

THE BRAVE NEW WORLD OF ESTATE PLANNING

PRESENTED BY:

ARIELLE M. PRANGNER

WRITTEN BY:

MELISSA J. WILLMS & MICKEY R. DAVIS

Davis & Willms, PLLC

3555 Timmons Lane, Suite 1250

Houston, Texas 77027

(281) 786-4500

melissa@daviswillms.com

mickey@daviswillms.com

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MELISSA J. WILLMS

Davis & Willms, PLLC

Board Certified - Estate Planning and Probate Law

Texas Board of Legal Specialization

Master of Laws (LL.M.) in Tax Law

3555 Timmons Lane, Suite 1250

Houston, Texas 77027

Phone (281) 786-4500

Fax (281) 742-2600

melissa@daviswillms.com

EDUCATION:

- LL.M., Tax Law, University of Houston Law Center, 1996
- J.D., Texas Tech University School of Law, 1992
- B.A., Psychology, B.A., Sociology, University of Texas at Austin, 1987

OTHER QUALIFICATIONS:

- Fellow, The American College of Trust and Estate Counsel (ACTEC)
- Board Certified, Estate Planning and Probate Law, Texas Board of Legal Specialization
- Best Lawyers in America, Trusts and Estates
- Admitted to Practice: State Bar of Texas; Federal District Court for the Southern District of Texas; United States Tax Court

PROFESSIONAL ACTIVITIES:

- Real Estate, Probate and Trust Law Section, State Bar of Texas, (Member, Decedents' Estates Committee, 2011-present)
- Tax Section, State Bar of Texas (Council Member, 2013-2015; Vice Chair, Estate and Gift Tax Committee, 2011-present)
- Fellow, Texas Bar Foundation
- Member, State Bar of Texas (Sections of Real Estate, Probate and Trust Law; Tax); Houston Bar Association (Section of Probate, Trusts and Estates); The College of the State Bar of Texas; Houston Estate and Financial Forum

RECENT SPEECHES AND PUBLICATIONS:

- Co-Author/Panelist: *It Slices, It Dices, It Makes Julianne Fries: Cutting-Edge Trust Tools*, State Bar of Texas 20th Annual Advanced Estate Planning Strategies Course, 2014
- Author/Speaker: *End-of-Life Issues*, State Bar of Texas Advanced Elder Law Course, 2014
- Co-Author/Speaker: *The Brave New World of Estate Planning*, San Antonio Estate Planners Council's Docket Call in Probate Court, 2014
- Comment letter to Department of Treasury on behalf of the Tax Section of the State Bar of Texas on proposed regulations regarding reporting of net investment income tax by trustees of charitable remainder trusts, February 20, 2014
- Author: *Decanting Trusts: Irrevocable, Not Unchangeable*, 6 EST. PLAN. & COMMUNITY PROP. L.J. 35, 2013
- Author: *What Happens After Death?*, The Houston Lawyer, Nov./Dec. 2013 issue
- Co-Author/Panelist: *Trust and Estate Planning in a High-Exemption World and the 3.8% "Medicare" Tax: What Estate and Trust Professionals Need to Know*, The University of Texas School of Law 61st Annual Tax Conference – Estate Planning Workshop, 2013; Amarillo Estate Planning Council 23rd Annual Institute on Estate Planning, 2014
- Author/Speaker: *The Net Investment Income Tax: A Trust and Estate Perspective*, Wednesday Tax Forum, 2013
- Author/Panelist: *Affordable Care Act: A Trust and Estate Perspective*, State Bar of Texas 31st Annual Advanced Tax Law Course, 2013
- Author/Speaker: *Between Death and Probate: Practical Items of Esoterica*, State Bar of Texas 37th Annual Advanced Estate Planning and Probate Course, 2013
- Co-Author/Speaker: *Planning for No Probate: Special Issues with Revocable Trusts and Nonprobate Assets*, Hidalgo County Bar Association, 2013 Probate, Trust & Guardianship Law Course, 2013
- Testimony at public hearing before the United States Department of Treasury and Internal Revenue Service on proposed Section 1411 regulations concerning net investment income tax, Washington, D.C., April 2, 2013
- Comment letter to Department of Treasury on behalf of the Tax Section of the State Bar of Texas on proposed regulations regarding net investment income tax under Section 1411 of the Internal Revenue Code, March 4, 2013
- Author/Speaker: *Living with the "New" Estate Tax*, Houston Bar Association, Probate, Trusts and Estates Section, 2013
- Author: *Decanting Irrevocable Trusts*, Texas Tax Lawyer, Fall 2012 issue
- Author/Speaker: *Estate Planning Pitfalls*, Houston CPA Society 26th Annual Personal Financial Planning Conference, 2012
- Author/Speaker: *Trust Decanting: Why, What, How . . . and More*, Texas Bankers Association, Advanced Trust Forum, 2012
- Author/Speaker: *Decanting Irrevocable Trusts*, State Bar of Texas 36th Annual Advanced Estate Planning and Probate Course, 2012
- Comment letter to Department of Treasury on behalf of the Tax Section of the State Bar of Texas concerning transfers by a trustee from an irrevocable trust to another irrevocable trust (sometimes called "Decanting"), May 22, 2012
- Co-Author/Panelist: *Planning for No Probate: Special Issues with Revocable Trusts and Nonprobate Assets*, State Bar of Texas 18th Annual Advanced Estate Planning Strategies Course, 2012

MICKEY R. DAVIS
Davis & Willms, PLLC

Board Certified - Estate Planning and Probate Law
Texas Board of Legal Specialization
3555 Timmons Lane, Suite 1250
Houston, Texas 77027
Phone (281) 786-4500
Fax (281) 742-2600
mickey@daviswillms.com

EDUCATION:

- University of Texas School of Law, J.D. with High Honors, 1982. Chancellors; Order of the Coif; Associate Editor, Texas Law Review; Member, Board of Advocates
- University of Arizona, B.B.A. with High Distinction, 1979. Beta Alpha Psi; Beta Gamma Sigma

OTHER QUALIFICATIONS:

- Fellow, The American College of Trust and Estate Counsel (ACTEC), (Chairman: Estate & Gift Tax Committee; Member: Business Planning, Fiduciary Income Tax, and Program Committees)
- Board Certified, Estate Planning and Probate Law, Texas Board of Legal Specialization
- Adjunct Professor, University of Houston School of Law, 1988–2013, teaching Income Taxation of Trusts and Estates and Postmortem Estate Planning
- Best Lawyers in America, Trusts and Estates
- Named Best Lawyers' 2013 Houston Trusts and Estates "Lawyer of the Year"
- Named by Texas Lawyer as a 2013 "Top Notch Lawyer" for Trusts and Estates
- Admitted to Practice: State Bar of Texas; Federal District Court for the Southern District of Texas; United States Tax Court
- Certified Public Accountant, Texas, Certified 1983

PROFESSIONAL ACTIVITIES:

- Editor, ACTEC Law Journal (2012-2013)
- Member of the Board of Directors, ACTEC Foundation (Chairman: Grant-making Committee)
- Member, State Bar of Texas (Sections of Real Estate, Probate and Trust Law; Tax); Houston Bar Association (Probate, Trusts and Estates Section); The College of the State Bar of Texas; Houston Estate and Financial Forum
- Member, Texas Society of Certified Public Accountants, Houston Chapter
- Estate Planning and Probate Law Exam Commission, Texas Board of Legal Specialization (Member 1993-2003, Chair 2000-2003)

RECENT SPEECHES AND PUBLICATIONS:

- Co-Author: Streng & Davis, RETIREMENT PLANNING—TAX AND FINANCIAL STRATEGIES (2nd ed., Warren, Gorham & Lamont (2001, updated annually)
- Co-Author/Panelist: *Recipes for Income and Estate Planning in 2014*, State Bar of Texas 20th Annual Advanced Estate Planning Strategies Course, 2014
- Co-Author/Speaker: *Income Taxation of Trusts and Estates—Ten Things Estate Planners Need to Know*, Southern Arizona Estate Planning Council, 2014
- Co-Author/Panelist: *The American Taxpayer Relief Act of 2012 One Year Later*, Houston Estate and Financial Forum, 2014
- Author/Speaker: *Funding Unfunded Testamentary Trusts*, University of Miami 48th Annual Heckerling Institute on Estate Planning, 2014
- Co-Author/Panelist: *Trust and Estate Planning in a High-Exemption World and the 3.8% "Medicare" Tax: What Estate and Trust Professionals Need to Know*, The University of Texas School of Law 61st Annual Tax Conference – Estate Planning Workshop, 2013; Amarillo Estate Planning Council 23rd Annual Institute on Estate Planning, 2014
- Author/Speaker: *Who Is Your Spouse? The Demise of DOMA and Its Impact on Estate Planning in Texas*, Attorneys in Tax and Probate (Houston), 2013
- Author/Speaker: *Tax Considerations in Lawsuits and Settlements*, Texas Society of CPAs Advanced Estate Planning Conference, 2013
- Co-Author/Speaker: *Taxes for Trusts and Estates—New Taxes, New Rates, New Challenges*, State Bar of Texas 37th Annual Advanced Estate Planning and Probate Course, 2013
- Co-Author/Speaker: *Estate and Trust Planning: Why You Can't Ignore Tax Issues Despite Portability and High Exemptions*, Hidalgo County Bar Association, 2013
- Co-Author/Speaker: *Living With the "New" Estate Tax—New Taxes, New Rates, New Challenges*, 18th Annual Texas Society of CPAs CPE by the Sea, 2013
- Co-Author/Panelist: *Planning and Administering Estates and Trusts: The Income Tax Consequences You Need to Consider*, ACTEC-ALI CLE Phone Seminar, 2013
- Author/Panelist: *Funding Testamentary Trusts: Tax and Non-Tax Issues*, State Bar of Texas 19th Annual Advanced Estate Planning Strategies Course, 2013
- Author/Speaker: *Warning! Your Annual Exclusion May Be an Illusion*, ACTEC 2013 Annual Meeting
- Co-Author/Panelist: *Using the \$5 Million Gift Tax Exemption: A 2012 Toolbox*, State Bar of Texas 18th Annual Advanced Estate Planning Strategies Course, 2012; Attorneys in Tax and Probate (Houston), 2012

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THE BRAVE NEW WORLD OF ESTATE PLANNING

1. INTRODUCTION¹

This outline is intended as an overview of traditional estate planning principles, interpreted in light of the American Taxpayer Relief Act of 2012 ("ATRA 2012") which was passed by Congress on January 2, 2013 and signed into law on January 4, 2013. The material emphasizes fundamental techniques common to single or married couples who reside in Texas and addresses some of the problems that may arise. A detailed knowledge of estate planning is not assumed.

