a legal relationship where one person, often called the grantor, transfers title to property to another person, called the trustee, for the benefit of another, called the beneficiary. Once a trust is established, the trustee is subject to law that developed over the centuries. Trusts can be established while the grantor is alive ("living trusts") or in a will ("testamentary trusts"). Normally, the grantor, the trustee, and the beneficiary are three different persons. But trust law is flexible. In the case of a revocable living trust for property management, the grantor, trustee, and beneficiary can be the same person — the property owner. In Texas, a trust is normally revocable by the grantor. But if the grantor clearly states that he means the trust to be permanent, it is called "irrevocable."

### **8.3.2 There are many kinds of trusts**

We now are concerned with a revocable living trust that a grantor sets up to provide a way for a trustee to manage his property for the grantor while he is alive. This trustee can be a third party such as a bank trust department. It can also be the grantor himself, with provisions for a backup trustee at the time when the grantor might become incapacitated. The grantor can put his property in the trust when it is first set up, or he can wait until later (procrastinate).

### **8.3.3 Advantages of revocable living trust for property management:**

- ▷ The trustee of a living trust is record owner of the property. This gives the trustee a stronger position than that of an agent under a power of attorney. This can be important when the assets are large or complicated.
- ▷ The law of trusts is well-developed throughout the United States. The living trust serves well for folks who have real property in several states. Executives who get shipped around the country (and the world) by their employers often find that a living trust “travels well.”
- ▷ Trustees are required by law to make regular reports to the beneficiaries and the standards of conduct for a trustee are well-understood.
- ▷ A living trust with a bank trust department or a trust company can provide you with good money management.
- ▷ The living trust can avoid probate. This is possible because the living trust can be designed to continue after the death of the grantor. The grantor can put in the living trust all the instructions he desires as to how his property will be disposed of after his death. On his death, the trust simply continues without the need for any action at the probate court. This feature of living trusts is important in many states (other than Texas) where probate is feared due to cumbersome court procedures and high costs.
- ▷ A living trust can give the family greater privacy. Because the living trust avoids probate, there is no inventory made available in the public records.
- ▷ A living trust can be an excellent tool to help a grantor maintain a separate property estate. Example: An elderly widower has a substantial separate estate which he plans to leave to his children by his deceased wife. The elderly gentleman then marries a younger woman and builds a community estate with her. This gentleman may find it advisable to place his separate property in a living trust which will pass on his death to his children and handle the rest of his estate through a will which benefits his wife.
- ▷ A living trust is an excellent tool to avoid litigation when there is a good reason to fear a will contest.

### **8.3.4 Disadvantages of revocable living trust for property management:**

- ▷ The living trust tends to be a formidable legal document that is expensive to write.
- ▷ Sooner or later, you have to put your property into the living trust for it to work. This is often quite expensive and time-consuming. You have to change your way of thinking and remember to maintain the trust as you go about your business. Some assets, such as a sole proprietorship business, cannot practically be placed into trust. The cost and hassle of funding a living trust and maintaining it correctly may be worthwhile in a state where probate costs are high; it is harder to justify these costs, however, in a state such as Texas where probate is efficient.

- ▷ It is rare that everything gets put into the trust. There will almost always be a will that is designed to "pour over" into the living trust any properties that are not placed in the trust before the grantor dies. So even though you put a living trust in place, usually you will have to probate the will anyway.
- ▷ The living trust has tax disadvantages. Some of the literature on living trusts suggests that the living trust offers a way to save taxes. This is misleading. The various strategies used to save estate taxes can be put into effect with a plan based on a living trust or a will. But the IRS estate tax forms and procedures favor having an executor and discriminate against a trustee who has the duty to pay estate taxes. There are small, but nevertheless annoying, tax disadvantages to using the living trust. For example, an estate can have a fiscal year for income taxes, which can be advantageous to the beneficiaries. A living trust receives similar treatment only if you make a special election.

## **8.4 What is the Better Plan?**

In one corner of the ring, you see a Texas will calling for independent administration, coupled with a well-written durable power of attorney for property. In the other corner of the ring, you see a well-written living trust designed to manage property and avoid probate. Which plan will be the winner?

### **8.4.1 Everybody's different**

Neither plan is right for everybody. Each estate owner should consider the advantages and disadvantages of each for his particular situation.

### **8.4.2 Typical plan**

I believe the living trust is the Rolls-Royce of estate planning. In an ideal world, perhaps everyone would have one. But a Rolls is costly to buy and maintain, and it requires a chauffeur. The standard plan for the Texas estate owner is and will likely remain a will coupled with a durable power of attorney for property. For most Texans, the additional benefits of a revocable living trust will not be worth the extra cost, chiefly because probate in Texas is efficient. I could do a living trust for myself for free, but I don't have one — I just don't need the hassle.

