THE BASICS OF ESTATE PLANNING

I. INTRODUCTION - WHAT IS AN ESTATE PLAN?

A. An estate plan:

1. Provides for distribution of your property at your death in accordance with your wishes.

2. Provides financial resources for family members after your death.

3. Can address the issue of incapacity during lifetime.

4. Can minimize or eliminate estate tax if planned properly.

B. What happens if I do not have an estate plan?

1. If no estate plan is in place, state law governs the disposition of your estate, and your property passes according to the laws of intestacy (to die "intestate" means that a person dies without a will).

2. The heirs of a person dying intestate depend on whether the decedent was married or single, whether he or she had children, and whether the property was community property or separate property.

3. For an explanation of how the laws of intestacy affect the distribution of property, see II below.

II. LAWS OF INTESTACY

A. Distribution of property under the laws of intestacy depends on whether the property is community property or separate property.

1. Separate Property: property acquired before marriage or property acquired during marriage by gift or inheritance.

2. Community Property: any property acquired during marriage that is not separate property.

A. Community Property

1. If your spouse survives and there are no children or descendants, your spouse inherits all community property, real and personal. Think of real property as real estate, including houses, commercial buildings, and land.

2. If your spouse survives and all children or descendants are children or descendants of you and your spouse, your spouse inherits all community property, real and personal.

3. If your spouse survives and you have children who are not children of both you and your spouse, your spouse keeps his or her one-half of community property and your half of community property passes to your children.

4. If your spouse does not survive, there is no community property, so all property passes as provided in B below.

B. Separate Property

1. If only your spouse survives (no children), your spouse inherits all personal property and one-half of real property outright, and your heirs at law inherit one-half of real property (unless you have no surviving parent, brother or sister or their descendants, then the spouse inherits all real property).

2. If your spouse survives and children or descendants survive, the property is distributed as follows:

   a. Spouse inherits 1/3 of personal property outright and a life estate in 1/3 of real property. A life estate gives the Spouse the right to use and occupy the property for his or her lifetime only.

   b. Children or descendants inherit 2/3 of personal property and real property outright and a remainder interest in other 1/3 of real property. A remainder interest describes what is left after the Spouse's life estate expires.

3. If your spouse does not survive, but children or descendants survive, all personal and real property passes to children/descendants outright.

4. If no spouse or children survive, then the property passes as follows:

   a. To parents equally, but if only one parent survives, one-half to the surviving parent and one-half to brothers and sisters and their descendants (but if no brothers and sisters or descendants, entirely

to surviving parent).b. If parents do not survive, all to brothers and sisters or their descendants equally.

c. If no brothers and sisters or their descendants survive, one-half passes to paternal kindred and one-half passes to maternal kindred.

III. LAST WILL AND TESTAMENT

A. Disposes of Estate According to your Wishes:

A will is a legal declaration of your wishes as to the disposition of the property in your estate. A will must be in writing and signed by the testator (the person making the will) and must also be attested by two witnesses in the presence of the testator (unless the will is wholly in the handwriting of the testator, in which case witnesses are not required).

B. Names Guardian for Minor Children:

If you have minor children, you can name a person to serve as the guardian of your minor children in the event of your death. If you do not name a guardian for your children, the court will appoint a guardian based on a preferential order mandated by statute and taking into consideration the best interest of the child.

C. Trust for Children or other Family Members:

You can also provide for your children (or other family members needing financial assistance) financially through the creation of a trust which will take effect upon your death to provide for the care of the children. The person named as trustee has the ability to distribute money to the children for their support and education without the necessity of creating a guardianship for the child's estate.

D. Names an Executor:

Your will should also name an executor to administer your estate. The executor is the person responsible for probating your will, paying the debts and expenses of the estate and distributing the estate in accordance with the terms of the will.

E. A will must be probated to effectively pass title to property:

The probate procedure in Texas is relatively simple and inexpensive compared to the procedures in other states because Texas law allows for an independent administration, which provides for the administration of an estate with little court involvement and supervision. The probate procedure is described in more detail in IV below.

F. A will can be drafted to include tax planning provisions which help minimize or eliminate estate tax due at your death.

See V below for a more detailed discussion of tax planning.

IV. PROBATE

A. Probate is a court procedure in which a will is proved to be valid and an executor or administrator is appointed to administer the estate.

1. If there is no will, an estate can still be opened, and an administrator is appointed to distribute the property in accordance with the laws of intestate succession (discussed in II above).