2. ESTATE AND GIFT TAXATION

The federal transfer tax system imposes a tax on the right to transfer assets, whether by gift or at death. IRC §§ 2001(a); 2501(a)(1). Estate and gift taxes are unified under one rate schedule. *See* IRC § 2502(a)(1). Although gifts are reported on an annual basis, the system contemplates a single lifetime account. *Id.* All taxable transfers, whether by gift or at death, are added together to determine the ultimate tax liability. IRC § 2001(b).

a. Historical Perspective. Prior to 2002, each person had a "unified" transfer tax credit which could be used to offset estate and gift taxes. IRC §§ 2010, 2505. This credit effectively sheltered a set amount of transfers (by gift or at death) without incurring any transfer tax. The Economic Growth and Taxpayer Relief Reconciliation Act of 2001 ("EGTRRA") "de-unified" the estate and gift tax credit, with the estate tax exemption exceeding the \$1 million lifetime gift tax exemption from 2004 through 2009. The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, P.L. 111-312 ("TRA 2010") re-unified the estate, gift and GST tax exemptions, increasing them to \$5 million for 2011, with an inflation adjustment for 2012. In 2013, the law was scheduled to revert to the law in effect in 2001, immediately prior to the enactment of EGTRRA. ATRA 2012, however, made the changes to the gift, estate and GST exemptions from TRA 2010 "permanent," while increasing the effective rate

on the excess from 35% to 40%. As a result, we have permanent, unified estate, gift and GST tax laws with an exemption of \$5,000,000, adjusted annually for inflation after 2010, and a top tax bracket of 40%. For 2014, after applying the inflation adjustment, the exemption is \$5,340,000. For reference, a chart outlining the estate tax exemption over the last several years is as follows:

Year of Death	Applicable Exemption or Exclusion Amount	Top Marginal Rate
1997	\$600,000	55%
1998	\$625,000	55%
1999	\$650,000	55%
2000	\$675,000	55%
2001	\$675,000	55%
2002	\$1,000,000	50%
2003	\$1,000,000	49%
2004	\$1,500,000	48%
2005	\$1,500,000	47%
2006	\$2,000,000	46%
2007	\$2,000,000	45%
2008	\$2,000,000	45%
2009	\$3,500,000	45%
2010	\$5,000,000 or unlimited ²	35% or 0%
2011	\$5,000,000	35%
2012	\$5,120,000	35%
2013	\$5,250,000	40%
2014	\$5,340,000, as adjusted for inflation	40%

² TRA 2010 permitted the executor of the estate of a decedent dying in 2010 to opt out of the estate tax, at the cost of foregoing in large part an adjustment to the cost basis of the decedent's assets at death.

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b. 2010 Decedents' Estates. As the foregoing table illustrates, EGTRRA provided that no estate tax applied to estates of decedents dying in 2010 (although the gift tax, with its \$1,000,000 exemption, continued to apply). However, TRA 2010 retroactively re-enacted the estate tax for 2010 estates, with a \$5 million exemption. Representatives of decedent's estates who died in 2010 could elect, however, whether to have the estate tax regime apply. If the representative chose the unlimited estate-tax-free regime by filing an IRS Form 8939, the assets of the estate would receive only a limited step-up (and no step-down) in basis for income tax purposes.

c. Terminology. The gift and estate tax exemptions technically operate through the use of a lifetime tax credit that exactly eliminates the tax on the exempt amount. For most clients, however, it is easier to understand this concept by referring to the exemption equivalent. Technically speaking, the Internal Revenue Code now describes the unified credit as the "Applicable Credit Amount," which is the tentative tax imposed on an exemption equivalent (now called the "Applicable Exclusion Amount").

d. Tax Rates. As noted in the table above, the top effective gift, estate and GST tax rate was 55% through 2001, 50% in 2002, and then decreased by 1% each year until 2007 when it reached 45%. TRA 2010 decreased the rate further to 35% for 2010 through 2012, but ATRA 2012 increased the top effective rate to 40%. IRC § 2001(c)(1).

e. Annual Exclusions. Annual gifts of up to \$14,000 per donee can be made without using any of the tax credit amount. This \$14,000-per-donee amount is referred to as the "annual exclusion." IRC § 2503(b). While the Internal Revenue Code states that the annual exclusion is \$10,000 per donor per donee per year, the Taxpayer Relief Act of 1997 ("TRA '97") provides for an inflation adjustment of this amount beginning in 1999, although the adjustment is rounded to the next lowest \$1,000. The annual exclusion increased from \$10,000 to \$11,000 in 2002, increased to \$12,000 in 2006, increased to \$13,000 in 2009, and increased to \$14,000 in 2013. Since each donor gets an annual exclusion, a married couple can currently give \$28,000 per year to any number of donees without

any gift tax impact. Also excluded from gifts are the costs of tuition paid directly to a college, and costs of medical care paid directly to the care provider. IRC § 2503(e). However, contrary to a commonly held belief, birthday, holiday, and other possibly nominal gifts do count.

3. TESTAMENTARY PLANNING³ FOR MARRIED⁴ COUPLES

a. Using a "Bypass" Trust. The fundamental technique of testamentary estate planning for moderately wealthy couples has traditionally involved the use of a Bypass Trust. This trust insures that a married couple takes advantage of each of their \$5,340,000 exemptions (or whatever the current Applicable Exclusion Amount may be), so that an aggregate of twice that amount can pass without estate taxation by the time of the second spouse's death. The Bypass Trust, also known as the "Family Trust," and its features are described below.

i. The Unlimited Marital Deduction. Since 1982, the transfer tax system has focused on transfers of property among generations. Subject to certain exceptions described below, no tax is imposed upon transfers of property between spouses. This result is obtained by allowing for a deduction for the value of property passing to one's spouse. In general, an *unlimited* amount of property can pass between spouses without estate or gift tax, so long as the recipient spouse is a U.S. citizen. The deduction permitting this tax-free transfer to spouses is referred to as the "unlimited marital deduction." IRC § 2056.

ii. Use of Testamentary Trusts. For couples whose combined net worth is never expected to

³ Although the following discussion focuses on testamentary estate planning through the use of a will, planning may be appropriate through the use of a revocable trust. A revocable trust would embody the same planning principles that would be effective at death, but under a different wrapper that could provide management assistance during life through the use of a trustee, and may address privacy concerns that the client may have as to the disposition of his or her estate.

⁴ Revenue Ruling 2013-17, 2013-38 IRB 201, (08/29/2013) expressly adopts a place-of-celebration rule for determining marital status, stating, "[I]ndividuals of the same sex will be considered to be lawfully married under the Code as long as they were married in a state whose laws authorize the marriage of two individuals of the same sex, even if they are domiciled in a state that does not recognize the validity of same-sex marriages."

exceed the Applicable Exclusion Amount, the increased unified credit and the unlimited marital deduction help ensure the availability of “simple” Wills without concern for estate taxes. The advent of the unlimited marital deduction does not mean, however, that it is appropriate for all couples to transfer all assets outright to a spouse. For creditor protection and other reasons as discussed below, other alternatives may be more appropriate. Diagram #1A depicts a typical trust plan under current law, assuming an \$11 million community estate, with each spouse thus having an estate of \$5.5 million, and assuming that the husband (“H”) is the first to die. (Because of community property rules, the order of deaths does not impact the tax analysis).

(1) Under current tax laws, H can leave his entire estate to his wife (“W”) outright without taxation. The unlimited marital deduction would make the value of H’s estate zero upon his death (\$5.5 million less \$5.5 million passing to W). However, this would increase W’s estate to \$11 million, effectively stacking the estates and “wasting” H’s exemption. Disregarding inflation or consumption, this would expose over \$5 million (\$11 million estate, less her exemption equivalent of \$5.34 million in 2014) to taxation, for a tax of \$2,264,000.

(2) It is not necessary to pass H’s entire estate of \$5.5 million to W to avoid taxation. The first \$5.34 million worth of H’s estate is *already* tax-free because of H’s Applicable Exclusion Amount, not because of the unlimited marital deduction. Accordingly, only the excess over this exempt amount needs to pass to W to eliminate the tax.