### **8.4.3 No reliable child**

I mentioned several cases where the living trust should be considered. But I saved one situation, which I see too often, for a separate paragraph: the estate owner with no child (or other younger relative) who is trustworthy. If you are old or ill and have no relatives who are trustworthy, you have no viable choice other than to establish a revocable living trust with a professional trustee such as a bank trust department — *and put all your assets into the trust immediately.*

- ▷ If you don't do this, you face grave risk from dangers worse than death: chaos in your personal life, contests among your unworthy relatives and friends (and all their lawyers) over your money, waste and theft of your property, physical neglect, and (if anything is left to salvage) a court-ordered guardianship.
- ▷ True, with a funded trust, fees will start right away. But you can test the waters and see if you are happy with your new trustee. Remember, the trust is revocable; you can change the trustee or cancel the trust altogether if you are unhappy.

## **8.5 Medical Power of Attorney**

The Texas legislature has prescribed a statutory form for a medical power of attorney. The agent has broad powers to manage the medical treatment of the patient signing the power, but this goes into effect only when the patient cannot communicate with the doctors. These powers include the power to withhold life-sustaining procedures from a terminally ill patient. The medical power of attorney must be signed exactly as described. Your doctors, nurses, and family should not be witnesses.

## **8.6 HIPAA Authorization**

New laws restrict medical providers from giving your medical information to others. So if you want family members to be able to discuss your case with the doctors, you may have to sign papers. I am including HIPAA authorization in my medical power of attorney documents and in a separate document as well.

## **8.7 Directive to Physicians or “Living Will”**

The Texas legislature has also prescribed a statutory form for the directive to physicians. The directive to physicians is often called a "living will." The directive to physicians usually states that you don't want to be kept alive by heroic means if you are terminally ill or suffer from an irreversible condition leaving you in a coma. If you sign a medical power of attorney, do you need also to sign a directive to physicians? Usually no. The medical power of attorney overlaps the directive to physicians. But you might not want to place the burden of the "pull-the-plug" decision on your agent under the medical power of attorney. You can relieve your agent from this by having a directive to physicians. If you are seriously ill, the directive to physicians clearly says what you want, and you might find that more comforting than the medical power of attorney alone. Finally, there are folks who don't have anyone they can appoint as agent for health care matters. They can use the directive to physicians without an agent.

## **8.8 Declaration of Guardian**

Some clients fear that a particular relative or associate may try to gain control by becoming guardian. There is a way to prevent this with a declaration of guardian in event of need. With this declaration you can pick your guardian in advance and rule out the persons who should not be guardian. If you are in this sad situation, consider a living trust with a strong trustee and use the declaration of guardian as well for defense in depth.

## **9 SPECIAL PROBLEMS**

### **9.1 The Migrant Executive**

Have you moved to Texas from another state?

#### **9.1.1 Update will**

Your out-of-state will probably does not call for independent administration. Also, your out-of-state will may not have been signed with the customary formalities expected in Texas. You probably should have your will reviewed to see if you need an update.

#### **9.1.2 Living trusts**

Folks from out-of-state often arrive with complicated living trusts designed to avoid probate where they used to live. Sometimes the assets have not been properly placed into the living trust, and things are a mess. Usually all this can be scrapped and replaced with a simpler Texas estate plan. Other folks are happy with their living trust because they have invested time and money in titling properties in the name of the trust. These trusts sometimes have to be bolstered with an amendment that makes sense in Texas.

#### **9.1.3 No-will situation**

There are laws to protect a surviving spouse if there is no will. In Texas, the community property law provides most of the protection. If a married couple moves to Texas from one of the 41 states without community property, most of "their" assets may legally be the separate property of the husband. Should he die without a will, the widow may be stripped of the protection she had in the home state at a time when she has little or no community property!

### **9.2 Divorce**

If you get a divorce, you will want to review your will. Here are some other things that should be checked after a divorce to be sure the name of the "ex" is out of the picture: insurance beneficiary forms, annuities, employee benefits at work, bank accounts, IRAs, signature cards on safe deposit boxes, powers of attorney, government bonds, partnerships contracts, trust agreements, designation of guardian in case of later need, and the living will. For example, suppose you have a retirement plan with Wife 1 as beneficiary. You divorce Wife 1 and marry Wife 2, but you forget to change the beneficiary designation form. On your death, Wife 1 may get the money in the plan!