2. The administration of an estate in Texas can be dependent or independent:

a. In a dependent administration, the administrator must obtain court approval to sell or invest property, pay debts and expenses of the estate, and distribute the estate to the heirs. After this has all been completed, the administrator must file a final account with the court before being discharged by the court. A dependent administrator is also required to obtain a bond insuring his or her service as administrator.

b. In an independent administration, the executor is free to administer the estate without obtaining court approval for every action. This results in fewer court costs and attorney's fees, which makes the administration of the estate less expensive and usually less time consuming.

c. You can provide for an independent administration in your will or an independent administration can be created if all of the heirs agree. In order to create an independent administration in your will, you must include language required by the Texas statute. If the appropriate language is not used, a dependent administration will result instead.

B. Probate Procedure:

1. File an application to probate the will with the court (or, if there is no will, file an application to open an estate and have the heirs of the decedent determined by the court).

2. Appear in court for a hearing to prove the validity of the will (or determine the heirs if there is no will) and appoint an executor or administrator for the estate.

3. Once the executor or administrator is appointed, the court issues Letters Testamentary or Letters of Administration to the executor/administrator, which authorize the executor/administrator to deal with third parties to administer the estate.

4. Publish a notice to unsecured creditors within 30 days and mail notice to secured creditors within 120 days.

5. File an Inventory, Appraisement and List of Claims with the court within 90 days. The inventory lists all of the assets of the decedent, along with their values as of the date of death.

6. Pay debts, taxes and expenses of administration prior to the final distribution of estate to heirs.

7. File the decedent's final income tax return and file a federal estate tax return, if necessary.

C. Non-Probate Assets

1. There are certain assets which pass at death to a named beneficiary and are not subject to the probate procedure. Because of a beneficiary designation or contractual provision, these assets pass automatically to the person named as the beneficiary and the terms of the will do not affect their disposition.

    a. For example, if a life insurance policy names your spouse as the beneficiary, the proceeds will be paid to your spouse automatically, even if your will says that the proceeds are to be paid to another person.

    b. Non-probate assets can become subject to the probate estate if a beneficiary is not named and the asset becomes payable to your estate instead of to a named beneficiary.

2. Examples of non-probate assets:

    a. Bank or brokerage accounts which are either set up as joint accounts with rights of survivorship or which have a payable on death provision.

    b. Life insurance proceeds.

    c. Retirement plans, IRAs, etc.

3. Even though non-probate assets are not subject to probate, they are still part of the estate for estate tax purposes and are therefore not exempt from estate tax.

V. THE FEDERAL ESTATE AND GIFT TAX

A. The estate and gift tax is a unified tax system that taxes the value of the sum of your gross estate and taxable gifts that are made during your lifetime. Currently, for individuals dying in 2011 and 2012, only estates valued at over $5,000,000 are taxed.

1. The federal estate tax is a tax on the privilege of transferring property at death.

2. Your taxable estate generally includes all assets (both probate and non-probate assets) owned at the time of death, including life insurance policies over which you hold the "incidents of ownership" (e.g., you have the power to name beneficiaries, to terminate the policy, or you are listed as the owner of the policy).

3. The tax is generally payable within nine months of the date of death.

B. The Estate Tax Rate for the years 2011 and 2012 is 35% for any amount in excess of $5,000,000.

C. Texas Inheritance Tax

The State of Texas does not currently impose an inheritance tax.

D. Unified Credit

Each individual has a credit against the estate tax that permits the transfer of up to $5,000,000 (for the tax years 2011 and 2012) tax-free.

E. Expiration of Recent Estate Tax Changes

Without further action by Congress, the estate tax exemption amount will return to $1,000,000 and the highest estate tax rate will return to 55% on January 1, 2013.

F. Unlimited Marital Deduction

1. The marital deduction allows you to leave property to your spouse without paying estate tax, provided that the property is transferred to your spouse in a manner that will cause it to be included in his or her estate at death.

Therefore, the marital deduction does not eliminate the tax; it simply defers the tax until the surviving spouse's death.

2. Although there is certainly an advantage to deferring the estate tax until the death of the surviving spouse, by transferring all of your property to your spouse, you may lose the use of the unified credit against the estate tax.

    a. To avoid possible loss of all or part of the deceased spouse's exemption, you can include tax planning provisions in your will creating a "bypass" trust to utilize the unified credit. At your death, up to $5,000,000 (or the unified credit exemption amount applicable at the time of your death) is transferred to a trust for the benefit of your spouse and/or children. The amounts in the trust are included in your estate, but because the value of the trust will not exceed the unified credit, no tax is due. At the death of the surviving spouse, the amounts in the trust are not included in the surviving spouse's estate and are therefore not subject to the estate tax.

    b. Although under the new law in effect for 2011 and 2012 there is the potential to transfer any unused exemption amount directly to the surviving spouse without using a "bypass" trust described above, that may involve electing that transfer on an estate tax return filed in the estate of the first spouse to die. Such an election is also an option to avoid losing any part of such exemption.