(3) Upon H’s death in 2014, he could pass \$5.34 million of his estate (or whatever amount is tax-free in the year of H’s death) to a “Bypass Trust.” This amount is tax-free when H dies (due to his exemption amount), and the trust assets are again tax-free when W dies (since they are not part of her estate). In other words, the entire amount remaining in the Bypass Trust at W’s death bypasses the estate tax at her death. The remaining \$160,000 in H’s estate passes to W, which eliminates the tax, due to the “marital deduction.” W’s estate increases to \$5.66 million (her \$5.5 million, plus the \$160,000 she inherited outright from H). The \$5.34 million placed

in the Bypass Trust is not taxed at the second death, regardless of the value of the property at that time.

(4) When W dies, her estate of \$5.66 million will be able to utilize her exemption equivalent of \$5.34 million (or whatever the exemption is in the year of her death) to offset any estate tax at that time. The tax on the remaining \$320,000 will be \$128,000—a net savings to the children (ignoring inflation) of \$2,136,000 (\$2,264,000 less \$128,000). This example is illustrated in Diagram #1B.

iii. Typical Bypass Trust Provisions. The provisions of the typical Bypass Trust are simple and straight forward.

(1) Distributions are permitted for the health, education, support and maintenance of the surviving spouse (often abbreviated as “HEMS”).

(a) This is the “ascertainable standard” that prevents the trust assets from being part of the spouse’s estate, even if she is the trustee of the trust. IRC § 2041; Treas. Reg. § 20.2041-1(c)(2).

(b) Distribution language that uses words such as “comfort” and “welfare” should be avoided if the surviving spouse is to be a trustee. Treas. Reg. § 20.2041-1(c)(1); Rev. Rul. 77-194, 1977-1 CB 283.

(c) Unlike a marital deduction trust (described below), which must pay all income to a surviving spouse, it is preferable *not* to require automatic distribution of the Bypass Trust’s income to the spouse. Instead, income distributions should be discretionary, in order to maintain income tax flexibility. In addition, since the property in this trust will avoid estate taxation when the surviving spouse dies, it may be desirable to allow this trust to retain its income and growth to the extent that other funds are available to the family.

(2) Usually, distributions to descendants would be permitted.

(a) Income tax savings can perhaps be achieved by distributions to descendants who are in lower tax brackets than the surviving spouse. See IRC §§ 661; 662. The trust will be a new taxpayer, requiring additional bookkeeping and accounting separate from the surviving spouse’s individually held assets. In addition, beginning in 2013, an additional

3.8% tax is assessed on certain amounts of a trust's undistributed net investment income.⁵ IRC § 1411.

(b) The surviving spouse can be given a veto power over distributions to descendants, so that the spouse retains control over the trust assets. This veto power is a common provision where the children are grown, and someone other than the spouse is serving as trustee.

(3) The surviving spouse is sometimes given a "special" power of appointment to direct disposition of trust assets by Will or during lifetime.

(a) The power of appointment permits the spouse to take a "second look" at family needs in deciding how assets should be distributed and incorporates additional flexibility in the estate plan.

(b) In order to avoid giving the surviving spouse a "general" power of appointment (which would cause inclusion of the Bypass Trust in the surviving spouse's estate), language should be included expressly prohibiting appointment to the "surviving spouse, his or her estate, his or her creditors or the creditors of his or her estate." Treas. Reg. § 20.2041-1(c)(1).

(c) Some people prefer to require equal distributions among children upon the termination of the trust, without giving the surviving spouse the power to alter this arrangement.

(4) The surviving spouse may also be given the right to withdraw property from the trust for any reason. Neither the granting of this withdrawal right nor its lapse will cause the entire trust to be included in the surviving spouse's estate, so long as the right is limited to the greater of \$5,000 or five percent of the value of the trust property per year. IRC § 2041. (Caution: Any unlapsed amount subject to withdrawal at the surviving spouse's death would be taxed in the spouse's estate.)

(5) The trust should include spendthrift trust provisions so that the assets are protected from claims of the surviving spouse's creditors, as well as creditors of any other permissible trust beneficiaries.

iv. Trustee Appointments. There are no special restrictions affecting trustee appointments.

(1) Many people are resistant to utilizing trusts in estate planning because of a mistaken belief that non-family trustees are required.

(2) The surviving spouse may be (and often is) the sole trustee.

(3) Management assistance may be built into the Will, either through appointing one or more other individuals to serve as the trustee (or as a co-trustee), through appointment of a corporate trustee, through an authorization to hire investment advisors for the trust, or through some combination of these methods.

(4) If distribution powers broader than HEMS are desired, an independent trustee should be appointed. An independent trustee can be given the authority to make distributions to the spouse and other family members in any amount and without regard to any standard. Caution should be exercised when granting broad powers to an independent trustee, since the IRS has taken the position that if a beneficiary has the right to replace the independent trustee, the beneficiary has the powers of the trustee. *See* PLR 8916032. The IRS has agreed that removal and replacement powers won't attribute trustee powers to the beneficiary, so long as the successor trustee is not a related or subordinate party. *See* Rev. Rul. 95-58, 1995-2 CB 191.

v. Planning for Estates Under the Applicable Exclusion Amount. Simple Wills without trust planning are often recommended for estates smaller than the Applicable Exclusion Amounts for both spouses. Trust planning may be important, however, even for relatively modest estates. The tax savings for a couple with an estate of \$11 million is approximately \$2,100,000. Lack of planning would cost the couple's children over 19% of the total estate at the time of the second spouse's death.

(1) Impact of Growth. Even with a much smaller estate, the impact of inflation and investment growth could make the savings dramatic. Consider a couple with an estate of \$2 million at the death of the first spouse, using 2014 tax rates and brackets for illustration.

⁵ A discussion of the 3.8% net investment income tax and its application to trusts is beyond the scope of this paper.

(a) Taxes without trust planning.

(i) If the first spouse's property passes outright to the surviving spouse, and if the surviving spouse lives for 20 years, a \$2 million estate growing at a 7% rate would increase to approximately \$7.7 million.

(ii) If the Applicable Exclusion Amount is \$5,340,000 at the surviving spouse's death, \$2,400,000 could be subject to tax in the amount of \$960,000.

(b) Taxes with trust planning.

(i) The Bypass Trust, funded with only one-half of \$2 million, or \$1 million, at the time of the first death, would incur no tax, despite the fact that it has grown to almost \$4 million at the death of the second spouse.

(ii) Survivor's estate of almost \$4 million would not incur any tax either, since it is under the surviving spouse's Applicable Exclusion Amount.

(iii) Thus, the savings obtained through the use of a Bypass Trust in this relatively modest estate is \$960,000.

b. Portability. TRA 2010 added, and ATRA 2012 made permanent, the notion of "portability" of a deceased spouse's unused Applicable Exclusion Amount. In essence, portability provides that upon the death of one spouse, the surviving spouse inherits any unused federal estate tax exemption of the deceased spouse, i.e. the deceased spouse's unused exemption amount can be ported to the surviving spouse. IRC § 2010(c)(2)(B). The unused exclusion amount is referred to in the statute as the "deceased spousal unused exclusion amount," otherwise known as the "DSUE amount." Once a spouse inherits his or her DSUE amount, the surviving spouse can use the DSUE amount either for gifts by the spouse or for estate tax purposes at the surviving spouse's subsequent death. An individual can only use the DSUE amount from his or her "last deceased spouse." To understand how portability works, assume, for example, that H dies in 2011 with an estate of \$3 million. He leaves \$2 million to his wife W, and the balance to his children. As a result, his taxable estate is \$1 million. H's executor could elect to file an estate tax return using \$1 million of H's

\$5 million estate tax exemption to shelter the gift to the children, and pass the other \$4 million of H's estate tax exemption (his "DSUE amount") to W. W would then have an estate and gift tax exemption of \$9 million (her own \$5 million exemption⁶ plus H's DSUE amount of \$4 million).

i. Disadvantages of Portability vs. Bypass Trusts. While portability will be a beneficial "second best" choice for estates of decedents who did no estate tax planning, most estate planners will continue to recommend bypass trust planning as the best alternative for married couples with potentially taxable estates. This is so for a variety of reasons:

(1) Need to Elect. Portability works only if H's executor files an estate tax return (IRS Form 706) electing to pass the unused exemption to the spouse. IRC § 2010(c)(5). Although the Form 706 may be filed with some simplified reporting allowed for marital and charitable bequests, executors of relatively modest estates may see the cost of filing a complete estate tax return as a high price to pay to get the potential benefit of portability.

(2) No Creditor/Divorce/Control Protection. Leaving property to one's spouse in a Bypass Trust affords a number of non-tax benefits which are not available if no trust is used. In particular, the assets passing to the spouse via a Bypass Trust: (1) are exempt from attachment by the creditors of the surviving spouse; (2) can't become commingled, and thereby be subject to loss in a divorce if the surviving spouse remarries and then divorces; and (3) are assured to pass to the persons designated as beneficiaries by the deceased spouse (unless the surviving spouse is given and exercises a power of appointment over the Bypass Trust assets).