### **9.3 Non-Citizen**

The rules on estate taxes discriminate against spouses who are not citizens. If your spouse is an alien, you need special provisions in your planning to get a marital deduction for your estate and defer the estate tax until her death.

## **10 LIFE INSURANCE**

Insurance will play an important part in most estate plans.

### **10.1 Death Protection**

When you are young, you need to protect your family against the risk you might die prematurely. Insurance is normally the key to this, usually with emphasis on term products which give lots of death protection for the premium you can afford. Because you pay for your term insurance normally from your own pocket with after-income-tax dollars, the proceeds received by your beneficiary on your death will be free of income tax.

### **10.2 Tax Shelter to Build Estate**

Permanent life insurance is a tax shelter. When you buy cash value life insurance, the "inside buildup" of accumulated income for the policy is not subject to immediate income tax. Eventually, if you cash in the policy, there will be income tax on the buildup, but you will benefit from the deferral of the tax. If you die with the policy, your beneficiary normally will receive all the proceeds free of income tax, including the inside buildup that was never taxed to you.

### **10.3 Protect Business**

If you are involved in a closely-held business, you and your partners should have a buy-sell agreement. Usually, it takes life insurance to make this work.

### **10.4 Exemption from Creditors**

Under Texas law, the cash value and the proceeds of life insurance is immune from the creditors of the insured and the creditors of the beneficiary. I discuss this in greater detail later in this Part IV later.



## **10.5 Is your Insurance Safe?**

A number of firms attempt to rate the financial strength of insurance companies. It's almost impossible for a consumer to get and correctly interpret all the ratings published about the 1,800+ insurance companies that are rated. But there is help. Get the latest Special Ratings Issue of the *Insurance Forum* (comes out in September each year). This gives you an independent and readable rundown on the ratings and warns you of insurance companies that are having financial difficulties. The *Insurance Forum* is a newsletter published by Joseph Belth, formally an insurance professor at Indiana University. It's available at many libraries. You can buy the ratings issue alone for \$25. Check it out at [www.theinsuranceforum.com](http://www.theinsuranceforum.com) or call 1.888.876.9590.

## **10.6 Fund for Death Taxes**

If you have a larger estate, insurance will probably play a role in paying for death taxes. Here the important point to remember is that your insurance is subject to death taxes (as distinguished from income taxes) unless you take special steps to prevent this by giving the insurance to your beneficiaries directly or in trust.

## **Part III**

# **SAVING TAXES WITH ESTATE PLANNING**

## **11 SPECIAL ALERT ABOUT CURRENT (CONFUSING) STATE OF DEATH TAXES**

The 2001 Tax Act ("2001 Act") was one of the first achievements of President George W. Bush. It included reductions in the estate tax. It repealed the estate tax in 2010. But this repeal lasts for only one year — throughout 2010. Then the 2001 Tax Act will expire beginning 2011. Like a Bouncing Betsy, the estate tax rules, rates, and tax-free amount in force at the beginning of 2001 come back in 2011! The idea the Republicans had, of course, was for Congress to eventually extend the repeal scheduled for 2010 and make it permanent. But this hasn't happened.

We now have the bizarre situation of having to deal with two different estate tax laws (2010—no tax; 2011—tough tax). My best guess now is that the estate tax will come back in 2011 and Congress will increase the tax-free amount to, say, \$1,500,000 to \$3,500,000. So with this warning, let's plow into a discussion of taxation of estates.

## **12 FEDERAL TAXES**

There are four federal taxes which are applied to the wealth of individuals:

### **12.1 Income Tax**

A tree yields fruit, and the income tax is paid from the fruit of the tree each year. This tax is levied on the individual while he is alive and on the income of his estate after he dies. The income tax on the estate is a different tax from the estate tax. The income tax on an estate used to be less than the income tax on the individual beneficiaries of the estate, and there was a tendency to keep estates running a long time as a shelter from income tax. Today, estates pay more income tax than an individual. Now it may save income taxes to close out the estate promptly.

### **12.2 Estate Tax**

This is a tax on the tree itself; it is paid after the owner of the tree dies. It can take a big chunk of the estate.

## **12.3 Gift tax**

The gift tax applies to gifts the property owner makes during this lifetime.

## **12.4 Generation-skipping Tax ("GST")**

This tax is vexing to wealthier folks who want to include grandchildren in their estate plans. Example: Many wills leave property in trust for children for life, and then the trust goes to grandchildren. Under the GST, there may be a tax when the children die. Further example: a large estate is given in a will to grandchildren. Both the estate tax and the GST will apply at confiscatory levels.