G. Gifts

1. For 2011 and 2012, gifts made during lifetime are also taxable to the extent they exceed the $5,000,000 gift tax exemption (or the lifetime exemption applicable at the time the gift is made). The tax is assessed based upon the value of the property transferred by gift.

2. There is presently a $13,000 annual exclusion against the gift tax which permits a donor to make an unlimited number of gifts to any one donee of up to $13,000 per year[1]. There is no limit on the number of donees; so for example, one person can make ten $13,000 gifts to ten different people, for a total of $130,000 tax-free, as long as any one donee does not receive more than $13,000.

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[1] The Taxpayer Relief Act of 1997 indexes the annual exclusion amount annually for inflation after 1998. The Act provided for a $10,000 annual exclusion, which increased to $13,000 beginning with the 2009 tax year based on inflation.

3. Split Gifts: You and your spouse can elect to split gifts of separate property so that although the property belongs to one spouse, the other spouse can elect to apply his or her annual exclusion amount to one-half of the separate property gift. This allows a married couple to gift $26,000 per donee per year, even if the property is the separate property of one spouse.

4. Any gift made in excess of the annual exclusion is a taxable gift, which requires the donor to file a gift tax return. Unless the gift exceeds the unified credit amount (or the donor has made prior gifts exceeding the unified credit amount), no gift tax will be payable due to the application of the unified credit. The amount of gifts exceeding the annual exclusion amount is added to the value of the donor's estate at death as an adjusted taxable gift.

H. Methods of Reducing Estate Tax Liability

1. Make Annual Exclusion Gifts

You can reduce your estate by making annual exclusion gifts of up to $13,000 (as adjusted for inflation) per donee (e.g., to children, grandchildren, etc.) free of federal gift tax, and over time the size of your estate can be reduced.

2. Utilization of the Unified Credit

As discussed above, the use of a bypass trust in your will can ensure that the unified credit is utilized by transferring a portion of your estate into a trust which can benefit your spouse, but is not included in your spouse's estate, which can result on a substantial savings in estate taxes.

3. Use of the Marital Deduction

As discussed above, an unlimited amount of property can be transferred to a surviving spouse with no estate tax due at the time of the death of the first spouse to die. This does not eliminate the tax, however, because the payment of the tax is simply deferred until the surviving spouse's death.

4. Use of an Irrevocable Trust to Exclude Life Insurance from your Estate

An irrevocable trust can be set up to hold life insurance on you and/or your spouse without the proceeds being includable in your or your spouse's estate at death. This provides liquidity for payment of estate taxes without creating greater estate tax liability.

5. Use of the Charitable Deduction

A gift to a qualified charity at lifetime or at death is deductible against the federal estate and gift tax. Charitable gifts can be made by a direct gift to the charity or through the use of charitable trusts.

6. Use of Unused Exemption by Spouse

In 2011 and 2012, if the executor of an estate elects to do so on an estate tax return, a portion of any unused estate tax exemption can be transferred to the surviving spouse.

VI. TRUSTS

A. A trust is a legal entity created by a grantor/trustor for the benefit of another (called a beneficiary) in which a trustee manages the property for the benefit of the beneficiaries.

B. Types of Trusts:

1. Testamentary Trust - a trust created by and contained in a will.

2. Inter Vivos or Living Trust - a trust created during lifetime.

3. Revocable Trust - a trust that can be amended or revoked.

4. Irrevocable Trust - a trust that cannot be amended or revoked.

C. Use of Trusts in Estate Planning

1. A trust can be used for the support of minor children after the death of a parent without the necessity of creating a guardianship.

2. A trust can be used to minimize or eliminate estate taxes by utilizing the unified credit against the estate tax (see discussion at V.F.2).

3. A trust can be used to exclude certain assets from an estate (such as the use of trusts to hold life insurance policies).

4. A trust can be used to provide for the educational needs of a child or grandchild.

5. A trust provides a vehicle for the management of trust property for the benefit of the trustor or for incapacitated or minor beneficiaries.