(3) No Shelter of Growth. Assets passing to the Bypass Trust are exempt from estate tax at the second death regardless of the value of those assets at that time. Thus, a spouse could pass up to \$5 million worth of property (\$5.34 million in 2014) to a Bypass Trust, and all of those assets, plus appreciation, would pass to the next generation, free of estate tax. Portability provides the surviving spouse with only

⁶ Although recognizing the Applicable Exclusion Amount is adjusted each year for inflation, \$5 million will be used for illustration purposes to make the math easier.

the DSUE amount, but the DSUE amount is not adjusted for inflation or growth. At the same time, keep in mind that although the growth in a Bypass Trust is sheltered from estate tax at the second death, the assets in the trust will not receive a new basis (whether stepped up or down) at second death.

(4) No GST Exemption. Portability applies only to the deceased spouse's estate tax exemption—not to the deceased spouse's GST tax exemption. By proper allocation of the GST exemption to the Bypass Trust, a married couple can effectively double the amount of property that will avoid estate taxation upon the death of their children. This doubling is lost if a Bypass Trust is foregone in favor of portability.

(5) Possible Loss upon Remarriage. The surviving spouse is entitled to use the DSUE amount only of the most recently deceased spouse, i.e. the "last deceased spouse." IRC § 2010(c)(4)(B)(i). If the surviving spouse remarries, and the new spouse then dies, the new spouse (who may have a substantial estate, or whose estate may not file an estate tax return to pass along any DSUE amount), becomes the last deceased spouse. Unless the surviving spouse makes large taxable gifts before the new spouse's death, any unused DSUE amount of the first spouse to die is then lost.

ii. Portability Should be Discussed with Clients. Although portability should be discussed with couples when they are considering tax planning in their Wills, in many instances the other benefits of a Bypass Trust may make it preferable to use Bypass Trust planning rather than relying solely on portability.

iii. Portability and Bypass Trust Planning Are Not Mutually Exclusive. Because of the high estate tax exemption under current tax law, most estates will have excess exemption. Even for estates with Bypass Trust planning, the value of the estate may be less than the exemption amount, and portability is still available to pass any unused exemption to the surviving spouse. So, don't forget that Bypass Trust planning and portability are not "either/or" propositions. Even if the decedent's Will included a Bypass Trust, the executor may still need to consider whether to make a portability election. If the estate

of the first spouse is not large enough to use his or her full exemption amount, if the Bypass Trust is not fully funded, or if for any other reason there is any "excess" exemption, it may be smart to elect portability in addition to utilizing a Bypass Trust.

c. Bypass Trust Planning by Disclaimer. Many couples have combined community estates of less than the Applicable Exclusion Amount, which they anticipate will grow to exceed that amount prior to the death of both spouses. Other people have estates that exceed this threshold, but who anticipate a decline in value as life insurance is discontinued, or retirement lifestyles begin to consume savings. Some clients choose to rely on portability and want to avoid the use of trusts if possible. A planning option for these couples is to utilize qualified disclaimers to provide flexibility.

i. Simple Wills. Wills are drafted to pass all property to the surviving spouse.

ii. Contingent Bypass Trust. Wills also contain a Bypass Trust to receive any property disclaimed by the surviving spouse.

iii. "Second Look" Through Disclaimer. When the first spouse passes away, the surviving spouse can take a "second look" at their financial and tax picture.

(1) If the total combined estates will be less than the Applicable Exclusion Amount then in effect, the survivor can accept the outright bequest. No trust is utilized, since no estate tax exposure exists. Of course, with the continued uncertainty of the tax laws, anticipating future estate tax exposure can be tricky, even in a world of so-called "permanent" estate and gift tax laws.

(2) If the total value of the estate is expected to exceed the Applicable Exclusion Amount, then the surviving spouse can disclaim all or any part of the inheritance. Language in the Will provides that the disclaimed amount passes into the Bypass Trust; the Will also outlines the terms of that trust.

iv. Disclaimer Requirements. In order for the disclaimer to be effective, it must comply with certain technical requirements of the Texas Estates Code and Internal Revenue Code. *See* Tex. Ests. Code Chpt. 122 (former Tex. Prob. Code § 37A); IRC § 2518.

(1) The disclaimer must be filed within nine months of the date of death *and* before any benefits of the disclaimed property are accepted.

(2) The disclaimed property must generally pass in a manner that the disclaiming party will not benefit from the property. An important exception to this rule, however, permits the surviving spouse to disclaim property and still be a beneficiary of the Bypass Trust. IRC § 2518(b)(4)(A).

(3) The disclaimed property must pass without direction or control of the disclaiming party. This requirement prevents the surviving spouse from serving as a trustee of the Bypass Trust, unless the trustee's powers are appropriately restricted, such as by the HEMS standard described above. If the Bypass Trust contains unduly broad powers, children or other family members (or a professional trustee) may serve as trustee. *See* Treas. Reg. § 25.2518-2(e)(2); Treas. Reg. § 25.2518-2(e)(5) Examples (4)-(5).

d. "Marital Deduction" or "QTIP" Trust. Regardless of whether a Bypass Trust is utilized, spouses have multiple options regarding the way that they leave property to their surviving spouse. Where the deceased spouse's estate exceeds the Applicable Exclusion Amount (\$5.34 million in 2014), most clients choose to defer estate tax on the excess by taking advantage of the estate tax marital deduction. Even for clients with smaller estates, or clients who intend to rely on portability, marital trust planning is a consideration.

i. Direct Payment to Spouse. For clients with estates in excess of the Applicable Exclusion Amount, the excess can pass directly to the surviving spouse, generally through a "marital deduction" clause in the Will, so long as the spouse is a U. S. citizen. This arrangement would effectively eliminate all estate tax at the first spouse's death (deferring the tax until the death of the surviving spouse). Outright bequests to a surviving spouse are typical where the excess estate is anticipated to be relatively small, as in Diagram #1B, and where there is no concern for an "unusual" family situation (such as children by prior marriages).

ii. Payment to Marital Trust. Often, however, an outright bequest to the surviving spouse may not

be the best option. For example, where the surviving spouse is not a citizen of the United States, where the amount of the estate in excess of the Applicable Exclusion Amount is expected to be quite large, where the couple has "his and her families," where the surviving spouse is concerned about keeping inherited assets exempt from attachment by his or her creditors, or in situations where the surviving spouse might need management help, different considerations arise.

(1) Many spouses prefer to know that their own portion of the estate will ultimately pass to their children. Note in Diagram #1B that only the tax-free amount passes to a trust, and ultimately on to H's children. The marital deduction gift passes directly to the surviving spouse, who can give it away to anyone she chooses. It is not uncommon for spouses to prefer instead an arrangement where their property can be earmarked for their children or other beneficiaries, which the outright marital gift does not accomplish.

(2) Fortunately, Congress addressed this issue as part of the tax law which became effective in 1982. IRC § 2056(b)(7). Diagram #2 illustrates transfers to a special trust for the surviving spouse which will qualify for the unlimited marital deduction. As in Diagram #1B, the tax-free amount (\$5.34 million) passes to the Bypass Trust. However, the excess (\$660,000 in this example) now passes to a "Marital Deduction Trust," rather than directly to the surviving spouse.

(3) Normally, a gift to a trust for the surviving spouse would not qualify for a marital deduction, since the spouse's interest in the trust terminates at his or her death and the value of the spouse's interest in the trust at the second death is therefore zero. IRC § 2056(b)(1). A deduction is allowed, however, for this special trust, even though the surviving spouse only receives a "terminable interest" in property. A trust with the qualifying terms is called a "qualified terminable interest property trust," or "QTIP trust" for short. IRC § 2056(b)(7).

(4) Unlike the Bypass Trust, the surviving spouse must be the only beneficiary of the Marital Deduction Trust during his or her lifetime. In order to be tax-deductible at the death of the first spouse,

the trust arrangement must include the following provisions:

(a) The surviving spouse must receive all of the income from the QTIP Trust, at least annually. IRC § 2056(b)(7)(B)(iii)(I). Accordingly, there is very little income tax flexibility; virtually all taxable income will typically be paid and taxed to the surviving spouse. Additionally, the surviving spouse must have the power to require that trust assets be made income-productive. Treas. Reg. §§ 20.2056(b)-7(c); Treas. Reg. § 20.2056(b)-5(f)(5).

(b) Principal distributions are not a requirement. In the typical situation, however, the surviving spouse is given access to the principal (if needed) for his or her health, support and maintenance.

(c) As with the Bypass Trust, the trust includes spendthrift provisions so that the trust assets are protected from claims of the surviving spouse's creditors.

(d) The Will of the first spouse to die generally specifies the distribution of after-tax assets upon the surviving spouse's death. The surviving spouse can, however, be given an opportunity to modify the distribution scheme through a testamentary power of appointment.

(5) At the surviving spouse's death, the trust assets are taxed as though they were part of the surviving spouse's estate. IRC § 2044(b)(1)(A). The representative of the estate of the first spouse to die must elect this treatment in writing at the death of the first spouse by filing a federal estate tax return. IRC § 2056(b)(7)(B)(v). Unless the surviving spouse's Will unambiguously provides otherwise, the tax is paid *by the trust* when the surviving spouse dies (not from the surviving spouse's own assets). IRC § 2207A. The tax borne by the trust is based upon the amount by which taxes increase as a result of adding the value of the trust at the surviving spouse's death to the balance of his or her estate. *Id.*

(6) If the election is made to treat the assets in the trust as taxable in the estate of the surviving spouse, those assets should receive a new cost basis upon the surviving spouse's subsequent death, since

he or she is treated as the owner of those assets for tax purposes. IRC §§ 2044(b)(1)(A); 1014(b)(10).