# **13 HOW THE FOUR FEDERAL TAXES WORK TOGETHER**

Let's focus next on the relationship of those four federal taxes to each other under current law:

## **13.1 GST and Estate Tax**

The GST works to support the estate tax. The rough idea is for there to be a death tax on each generation no matter how matters are arranged.

## **13.2 Gift Tax and Estate Tax**

The gift tax supports the estate tax: you can't escape the estate tax by giving away all your property.

## **13.3 Gift Tax and Income Tax**

The gift tax also supports the income tax. If there were no gift tax, wealthy parents could shift assets to lower-bracket children to reduce income tax.

## **13.4 Estate Tax and Income Tax**

Don't give up on me! This section contain really important information!

### **13.4.1 Basis of inherited property**

Property generally has a "basis" for income tax purposes of the value of what you paid for the property. If the property goes up in value and you sell it, you pay income tax on your gain. If the property goes down and you sell it, you have a loss. When property changes ownership by being inherited at death, the law does not considered this a "sale or exchange" to generate an income tax

gain or loss. But even though there's no sale, the tax law (remember - we are assuming the estate tax comes back in 2011) gives the estate beneficiary an income tax basis in the property equal to the fair market value of the property when the estate owner died.

### **13.4.2 Basis boost**

Because most property has been increasing in value in recent decades, this new-basis-at-death rule usually gives the heirs a "basis boost" in the property. This is true whether the estate is large enough to attract an estate tax or not.

- ▷ The reason why a new basis is given at death is primarily for convenience. It would be difficult for heirs to know what the true basis of the property was in the hands of the persons from whom they inherited it.
- ▷ The reason why there is no income tax on appreciated assets at death (or income tax loss created on depreciated assets at death) probably relates to the feeling that it would be unduly burdensome to charge an estate tax and an income tax at the same time on property that passed through an estate.
- ▷ Basis boost at death has been a huge benefit for both middle class and wealthy families who own capital assets passed down by inheritance. But now the values of assets are dropping because we are in a severe recession. This can result in "basis bust" at death, i.e., the children may inherit less basis in the property than what the parents paid.

### **13.4.3 Illustration of basis boost at death**

- ▷ Example: Jiggs and Maggie have a Texas community property estate of \$3,000,000 consisting of a farm they bought in 1950 at a low price. There is practically no basis for income tax purposes; if they sold the farm, there would be \$3,000,000 of income to be taxed. Jiggs dies in 2004 and his half of the farm goes to Maggie. Because of the marital deduction (see Section 18.1.2), there will be no death tax.
- ▷ Maggie misses the income that came in from Jiggs' operation of the farm. She promptly decides to sell her half of the community and Jiggs' half she inherited. Everything will be reinvested in income-producing bonds.
- ▷ How much income tax will be due when Maggie sells the farm? Answer: None! Both Jiggs' half and Maggie's half of the community farm receive a new basis for income tax purposes equal to the fair market value of the farm at Jiggs' death. This basis boost or step-up in basis at death applies, and the built-in income tax liability disappears, even though no estate tax was paid!
- ▷ The basis boost works just the same for stocks or other low-basis property. Because of this basis boost at death, it has been estimated that the true rate of taxation on profits on capital type properties in the U.S. as a whole is far less than 15%. Here are some other ramifications of the basis boost at death:

**13.4.3.1 Carry-over basis for gifts** Gifts to children of low-basis property may save estate taxes, but the children lose ground later when they sell the property. A gift just carries its old basis with it; and when the donor dies, there is no basis boost. If you are going to make a gift to a child, maybe cash is the better choice.

**13.4.3.2 High appraisals** In smaller estates (that pay little or no estate tax), or where the marital deduction is used to defer estate tax, it may pay to appraise property high. Why? To save income taxes later. Caution: IRS has penalties to combat grossly inaccurate appraisals.

**13.4.3.3 Til death do us part** The older a property owner is, the greater the incentive to hang on to the low-basis property rather than sell it. If the owner sells just before death, there will be an income tax followed by an estate tax on what remains from the sale.

## **14 STATE TAXES**

Texas has no general income tax. (Texas does now have a “margin tax” on substantial businesses, and this margin tax is similar to an income tax.) Texas had an inheritance tax (and a generation-skipping tax). But this amounted to a kind of tax-sharing device where the Federal government used to cede taxes to the state of Texas. The tax-sharing was repealed as part of the 2001 Act. Does the Texas inheritance tax come back when the 2001 Act expires? Stay tuned.