D. Use of Living Trust to Avoid Probate

1. It is possible to set up a living trust which provides for the disposition of your property at death without the necessity of probating a will.

   a. A trust is created by executing a Trust Agreement, which contains a set of instructions to the trustee of how the property is to be managed and how the property is to be distributed after your death.

   b. When the trust is created, you should also execute a new will, known as a "pour-over" will, that will transfer any assets held by you individually at death into the trust.

   c. After the trust is created, all assets must be transferred into the trust in order for the terms of the trust to govern their disposition. Any probate asset that is not held in the name of the trust will require that your pour-over will be probated in order to dispose of that asset.

   d. The trust may contain the same tax-planning provisions as a tax-planned will (i.e., a bypass trust provision) to reduce or eliminate estate taxes.

2. Advantages to the use of a living trust:

   a. Any assets held by the trust are not subject to probate.

   b. The trust can be amended or revoked at any time.

   c. The trust can help plan for incapacity by naming a substitute trustee who can take over the management of the trust assets in the event the original trustee becomes unable to manage the property.

   d. If you have property in more than one state, can avoid ancillary probate proceedings in the other states.

   e. The terms of the trust are private and are not required to be filed of public record.

3. Disadvantages:

   a. A trust requires a higher initial cost to set up than simply executing a will.

b. Must transfer all assets into the trust to enjoy all benefits of creating the trust. If you fail to transfer any probate asset into the trust, your will must still be probated.

c. Administrative complications of maintaining records of trust as a separate entity and making sure that all new assets are acquired in the name of the trust.

4. Note regarding "Living Trusts":

Living Trusts are a highly publicized method of avoiding probate. However, in Texas, due to the availability of an independent administration, probate proceedings are much less cumbersome and expensive and the avoidance of probate is not usually necessary. Therefore, creating a living trust in Texas solely for the purpose of avoiding probate is generally not necessary.

VII. INCAPACITY

A. An incapacitated person as defined in the Texas Probate Code means an adult individual who, because of a mental or physical condition, is substantially unable to provide food, clothing, or shelter for himself or herself, to care for the individual's own physical health, or to manage the individual's own financial affairs.

B. Guardianship

1. If an individual becomes incapacitated, a court can appoint another person to act as a guardian of the person and/or estate of the incapacitated person. The Probate Code provides a priority of persons who are entitled to serve as guardian for an incapacitated individual.

a. A guardian of the person is entitled to the charge and control of the person who is incapacitated, including the right to have physical possession of the ward, the duty of care, the duty to provide the ward with clothing, food and shelter, and the power to consent to medical treatment.

b. A guardian of the estate is entitled to the possession and management of all property belonging to the ward, and the guardian has the duty to manage the estate as a prudent person would manage the person's own property.

2. Declaration of Guardian - you can name another to serve as guardian for you in the event a guardianship is ever deemed necessary. In addition, you can also specifically name any person that you do *not* want to serve as your guardian.

C. Disadvantages of Guardianships

1. Court proceedings can be expensive and emotionally difficult for the family to have a court officially declare their family member incapacitated.

2. The guardian will be required to post a bond to protect the assets of the incapacitated person's estate.

3. The guardian will be required to file annual accounts with the court, and will be required to obtain court permission before taking any action with regard to the assets of the estate (e.g., to sell property, to make certain types of investments, etc.).

D. Planning for Incapacity

1. Revocable Living Trust - the trust agreement can name a successor trustee to manage the trust property in the event the original trustee becomes incapacitated (however, the successor trustee will only have the ability to manage the assets that have actually been transferred to the trust).

2. Durable Power of Attorney - a durable power of attorney gives the person named as the agent (also known as the "attorney-in-fact") the authority to act on behalf of the principal with respect to the principal's property and financial affairs.

a. "Durable" means that the power of attorney is not affected by the subsequent disability or incapacity of the principal.

b. The power of attorney can either become effective immediately or it can become effective only when the principal actually becomes incapacitated (known as a "springing power of attorney"). If a springing power of attorney is used, the agent may have problems proving to the third person who is relying on the power of attorney that the principal is actually incapacitated. Therefore, it is generally recommended that the power of attorney be made effective immediately so that the problems in dealing with third parties are minimized.

3. Durable Power of Attorney for Health Care - gives the agent the authority to make any and all health care decisions for the principal in accordance with the principal's wishes, including moral and religious beliefs, when the principal is no longer capable of making those decisions.

4. Directive to Physicians - a document which directs that if the person executing the document has an incurable or irreversible condition certified to be terminal by two physicians, and if the application of life-sustaining procedures would only serve to artificially prolong death, then those procedures are to be withheld or withdrawn and the person is permitted to die naturally.

VIII. CONCLUSION

The intent of this information is to provide you with a basic understanding of the issues that need to be considered when developing an estate plan. Obviously it is not an exhaustive reference, so you are encouraged to ask questions about any issue that you do not understand or would like to know more about. We appreciate your interest in our firm and look forward to working with you.