(7) Another important reason for the use of a marital deduction trust is the preservation of the first spouse's "generation-skipping" transfer tax exemption. This topic is discussed in detail below.

(8) Finally, as mentioned above, no federal estate tax marital deduction is allowed for outright transfers to a spouse who is not a citizen of the United States. For married clients with taxable estates whose spouse is not a U.S. citizen, estate tax can be deferred only through the use of the "Qualified Domestic Trust" or "QDOT," discussed below. IRC § 2056A.

4. TESTAMENTARY PLANNING FOR DESCENDANTS⁷.

The foregoing material deals with testamentary planning when one spouse dies. Another important area of concern is the disposition of assets when both spouses are deceased, or when a single parent passes away, survived by children or other descendants.

a. Trusts for Minor Children. Couples with minor children often utilize trusts in their Wills to hold assets after both of their deaths. These trusts enable a trustee to administer the property without the cost and inconvenience associated with a court-supervised guardianship proceeding. These trusts often last beyond the legal age of majority, since many couples feel that age 18 is too early for children to receive substantial assets. Instead, the trusts can be made to continue until the children are "old enough" to manage the property prudently. At the designated time, the trust assets may be distributed outright to the children.

b. Lifetime Trusts for Children. It may be more advantageous *not* to make outright distributions to their children, but rather to pass the assets to lifetime trusts for the children, as illustrated by Diagram #3.

c. Distribution Provisions. A typical child's trust contains flexible distribution provisions comparable to the Bypass Trust. Each of the provisions can

⁷ Although the discussions in this outline make reference to children or descendants as beneficiaries, the same principles apply if the beneficiaries are a person's parent, sibling, niece, nephew, friend, etc.

apply to later generations, so these trusts are also known as "descendants' trusts."

i. Ascertainable Standard. Distributions are typically permitted for health, support, maintenance and education of the child and the child's descendants. Again, if the child is or may be the trustee (or is given the power to replace the independent trustee) the same "ascertainable standard" or "HEMS" standard is utilized, as in the Bypass Trust. IRC § 2041(b)(1)(A).

ii. Powers of Appointment. The child and or each subsequent descendant is often given a "power of appointment" to direct disposition of the trust assets at death, insuring additional flexibility in the estate plan for changing circumstances. Generally, the trust is not intended to eliminate a child's control of the trust assets. If the parents want to control the ultimate distribution of trust assets, the power of appointment can be restricted or eliminated.

d. Phasing Children Into Trustee Role. Although assets pass to trusts for the benefit of the children, the children can still be given "control" at an age or on the occurrence of an event specified by the parents. This control is afforded by allowing each child to become the trustee of his or her trust. Often this control is awarded in stages, allowing a child to become co-trustee at a given age, and sole trustee at a later age. The two-stage arrangement gives a child some management "practice" as a co-trustee, before giving the child sole management responsibility. Management assistance may be continued during the child's lifetime if the parent feels that the child cannot or will not manage assets prudently.

e. Advantages of Lifetime Trusts. There are many advantages of a lifetime trust arrangement, as opposed to outright distribution.

i. Creditor Protection. Although the child can "control" the assets as trustee, the trust property cannot be reached by claims of creditors (or by the jurisdiction of a divorce court except for child support obligations) if the trust so provides. Tex. Prop. Code § 112.035.

ii. Income Shifting. The trust can provide for income distributions to grandchildren or other more remote descendants, who may be in lower income tax

brackets than the child. Keep in mind that, as mentioned above, beginning in 2013, an additional 3.8% tax is assessed on certain amounts of a trust's undistributed net investment income. IRC § 1411.

iii. Management Help. Management assistance can be provided for a child until a designated age, or for lifetime if needed.

iv. Estate Tax Benefits. At the child's death, a portion of the trust assets may escape federal estate taxation upon passage to the third generation through the allocation of the parents' generation-skipping transfer tax exemption.

f. Utilizing the Generation-Skipping Transfer Tax Exemption.

i. The GST Tax. Under the Tax Reform Act of 1986, a "generation-skipping transfer tax" is imposed on transfers from grandparents to grandchildren, whether made directly or through a second-generation trust. The tax rate on generation-skipping transfers is equal to the top estate tax rate (40% in 2013 and beyond). IRC §§ 2621, 2622.

ii. The GST Exemption. Each grandparent has an exemption from the generation-skipping transfer ("GST") tax. IRC § 2631(a). This GST tax exemption was \$1,000,000. TRA '97 increased the exemption for inflation beginning in 1999, rounded down to the nearest \$10,000. In 2003, the exemption was \$1,160,000. For years after 2003 (when the estate tax exemption increased to \$1,500,000 and beyond), the GST exemption equals the estate tax exemption. Accordingly, in 2014, a married couple can currently place \$10.68 million in trust for their children. If properly structured, the trust property is available to the children as needed, but to the extent that the children do not consume the trust property, the entire \$10.68 million (*plus growth*) escapes taxation when the trust assets ultimately pass to the third generation.

iii. Benefits of Exemption. If property passes outright to the children, it will be fully subject to estate taxation in the second generation. A trust arrangement thus enables a family to take advantage of the \$10.68 million GST exemption.

iv. Before or After Grandchildren. The use of second generation trusts to avoid the GST tax does not require that grandchildren already be in existence. The trusts established by the first generation are trusts for the lifetime benefit of children, so the arrangement is appropriate for anyone with children.

v. Amounts in Excess of Exemption. If the initial value of the property placed into trust exceeds \$10.68 million (i.e., the husband and wife's combined exemption through 2014), the excess may potentially be subject to the GST tax. Typically, amounts in excess of \$10.68 million are placed into separate trusts for the children, so-called "non-exempt trusts." The children are then given a general testamentary power of appointment over this excess trust, so that any property remaining in the trust will be taxed at the child's death at the then current estate tax rates, instead of being subject to an automatic GST tax at the highest estate tax rate. *See* IRC § 2612(a)(1)(A). In lieu of a general power, the children can be advised to intentionally cause estate tax inclusion of the non-exempt trust by exercising their special power in a manner that restarts the running of the Rule Against Perpetuities (the so-called "Delaware Tax Trap"). *See* IRC § 2041(a)(3). The trustee is often encouraged (or required) to distribute assets to the children from the non-exempt trust prior to distributing any funds from the exempt trust, so that the value of the former trust is minimized at the time of the child's death.

vi. Potential Tax Savings. The potential tax savings from trust planning can be illustrated by comparing three couples, each with a total estate of \$11 million. The tax savings makes the simplifying assumption that all deaths occur in 2014 when a \$5,340,000 Applicable Exclusion Amount is in place, and that there is sufficient GST tax exemption to shelter the entire estate. Tax rates are those in effect for 2014.

(1) Couple No. 1 - no trust planning (all to spouse, outright to children at second death)⁸

Gross Estate	\$11,000,000.00
Tax at 1st death	\$0.00
Net to Spouse	\$11,000,000.00
Tax at 2nd death	\$2,264,000.00
Net to Kids	\$8,736,000.00
Tax at Kids' death	\$3,494,400.00
Net to Grandkids	\$5,241,600.00
Percent to Grandkids	47.65%

(2) Couple No. 2 - basic trust planning (Bypass Trust for spouse, outright at second death)

Gross Estate	\$11,000,000.00
Tax at 1st death	\$0.00
Net to Spouse	\$11,000,000.00
Tax at 2nd death	\$128,000.00
Net to Kids	\$10,872,000.00
Tax at Kids' death	\$4,348,800.00
Net to Grandkids	\$6,523,200.00
Percent to Grandkids	59.30%

(3) Couple No. 3 - full trust planning (Bypass Trust, Marital Deduction Trust, Second Generation GST Trusts for children)

Gross Estate	\$11,000,000.00
Tax at 1st death	\$0.00
Net to Spouse	\$11,000,000.00
Tax at 2nd death	\$128,000.00
Net to Kids	\$10,872,000.00
Tax at Kids' death	\$76,800.00
Net to Grandkids	\$10,795,200.00
Percent to Grandkids	98.14%

⁸ All examples assume that portability is not elected at the first death and that all children have estates in excess of the Applicable Exclusion Amount.

(4) The calculations shown above are without providing for growth or inflation. If the children do not need all of the income and growth in their trusts, the children's GST-exempt trusts may increase in value over the children's lifetimes. Accordingly, the savings may be much larger than those illustrated above.

5. LIFE INSURANCE AND GIFT PLANNING

a. Taxation of Life Insurance. Generally, life insurance is subject to estate taxation if the insured owns or controls the policy, or if the policy is payable to the estate of the insured. IRC § 2042. If the policy is community property, only one-half is includable in the deceased spouse's estate. Treas. Reg. § 20.2042-1(a)(3).

i. Estate Tax Reductions Through Policy Transfers. As shown earlier, proper estate planning can protect up to \$10.68 million from estate taxation for a married couple. Where the combined estates exceed \$10.68 million, consideration can be given to reduction of the estate. One of the most effective methods of estate reduction is through an assignment of assets that will appreciate substantially between the date of gift and the date of death. These assets may be difficult to identify. Life insurance policies, by their very nature, however, are excellent candidates for transfer, since the death benefit generally exceeds the lifetime value by a substantial amount.

ii. Payment to Spouse. If the non-insured spouse is the beneficiary of a policy, there is no immediate estate taxation, since proceeds are eligible for a marital deduction. The proceeds received by the spouse, however, are added to his or her estate, so the tax burden is merely deferred until death of the spouse.

b. Life Insurance Trusts. The purpose of an irrevocable life insurance trust (a/k/a "ILIT") is to remove the insurance proceeds from the estates of both spouses. A detailed discussion of this complex subject is beyond the scope of this outline, but the basic concepts are set forth below.

i. Creation of Trust. The bypass trusts marital trusts and descendants' trusts discussed in Parts 3 and 4 above are typically created at death. By contrast, life insurance trusts are created during the lifetime of

the insured with the insured being the grantor of the trust.