## **15 DOUBLE OR TRIPLE TAXATION OF ESTATES**

Most states other than Texas have death taxes on real estate located within their borders. So if you have property scattered around the United States (or the world) and several residences, your beneficiaries might be faced with several governments trying to levy death tax on the same property two or more times. This is the Howard Hughes problem, where the U.S., the State of Texas, and the State of California all had pretty decent claims that totaled more than the estate! The multi-jurisdictional estate requires special planning.

## **16 WHAT’S YOUR ESTATE FOR ESTATE TAX PURPOSES?**

Uncle Sam has good eyes: he sees as part of your estate virtually everything you own or which passes at your death. This includes property you gave away during life if you kept legal "strings" attached to it. So this tax definition of “estate” is quite different from the definition of “estate” to the judge of the probate court, who is usually only interested in the assets that pass thru the will.

## 16.1 Insurance

The insurance man told you the policy would be received by your family "tax free." He meant it would not be income to the beneficiary to trigger income tax. But as I explained earlier, insurance is normally subject to estate tax. Death benefits at work, retirement plans, and IRAs are also part of the estate for figuring the estate tax.

## 16.2 Community Property

When you die, only your half of the community property is in your estate. The interest of your spouse in the community is in his account and is not part of your estate.

## 16.3 Rule of Thumb

Add all your separate property plus half your community (don't forget your insurance and retirement assets) — this gives you a rough idea about your estate for estate tax purposes.

# 17 SUMMARY OF DEATH TAX RULES FOLLOWING 2001 TAX ACT

Now it is time to more closely at the death taxes under the 2001 Act.

## 17.1 Estate Tax

You probably know that the law gives each estate owner a "tax-free amount" that he can leave to anyone without there being an estate tax. Here is a table showing the increases in the tax-free amount for estates in the 2001 Act.

Year	\$ Tax-free Amount
2002	1,000,000
2003	1,000,000
2004	1,500,000
2005	1,500,000
2006	2,000,000
2007	2,000,000
2008	2,000,000
2009	3,500,000
2010	0 - tax repealed
2011	1,000,000 - tax reinstated

The estate tax was repealed for the year 2010. In 2011, the repeal ran out and the law we had in 2001 is reinstated. (The law then called for the tax-free amount to be \$1,000,000 in 2011.)

## **17.2 Gift Tax**

Minor gifts are not counted at all for death tax purposes. You can make a gift of \$13,000 to anyone without any gift tax concern. Spouses can make gifts of \$26,000 in a year to any recipient. The tax-free amount for major gifts is now \$1,000,000. This has not increased like the tax-free amount for the estate tax. Further, after 2009, the gift tax was not repealed, as was the estate tax. It was retained to discourage big gifts to younger family members who might then pay less income tax on income from the gifts.

## **17.3 GST tax**

The GST tax will have the same tax-free amount as the estate tax. It was repealed for the year 2010 and is back in all its glory in 2011.

## **18 DEATH PLANNING**

### **18.1 Basic Themes**

There are three themes to keep in mind when considering the tax-saving estate plan:

#### **18.1.1 Tax-free amount**

It appears each estate owner will likely have at least a \$1,500,000 tax-free amount which he can leave to anyone without an estate tax. Because of the tax-free amount, I suggest that tax-saving estate planning today is of interest only to a person or couple whose estate is considerably larger than \$1,500,000.

#### **18.1.2 Unlimited marital deduction**

Now we consider the “unlimited marital deduction.” You may leave as much as you want to your surviving spouse without any tax. Example: Mark Cuban could leave the State of Texas to Mrs. Cuban and there wouldn’t be estate tax. But the unlimited marital deduction doesn’t eliminate the estate tax — it only defers it until Mrs. Cuban dies. The idea is that the estate tax need apply only when the estate has been enjoyed by both the husband and wife and then passes to new owners. There is now a great impetus to leave everything to the surviving spouse in all estates. This is unpopular with children when the estate is large, because some of them might not live long enough to see their inheritance and those who survive may be old. The children’s grief is even greater when Daddy has married a second or third wife not much older than the children.

#### **18.1.3 The tax-savings from your plan will mostly benefit the kids**

Thanks to the unlimited marital deduction, you can leave everything to your spouse without a tax on the first death. As far as you or your spouse is concerned, the Mortimer Schnerd will is wonderful estate tax planning. If your husband dies, you get it all and there’s no tax! Since a simple will is the best you can do for the surviving spouse, it follows that most trusts in wills and other devices used in estate planning are designed to benefit the children by saving taxes.



## 18.2 Classic Tax-Saving Plan

With the basic themes in mind, let us work through the classic Texas tax-saving estate plan. Consider a couple, Jiggs and Maggie, with a community estate of \$3,000,000 and several children. Let's say the tax-free amount is \$1,500,000 and the top rate is 45%.

Jiggs dies first. Jiggs' will leaves everything to Maggie. There is no tax. When Maggie dies later, her estate looks like this:

Tax	
Gross estate	\$3,000,000
Less tax-free amount	-1,500,000
Taxable estate	<u>1,500,000</u>
Tax	\$555,800

Distribution	
Maggie's estate	\$3,000,000
Tax on her estate	<u>555,800</u>
To the children	\$2,444,200

But this tax of \$555,800 could have been entirely avoided. Let's see how.

On Jiggs' death, Maggie has her half of the estate in her own account. From Jiggs' part of the estate, the tax-free amount of \$1,500,000 goes to a trust set up in his will for the benefit of Maggie, i.e. the family trust. Maggie is the sole trustee of the trust. Maggie is the only beneficiary of the trust for the rest of her life; on her death, the trust will go to the kids. There is no tax now on Jiggs' estate because of the tax-free amount of \$1,500,000; when Maggie dies, there will be no tax either on this trust because it will go directly to the kids. When Maggie dies, here is the picture:

Tax	
Maggie's estate	\$1,500,000
Less tax-free amount	-1,500,000
Taxable estate	<u>0</u>
Tax	\$0

Distribution	
Maggie's estate	\$1,500,000
From Jiggs' estate	<u>1,500,000</u>
To the children	\$3,000,000

The family trust in Jiggs' will bypasses Maggie's estate. The kids get the whole \$3,000,000 estate. They are \$555,800 better off than under the simple will plan. (I know, 45% of \$1,500,000 is \$675,000. But the tax is less because part of the \$1,500,000 is taxed at a lesser rate.)

### 18.2.1 Advantages to family trust

In the first example where Jiggs had a simple will, he wasted his tax-free amount. But with a family trust, this couple can get at least \$3,000,000 to their children with no estate tax at all — \$1,500,000 from each spouse. Other advantages of the family trust are:

- ▷ Can yield modest income tax savings.
- ▷ Tends to secure the inheritance of the children from Jiggs' half of the estate. So if Maggie re-marries, she cannot later give Jiggs' property to her new husband!
- ▷ Protects estate from wife's creditors.

### 18.2.2 Disadvantages of family trust

There are some serious costs and problems with the family trust:

- ▷ There will be legal and accounting fees to set up the trust. The trust is a separate taxpayer, so there must be separate books, etc.
- ▷ The children have a legal interest in the trust. They may come snooping around.
- ▷ Some widows find the trust confusing. Some widowers find the trust interferes with their business.

Because of these problems and due often to lack of leadership, a lot of family trusts called for in wills never get set up. Then on the second death, the survivors are often faced with large estate taxes that easily could have been avoided. (What happened to that trust under Daddy's will!?)

## 18.3 How Much Can the Classic Plan Protect?

It's impossible to predict tax savings when the law is itself uncertain. But it seems quite possible that a Texas couple will be able in the future to use a proper estate plan to protect a community estate of \$3,000,000 from death taxes. As seen in the example above, this could save as much as, say, \$555,000 in taxes for the family.

## 18.4 QTIP Plan

If you have a larger estate, sooner or later you will hear something about a "QTIP trust". Here's the scoop:

**18.4.0.1 Not Q-tip** "Q-tip" is a famous trademark. "QTIP" is tax jargon dreamed up by Congressional tax code drafters at a happy hour. It stands for "qualified terminable interest property."

**18.4.0.2 Special trust for spouse** Usually QTIP means a special trust set up by a husband in his will so his wife can enjoy the trust for the rest of her life and then pass on the wife's death as the husband directs in his will. Here are situations that might call for a QTIP trust:

- ▷ You built up a business and your wife is a lot younger than you. If you leave your business to her outright, it may eventually go to her second husband along with your golf clubs.
- ▷ You have children from a prior marriage. If you leave everything to your second spouse, he or she may leave the property to someone else and cut out your children.
- ▷ You inherited separate ancestral property that you wish to keep in the bloodline. If you leave it to your wife outright, she might not leave it back to your family.

In all these situations, you can use a QTIP trust. With a typical QTIP trust, all the income goes to your spouse for life. Then on the spouse's death, the trust goes to your children or other beneficiaries. If you use a QTIP trust, you can defer the death taxes until your spouse's death the same as if you had left the property to your spouse outright. But when the spouse dies, the taxes will fall due.

Sorry, the QTIP doesn't work if you want the trust for her to end if she re-marries. She has to get all the income from the trust for the rest of her life.