(1) Life insurance trusts must be made irrevocable. Under Texas law, a trust is revocable unless the trust instrument otherwise expressly so provides. Tex. Prop. Code § 112.051(a).

(2) The insured can retain no control over the policy or its proceeds. If the insured possesses any "incident of ownership" (economic interest or control) in the policy, it remains subject to estate taxation. IRC § 2042(b).

(3) A major problem area regarding life insurance trusts relates to the transfer of funds to make premium payments and qualifying the transfers for the gift tax annual exclusion.

(a) The first \$14,000 (\$28,000 for gifts by husband and wife) (for tax year 2014) of present interest annual gifts to each donee is excluded from the gift tax. IRC § 2503(b).

(b) A "present interest" is the unrestricted right to the immediate use, possession or enjoyment of property or its income. Treas. Reg. § 25.2503-3(b).

(c) A gift to a typical trust is *not* a present interest gift, since the trust property will typically not vest in the beneficiary until a future date. However, if the trust beneficiary can withdraw principal in an amount equal to annual additions to the trust, gifts to the trust can qualify for the annual exclusion. Thus, for tax year 2014, payments to a trust with these withdrawal provisions (a so-called "Crummey" trust) can qualify up to \$14,000 per donor per beneficiary. *Crummey v. Commissioner*, 397 F.2d. 82 (9th Cir. 1968). The basis for the *Crummey* decision is that the trust beneficiary's withdrawal right makes his interest presently vested, at least to the extent of the withdrawal right. The IRS takes the position that "Crummey" powers are effective only if the beneficiary holding the power is given notice of the existence of the power and a reasonable opportunity to exercise it.

ii. Typical Trust Formats. There are two typical formats for life insurance trusts.

(1) In the first format, the insured spouse creates a trust for the benefit of the non-insured spouse and descendants.

(a) Since the non-insured spouse is a beneficiary of the trust, it is important that the non-insured spouse not make contributions to this type of trust. Texas community property rules complicate compliance with this requirement. If an existing community property policy is being given to a trust, the policy must be established as the insured's separate property prior to the transfer to the trust. Otherwise, the beneficiary spouse will be treated as making a gift to a trust for his or her own benefit, causing inclusion of part of the trust in his or her estate. In addition, all amounts given to the trust to pay future premiums must be given from the insured's separate property (often requiring a partition of funds).

(b) Distributions are typically permitted for health, support, maintenance and education of the non-insured spouse and descendants (generally parallel to a Bypass Trust in a Will, discussed in Part 3 above).

(2) In the second format, insurance is purchased by or assigned to a trust for the children and other descendants, which does not provide benefits to the insured's spouse.

(a) If this approach is used, there is no necessity to partition assets to create separate property. Since neither spouse is a beneficiary, they can both serve as grantors of the trust.

(b) Often, at least historically, insurance employed in this form of trust is purchased to pay estate taxes. This is particularly true of "second-to-die" policies which insure the joint lives of both spouses, and pay death benefits only after the second death.

(c) This type of trust can be structured in exactly the same manner as second-generation trusts for children under the Wills. All of the benefits of those trusts discussed in Part 4 above (protection from divorce and creditors, generation-skipping transfer tax savings, and management assistance) can be built into insurance trusts. This type of trust may also be useful for families where there are children of a prior

relationship that are to be provided for upon the death of the parent, as further discussed below.

iii. Avoiding the Three-Year Rule. One of the problems in attempting to remove insurance from the insured's estate is the avoidance of the "three-year rule" set forth in Section 2035 of the Internal Revenue Code. Any transfer of a life insurance policy *by the insured* results in inclusion of the proceeds in the insured's estate, if the transfer was made within three years of the insured's death.

(1) Since only a transfer by the insured is subject to application of the rule, an obvious solution to the problem is to have the intended donee purchase the policy from the beginning rather than transferring an existing policy to the trust, so that there will be no *transfer* of the policy. It is at this point, however, that difficulties often arise, particularly if funds for the purchase of the policy are provided by the insured.

(2) An important line of cases dealt with the purchase of insurance by an irrevocable life insurance trust, using funds furnished by the decedent. Although this procedure involves no formal transfer of the insurance policy by the insured, the IRS took the position that the arrangement was in substance the same as a transaction whereby the insured bought the policy and then transferred it to the trust. In several cases, the courts held that under this set of facts, the taxpayer *never possessed* incidents of ownership so Section 2035 was inapplicable. As a result, the IRS has abandoned its position in this area. A.O.D. 1991-012 (07/15/91).

iv. The "Generation-Skipping" Life Insurance Trust. The life insurance trust presents a unique opportunity to minimize transfer taxes at the children's as well as the parents' level.

(1) As mentioned earlier, one of the major changes made by Tax Reform Act of 1986 involves the "generation-skipping transfer" ("GST") tax, which is imposed on the transfer of wealth from the first generation to the third generation (e.g., from grandparents to grandchildren).

(a) A tax is imposed on trusts at the time when property passes to the third generation. IRC §§ 2621, 2622.

(b) An exemption from the GST tax equal to the Applicable Exclusion Amount (\$5.34 million in 2014) is available for each grantor. IRC § 2631(a). Thus, in 2014, grandparents can collectively pass \$10.68 million to grandchildren without taxation, even if the children have the lifetime use and enjoyment of the property through a properly constructed trust.

(c) The Tax Reform Act of 1986 exempted from GST tax any transfers which were within the annual gift tax exclusion. This provision has been "corrected" to deny exempt status to any transfers in trust (unless the trust is solely for one individual, and the trust assets are includable in the individual's estate). IRC §§ 2642(c), 1014(e). As a result, although gifts qualifying for the annual exclusion through "Crummey" clauses are exempt from gift tax, they are *not* GST tax-exempt, unless the donor files a gift tax return (IRS Form 709) electing to use some of his or her GST tax exemption. The gift tax return is due at the same time as the grantor's income tax return. EGTTTRA sought to modify this "electing" regime by *automatically* applying GST exemption to certain "indirect skips" to a "GST Trust." Unfortunately, in many cases, the definition of a GST Trust can be circular, and many practitioners recommend continuing to file gift tax returns to ensure proper allocation of the GST tax exemption. Filing of the gift tax returns is also helpful for record-keeping purposes, in order to keep track of the GST tax exemption that has been used. Because the GST tax exemption will need to be allocated even for the portion of a gift qualifying for the annual exclusion, a mismatch of the grantor's remaining estate tax exemption and GST tax exemption will occur. Also, keep in mind that, like the federal estate tax exemption, when a portion of the GST tax exemption is used during the grantor's life, it reduces the amount available at the grantor's death.

(2) The life insurance trust offers a unique opportunity to "leverage" the GST tax exemption.

(a) For example, an insurance trust can create lifetime trusts for children (and perhaps grandchildren or later generations). If the premiums gifted to the trust are exempted from GST tax through the filing of an annual gift/GST tax return, the entire trust remains GST tax-exempt. Thus, by using a relatively small

amount of exemption (the premium amounts), a much larger amount (the insurance proceeds and any appreciation during the children's lifetimes) can be exempted from the GST tax.

(b) Special concerns exist regarding the type of withdrawal right given to a beneficiary. As noted earlier, trust beneficiaries can be given withdrawal rights in order to qualify gifts to the trust for an annual gift tax exclusion. However, if the beneficiary has a withdrawal right which lapses in an amount that exceeds \$5,000, or if larger, 5% of the trust assets, then the *lapse* of the withdrawal right has the same effect as the exercise of a general power. IRC § 2041(b)(2). In other words, if a child can withdraw more than \$5,000 or 5% of the trust assets in any year and fails to do so, that failure is treated as a "gift" by the beneficiary to the trust equal to the amount that was subject to withdrawal in excess of the greater of \$5,000 or 5% of the trust value. Since the beneficiary has a retained income interest in the trust, the trust property (at least in part) will become subject to estate tax upon the death of the beneficiary. IRC § 2036(a)(1). Thus, an *estate* tax will be imposed at the beneficiary's death, even if the trust is GST tax exempt.

(i) If one intends to make effective use of the GST tax exemption to establish a multi-generational life insurance trust, one course would be to limit the beneficiary's *withdrawal right* to the greater of \$5,000 or 5% of the assets out of which the withdrawal right could be satisfied. Using a "5 or 5" limitation means that the withdrawal right will typically be significantly less than the available annual exclusion amount. As a result, a much smaller amount can be transferred to the trust on a completely tax-free basis. If the grantor makes gifts larger than \$5,000 or 5% of the trust's value, a gift tax return will need to be filed reporting the gift, and some of the grantor's Applicable Exclusion Amount may have to be utilized. Nevertheless, the opportunity to leverage the GST tax exemption may make this a very effective use of the Applicable Exclusion Amount where it appears highly likely that annual premium needs can be provided for without exceeding the "5 or 5" limit.