**18.4.0.3 Harder than it sounds** A QTIP trust is usually a important arrangement with a built-in conflict of interest that applies to a lot of money that must be managed for a long time. This is a petri dish for trust litigation. I'm sure there are exceptions, but in my book, if the situation calls for a QTIP trust, it also calls for a trust company or bank trust department as executor and trustee. (I see a lot of QTIP trusts thrown into wills like routine boilerplate, usually with the surviving spouse as executor and trustee. These trusts will be a source of consternation, and I suspect that many or most of them will be stillborn or soon abandoned.)

## **18.5 Community Property Trust**

There are situations where the husband feels that everything, including the wife's part of the community, should be handled by a professional trustee for the wife after the husband dies. The husband often thinks along these lines when he has built a complicated business that must continue to operate after his death. Typically, there is a committee of trustees, with a bank or trust company included, and the wife is asked to put her survivor's interest in the estate into a trust for her own benefit.

## **18.6 Trusts to Avoid Tax on Generation-Skipping Transfers**

Older persons with large estates often want to benefit grandchildren. The tax on generation-skipping gifts can make this very expensive. But there is an exemption from the tax on generation-skipping gifts. Special trusts can be included in a will to leave the exempt amount for the benefit of grandchildren without confiscatory tax.

## **19 HOW CAN YOU REDUCE TAXES ON THE LARGER ESTATE?**

What can you do to cope with the death taxes on the larger estate (in addition to the tax-saving trusts discussed earlier)? There are basically three things to consider:

- ▷ You can give property away before you die.
- ▷ You can build up a liquid fund for payment of taxes.
- ▷ You can attempt to freeze or even depress the value for tax purposes of your portfolio and your interest in your closely-held business.

### **19.1 Gifts**

One way you can save on death taxes is to give your property away before you die. But don't give money to your children unless you're sure to have all you will ever need. Remember: one mom can take care of seven children, but seven children can't take care of one mom!

#### **19.1.1 Annual exclusion**

You can give \$13,000 to each child (or anybody else) each year. (A husband and wife can give \$26,000.) This escapes permanently from the gift and estate tax, and no gift tax return is filed. The easy way to do this is for you to make gifts outright to older children. For younger children, you can make gifts easily to a custodian under the Texas Transfer to Minors Act. The custodian will take care of the gift and turn it over to the child at age 21. If you want the money to go to the child later than 21, you can use a trust.

#### **19.1.2 Use tax-free amount**

The tax-free amount can be used during life instead of at death.

### **19.2 Irrevocable Life Insurance Trust**

If you build up a fund with insurance (or other liquid assets) to pay death taxes, the fund itself will often be partly consumed by death taxes. If you want to get this to the children with no estate tax on the husband's or the wife's death, but still need to keep a degree of control, a popular solution is the irrevocable insurance trust. This type of trust does not have to own insurance, but this is the convenient asset.

### **19.2.1 Who can use it?**

The irrevocable life insurance trust is the usual "second step" in tax-saving estate planning for many folks who have already taken the usual "first step" of signing classic tax-saving wills with family trusts. To be a prospect, you should:

- ▷ Have an estate of substantially more than \$3,000,000.
- ▷ Have plenty of cash flow to make gifts.
- ▷ Know exactly who your beneficiaries are.

### **19.2.2 The estate siphon**

One approach is to siphon out of your estate into the life insurance trust each year gifts that are covered by the \$13,000 exclusion for each child (no gift tax return). When you die, the trust is owned by the children, not you, and there is no estate tax. The buildup of cash values inside is tax-free. The eventual receipt of the insurance is also income tax-free to the children.

### **19.2.3 One-pay trust**

Another approach is to make a large gift to the life insurance trust immediately and file a gift tax return. If the gift is less than the tax-free amount, there will be no gift tax unless you have already made large gifts. The gift goes to work tax-free and will make a large amount available to your children when you die without being reduced by income or death taxes.

### **19.2.4 Second-to-die policy**

By using the unlimited marital deduction, you can normally defer tax until the second death. One popular way to take maximum advantage of the life insurance tax shelter is to buy a policy that pays only after both spouses have died and the tax falls due.

### **19.2.5 Support trust**

Another (and more aggressive) plan is to let the insurance trust pay benefits to the surviving spouse for life and then go to the children. The idea is to make income from the insurance trust available to the surviving spouse but not have it included in her estate when she dies.