(ii) An alternative course is to give each beneficiary a withdrawal right equal to the full annual

exclusion (currently \$14,000 per donor per donee per year), but limit the *lapse* to the “5 or 5” amount. This approach, sometimes called a “hanging withdrawal right” or “hanging power” has been criticized by the IRS. See PLR 8901004. It has, however, been approved if properly drafted. See PLR 9311021.

(iii) If substantial gifts are made over several years, the amount available for withdrawal could also become substantial, although delaying termination of the ILIT for a year or two after the insured's death can clean out excessive hanging powers by creating a substantially increased amount from which withdrawal rights may be satisfied, thus increasing the 5% side of the “5 or 5” amount. For example, upon maturity of a \$2,000,000 policy, the “5 or 5” amount is \$100,000 (5% of \$2,000,000). This means that accumulated withdrawal rights of up to \$200,000 per beneficiary would fully lapse in approximately 2 years.

Word to the wise: Hanging withdrawal rights are very complex to design and administer properly. They should be undertaken only by practitioners who are thoroughly satisfied with their command of the subject.

(iv) In any event, the donor(s) should make a *timely* allocation each year to exempt the premium gifts from GST tax. If a timely allocation (by the due date of the income tax return) is not made, the value of the trust at the date of allocation (or rather, the first day of the month in which the allocation is made and the late gift tax return is filed), not the date of the gift, must be used for any late allocation. If the insured dies prior to a late election being made, the entire insurance proceeds will be included in the trust value, thus eliminating the opportunity to leverage the exemption. Some practitioners take an aggressive approach to this “date-of-election” rule by filing gift tax returns after the due date, using the late allocation rules. In so doing, they rely on the fact that the value of premiums contributed to a policy typically decline during the year, so that the *value* of the gifted premium may be less than the amount of cash transferred. As mentioned above, if the insured dies after the due date of the return but before it is filed, the gamble is lost, since then the death benefit, and not just the premium, is the value against which the GST tax exemption must be utilized.

(3) Example. The following is an example of a typical situation where insurance trust planning might be appropriate: H and W have an estate of \$12 million. After considering the impact of projected estate growth, they decide to purchase a \$750,000 second-to-die policy to pay their estate settlement costs. Cash is transferred to a life insurance trust, and the trustee applies for and purchases the new policy. The trust agreement creates lifetime trusts for their three children, with a “Crummey” withdrawal right limited to “5 or 5.” The total premiums paid will be \$100,000, in eight installments of \$12,500. In each of the eight premium payment years, a gift tax return is filed, electing to use \$6,250 of each of the donors' respective current GST tax exemption. H and W also have Wills which contain full trust planning. This example assumes that both spouses die in 2014, and that each spouse's available GST exemption is \$5,340,000. After payment of the premiums, their combined estate is \$11,900,000.

The tax results of this arrangement may be summarized as follows (Diagram #4):

(a) \$5,340,000, plus the growth thereon is sheltered at the first death from estate tax being imposed at the second death; an additional \$5,340,000 is sheltered from estate tax at the death of the second spouse.

(b) \$5,290,000 (the remaining GST tax exemption after *each spouse* uses \$50,000 to exempt the \$100,000 in premiums paid), plus the growth thereon, is sheltered from estate and GST tax when children's testamentary trusts pass to grandchildren; an additional \$5,290,000, plus the growth thereon, is set aside at the death of the second spouse to be sheltered from estate and GST tax at the children's death.

(c) \$750,000 in life insurance proceeds are exempt from estate taxation at death of H and W if in the ILIT, and the remaining ILIT assets are exempt from tax when children die.

(d) Since only \$100,000 worth of the parents' \$10.68 million exemption was used to shelter the \$750,000 life insurance proceeds, the amount of property sheltered from estate and GST tax actually totals \$11,330,000 (\$5,290,000 from each parent's estate plus \$750,000 in life insurance).

c. Beneficiary Designations. When life insurance is not being held in an irrevocable trust, it is important that the beneficiary designation be coordinated with the testamentary plan.

i. Payment to Spouse. If the insurance is intended to fund the Bypass Trust or Marital Trust, the beneficiary should not be the surviving spouse directly, since the proceeds would then not be available to fund the testamentary trusts.

ii. Payment to Testamentary Trust. A typical beneficiary designation would require payment to "the trustee named in the last Will of the insured." The Will must then contain a specific clause which directs the trustee to distribute to the surviving spouse his or her community one-half interest in the proceeds, and to allocate the balance between the Bypass Trust and Marital Trust.

6. SPECIAL PROBLEM AREAS

The foregoing material discusses basic concepts as they apply to the "traditional" family. Many families, however, involve less traditional structures. Some of the more common "non-traditional" arrangements merit special mention.

a. Children from Multiple Relationships. One of the most difficult problems facing many couples is the allocation of assets when there are children from prior relationships.

i. Family Goals. Obviously, the primary consideration in estate planning is to ascertain the family goals. It is important to coordinate these goals with proper planning for both probate and non-probate assets, while being mindful of relevant tax issues.

ii. Common Arrangements. There are several common arrangements which can be considered.

(1) All children can be treated as the children of both spouses for purposes of estate planning. In that event, the basic testamentary techniques described earlier would be used. One potential disadvantage of this plan is that the surviving spouse could change his or her Will after the death of the first spouse, thereby diverting the estate from the other spouse's children.

(2) Each spouse may provide a testamentary trust arrangement for the other spouse, but with ultimate distribution only to the deceased spouse's children. The purpose of this arrangement is to allow the surviving spouse to have lifetime use of assets, while protecting the inheritance of the deceased spouse's children. This arrangement can, however, create an uncomfortable relationship and tension between the surviving spouse and his or her step-children, since distributions to the spouse reduce the ultimate inheritance of the children. If the surviving spouse is the trustee, the spouse is accountable to his or her step-children for the way the trust is administered, including investments and distributions.

(3) Separate benefits can be provided for the surviving spouse and children. It may be desirable to provide benefits for the children which they can receive prior to the second spouse's death. The Will can allocate a specified amount to the children (or spouse), with the balance of the estate passing to the other spouse. With the ever-changing tax laws, it typically is not a good idea to tie this type of bequest to the Applicable Exclusion Amount. Many couples choose to provide for children from a prior relationship through a life insurance trust or by naming children themselves as beneficiaries of a life insurance policy, using other testamentary planning for their spouse and children of the marriage.

b. Qualified Plan Benefits. Often an estate's assets will include pension, profit sharing, IRA, or other retirement benefits. In fact, in many cases, these assets form a significant part of a client's net worth. These assets can create a difficult choice between income and estate tax considerations.

i. Payment to Spouse. If the client is married and retirement benefits of the participant-client are paid directly to the surviving spouse, income tax can be deferred by creation of a spousal rollover IRA. IRC § 408(d)(3)(A). Unless the deceased spouse's interest in other assets totals at least \$5,340,000 (or the current Applicable Exclusion Amount), however, payment of all of the pension assets to the surviving spouse may result in underfunding of the Bypass Trust, if that type of planning is desired. In these circumstances, it may be important to file an estate tax return at the death of the participant spouse

to pass his or her DSUE amount to the surviving spouse.

ii. Payment to Testamentary Trust. If pension benefits are paid to the Bypass Trust in order to remove them from future estate taxes in the second spouse's estate, income tax deferral through a spousal IRA is not available. See IRC § 408(d)(3)(C). If benefits are paid outright to the spouse, after a spousal rollover, the spouse may defer withdrawals until he or she reaches age 70-1/2, and may elect to compute distributions using the favorable joint life expectancy tables. Some deferral may be obtained if the funds are paid to the Bypass Trust, however, so long as the trust constitutes a "designated beneficiary" as defined in Treasury Regulation Section 1.401(a)(9)-4, A-5. This treatment would generally permit the Bypass Trust to withdraw funds over the spouse's remaining life expectancy, but would not permit the surviving spouse to defer distributions until age 70-1/2 or use the joint life expectancy tables.

iii. Income vs. Estate Taxation. Most couples seem to prefer direct payment of retirement benefits to the spouse (even wealthy couples for whom this strategy may mean a possible increase in ultimate estate taxation), since this technique maximizes income tax deferral, thereby leaving more assets available to the surviving spouse. Frequently, the participant's testamentary trustee is named as the secondary beneficiary. This technique ensures that retirement assets flow into trusts for children and other descendants if the non-participant spouse dies first. In addition, flexibility is added through consideration of a disclaimer by the surviving spouse.

iv. Example. Consider the following example: H and W have a community estate of \$10 million, consisting of a \$5,000,000 IRA rollover of H's retirement plan, and \$5,000,000 in other assets. H and W execute Wills containing Bypass Trusts.

(1) At H's death, only \$2,500,000 (one-half of the non-IRA assets) is available to fund his Bypass Trust, unless the IRA is made payable to the trustee of the testamentary trust under H's Will.

(2) Choice No. 1: payment of IRA to the testamentary trust

(a) Advantage - The Bypass Trust will be fully funded, saving estate tax when W dies.

(b) Disadvantage - Income tax deferral may be reduced, since a trust may not be able to continue the tax-deferred IRA structure to the same extent as a surviving spouse.

(3) Choice No. 2: payment of IRA to W

(a) Advantage - W can elect to place the IRA proceeds in a spousal rollover IRA, continuing income tax deferral.