## **19.3 Charitable Trusts**

Tax-wise, it is sometimes almost better to give than to receive. From this observation an entire industry has arisen, called "planned charitable giving." Example: you have highly-appreciated stock in a corporation that pays only a meager dividend. If you sell it, the gains tax will eat up much of the capital. But if you give the stock to a charitable trust and keep the income of the trust for life, you can sell the stock without a gains tax and reinvest the proceeds to improve your income. You also get an income tax deduction now. And you can be the trustee! But when you die, the trust will go to the charity, and not to your kids. Solution: buy life insurance with the money you saved on your income tax to replace the wealth that will pass from the trust to the charity when you die.

## **19.4 Liquidity**

Nothing beats having cash when estate taxes are due. Where the estate mostly consists of a closely-held business, farm, or ranch, there are various ways of qualifying the estate for installment payments or reduced tax based on agricultural values. But these provisions are very complicated and can backfire if the taxes are deferred while the estate drops in value.

## **19.5 Freeze or Depress the Value**

Here is a brief rundown on current thinking about techniques to freeze or depress the value of your estate for estate tax purposes.

### **19.5.1 Family limited partnership**

A partnership can be set up with family members to hold business assets. Then the parents can give units in the partnership to the children at a substantial discount (for lack of marketability and minority interests) for gift and estate tax purposes. This has been popular in recent years even when the assets in the partnership were just passive investments. But lately the IRS has been winning cases that make it harder to use the family limited partnership with confidence in situations where there isn't an active business in the partnership.

### **19.5.2 Corporate recapitalization**

A corporate recapitalization to freeze the value of a business is possible. You can consider giving common stock to your children while retaining a preferred stock interest in the business for your security in retirement. If the business goes up in value, the increase in value would be reflected in the common stock owned by the children, and your interest in the business would be frozen.

### **19.5.3 Partnership freeze**

You can consider a partnership freeze. Here you would retain a preferred partnership interest in the partnership assets (usually portfolio investments) and give the growth partnership interest to the children. As in the case of the corporate recapitalization, you would have to accurately value the gift.

### **19.5.4 Installment sale**

You can sell a part or all of the business to the children and receive back notes from them for the purchase price. The price must be realistic and the notes must call for reasonable interest, or there will be a gift to the children subject to gift tax. If the business grows, the increase in value will not be in your estate.

### **19.5.5 Private annuity**

In a private annuity, you sell your business (or portfolio investment) to a child for his promise to pay you a certain amount of money each year for the rest of your life. If you follow the IRS rules on how much the child must pay, there will be no gift when the sale is made. If you live for a long time, you have the promise of income. If you die prematurely, the property will not be in your estate, and estate taxes will be saved. The big drawback is that the basis of the property sold will be the amount of the note. But this may not be a problem if the buyer expects to hang on to the assets for the rest of his life and intends to leave it to his heirs with a step-up in income-tax basis. Caution: the IRS has recently been on a campaign against certain private annuities considered to be abusive by the Treasury—you would need to check this out before entering into a private annuity.

### **19.5.6 Minority discount**

A gift of a small percent of ownership in a closely-held business or an investment can often be valued surprisingly low for gift tax purposes. If you give a minority interest in your business to a child, it would be harder to sell than a controlling interest. So the IRS will allow you a "minority interest discount" and value the gift less than its proportionate fraction of the full value of the business. Also, you can whittle down your ownership of the family business through gifts until you own less than a controlling interest. If you haven't been too obvious about your plan, the value of the minority interest that remains in your estate should be marked down to save estate taxes.

### **19.5.7 Buy-sell agreement**

You can have a buy-sell agreement with your children that will be respected by the IRS. But you must show that it was entered into for a bona fide business purposes using realistic values and is not just a technique to sidestep tax.

### **19.5.8 Employment contract**

You can give the business to your children while remaining on the payroll or working with the business as an independent contractor. This is a way to get the growth to them while retaining a reasonable income for your retirement.

### **19.5.9 Frequent appraisals**

Business owners should pay close attention to accurately valuing their interests.

## **19.6 Succession to Business Interests**

If you have a business, your estate plan should get it to the children or employees that should succeed in ownership and management. At the same time, the plan must be fair to the other children (and maybe your spouse) who are not involved in the business. This is a challenging task. Above all, start early and keep everyone informed. Here are some ideas:

### **19.6.1 Identify roles**

If one child is active in the business and others are not, segregate what is being done for the active child as an heir from what is being done for him as an executive.

Consider employee stock options for the active child and a buy-sell agreement where he will pay adequate value.

### **19.6.2 Divide and conquer.**

Transfer (by gift or will) business interests to the active child and other type assets (cash or publicly held stock) to children outside the business. Sometimes real estate used in the business can be transferred to those outside the business, who will then lease it to the business.