(b) Disadvantage - The Bypass Trust will be funded with only \$2,500,000 (H's interest in the non-IRA assets), and W's taxable estate will be larger at her subsequent death, which may result in additional estate taxes. If the executor of H's estate files an estate tax return electing portability, and if W remains eligible to use H's DSUE Amount, estate tax at W's death may be minimized. However, W may give the IRA assets to anyone of her choosing, including a new spouse or W's children of a different relationship.

(4) Choice No. 3: naming spouse beneficiary of IRA, but naming testamentary trustee as secondary beneficiary.

(a) Advantage - W can elect within nine months after H's death to disclaim all or part of the IRA, potentially reducing income tax deferral, but fully funding the trust. In this example, W might disclaim \$2,500,000 to fully fund the Bypass Trust, and accept the balance of the IRA, or roll it over to her own IRA to defer income taxes. This decision is made with the benefit of hindsight, since it is made after H's death. Technical components of a qualified disclaimer are discussed in Part 3, above.

(b) Disadvantage - Income tax deferral may be reduced to the extent of the disclaimed amount. If W does not disclaim, the IRA assets may be given by W to anyone of her choosing, including to a new spouse or to children of a different relationship.

Word to the wise: The use of trusts with retirement benefits is extremely technical and can cause negative income tax consequences if not undertaken properly.

c. Provisions for Other Family Members. Often there may be a need to provide for parents or other family members.

i. Effect of Special Bequests. Specific bequests to persons other than a spouse would reduce the amount of exemption available to fund the Bypass Trust.

ii. Secondary Trust Beneficiaries. An alternative method of providing for other family members is to include them as permissible beneficiaries under the testamentary trusts.

(1) Although other beneficiaries cannot be included in the Marital Trust during the surviving spouse's lifetime, the Bypass Trust can provide for distributions to children, parents, or any other person or entity.

(2) When both spouses are deceased, the second-generation trusts for children can also permit distributions to other family members.

(3) For example, by adding parents as secondary beneficiaries of the testamentary trusts (other than a Marital Trust), their care can be assured while avoiding outright distribution of assets to older beneficiaries, who might need management assistance. In addition, this method avoids the prospect of paying tax at the first death, only to subject the same property to a second layer of estate taxes upon the parents' deaths, before the property ultimately passes to lower generational levels.

d. Joint Ownership of Assets. It is important to be sure that adequate assets are available to fund the Bypass Trust.

i. Joint Tenants with Rights of Survivorship. Often, brokerage accounts or bank accounts when established will be styled as "joint tenants with right of survivorship." Texas courts at one time construed the Texas constitution to make these designations ineffective for spouses with respect to their community property. Amendments to the Texas constitution now make these accounts effective, even among spouses, to vest title to the property in the survivor upon the death of one of the depositors.

ii. Use with Trusts. Survivorship accounts should be avoided where the account owner's estate is

intended to pass to a testamentary trust, since the survivorship accounts will be payable directly to the spouse (or third party) and will reduce the amount available to fund the trusts.

iii. Reviewing and Updating Account Designations. Many people are unaware of their account designations, and they should be reviewed. If necessary, the client should contact the financial institution to eliminate any right-of-survivor designations. Some financial institutions have proven uncooperative in altering these designations, based apparently on the well known legal maxim "that's the way we always do it. There's no reason for it, it's just our policy." Section 113.157 of the Texas Estates Code, however, allows any party to a survivorship account to alter its effect by written order received by the financial institution. (Presumably, sending the order by certified mail, return receipt requested would satisfy any burden of proof with respect to this receipt requirement). Tex. Ests. Code §§ 113.156, 113.157 (former Tex. Prob. Code § 440).

e. Spouses Who Are Not U.S. Citizens. As indicated above, no estate tax marital deduction is permitted for transfers to a spouse who is not a citizen of the United States. IRC § 2056(d). Congress apparently perceived a potential abuse in allowing a taxpayer to transfer substantial sums to a non-U.S. citizen surviving spouse, only to have the spouse return to his or her country of origin, thereby avoiding U. S. estate taxes entirely.

i. Qualified Domestic Trusts. The Internal Revenue Code does permit persons married to non-U.S. citizens to defer estate taxes at the death of the citizen spouse through the use of a special trust known as a "Qualified Domestic Trust" or "QDOT." IRC §§ 2056(d)(2)(A); 2056A.

ii. Trust Terms. In order to qualify for the marital deduction, the trust must have terms sufficient to qualify it as a QTIP trust, as discussed above. In addition, the trust must, by its terms, require that at least one trustee be an individual citizen of the United States or a domestic corporation, and must provide that no distributions in excess of income can be made unless the domestic trustee has the right to withhold tax on the distributions. IRC § 2056A(a). Treasury

Regulations set forth a number of detailed additional requirements that must be included in the trust and which are designed to secure payment of the tax.

iii. Computation of Tax. Unlike a QTIP trust, which pays tax upon the surviving spouse's death at his or her marginal rate, the Qualified Domestic Trust pays tax whenever principal is distributed, whether at death or during the spouse's lifetime. The tax is computed by figuring the marginal tax that would be paid by the estate of the *first* spouse to die if no deduction had been permitted. IRC § 2056A(b).

iv. Post-death Corrective Action. The Internal Revenue Code permits spouses who are not U.S. citizens to qualify transfers to them, after the death of the first spouse, so long as corrective action is taken prior to the time that the estate tax return for the estate of the first spouse is due. This corrective action may include the formation of a QDOT by the surviving spouse. Alternatively, if the surviving spouse attains his or her citizenship prior to the due date for the return, so long as he or she has remained a resident of the United States at all times after death and until the return is filed, any transfers will qualify for the marital deduction. IRC § 2056(d)(4)-(5).

7. OTHER BASIC PLANNING DOCUMENTS

In addition to testamentary planning documents, a majority of estate plans will include one or more of the documents mentioned below.

a. Statutory Durable Power of Attorney. Texas's Durable Power of Attorney Act begins with Section 751.001 of the Texas Estates Code. A power of attorney is a written document that enables the person executing the document (the "principal") to designate a holder of the power (the "attorney-in-fact" or "agent") to act on the principal's behalf for financial matters. A durable power of attorney does not lapse because of time unless the document so provides. Tex. Ests. Code § 751.004 (former Tex. Prob. Code § 483). The power of attorney can be effective on the date that the principal signs the document or it can "spring" into effect when the principal becomes incapacitated or disabled. Tex. Ests. Code § 751.002 (former Tex. Prob. Code § 482). The attorney-in-fact has the power to act on behalf of the principal only with respect to powers specifically enumerated in the document. The attorney-in-fact is a fiduciary and

must account to the principal. Tex. Ests. Code § 751.101 (former Tex. Prob. Code § 489B). In an attempt to standardize the appearance and content of powers of attorney, Texas law provides a suggested, but not mandatory, form Statutory Durable Power of Attorney. Tex. Ests. Code § 752.001 *et seq.* (former Tex. Prob. Code § 490). The powers granted under a statutory durable power of attorney are extremely broad and are defined by statute. Tex. Ests. Code §§ 752.101-115 (former Tex. Prob. Code §§ 491-504). It is also possible for the principal to include special instructions to the agent which may include powers that are not defined by statute, such as the power to make gifts and the ability to reimburse the agent for expenses or pay reasonable compensation to the agent.

b. Medical Power of Attorney. A person can designate a third party to make health care decisions, through a "Medical Power of Attorney." Tex. Health & Safety Code § 166.151 *et seq.* Although part of the Advanced Directives Act, the specific statute authorizing powers of attorney for health care is separate from the directive-to-physician statute.

The primary purpose of a Medical Power of Attorney is to appoint an agent to make health care decisions on behalf of the individual executing the Medical Power of Attorney which that individual could have made, but for his or her lack of competency. The agent's authority generally begins when a doctor certifies that the individual who executed the Medical Power of Attorney lacks the competency to make health care decisions for himself or herself. Tex. Health & Safety Code § 166.152(b). However, there are generally some limits. For example, no Medical Power of Attorney can convey the power to make voluntary inpatient mental health service decisions, convulsive treatment, psychosurgery or abortion. Tex. Health & Safety Code § 166.152(f). Other than the statutory limitations, the Medical Power of Attorney generally gives the agent the ability to make any and all health care decisions in accordance with the wishes of the person granting the power, including religious and moral beliefs, once the person granting the power is no longer able to make them himself or herself. A form and related disclosure statement are provided by statute. *See* Tex. Health & Safety Code §§ 166.163, .164.

c. Directive to Physicians. Sometimes referred to as a “Living Will,” the Directive to Physicians and Family or Surrogates is a document indicating the patient’s intentions should the patient become disabled and lack the legal capacity to make decisions for himself or herself with regard to life-sustaining treatment. Generally speaking, the Directive deals with health care measures that the patient wants imposed should he or she become unable to express his or her desires. The statutory form Directive, which can be found in Texas Health & Safety Code §166.033, divides medical conditions into two broad categories—“irreversible conditions” and “terminal conditions”—and gives the patient the choice in each case to have life-sustaining procedures either applied or withheld. Tex. Health & Safety Code § 166.001 *et seq.* Some clients like to also include additional requests to clarify the types of treatments he or she would want or would not want to have under certain circumstances.

i. Terminal Conditions and Irreversible Conditions. In the Directive, the patient indicates whether to have life-sustaining treatment either applied or withheld, and this decision must be made for each of two situations: “irreversible conditions” and “terminal conditions.” Each of the conditions is determined in the judgment of the patient’s physician.

(1) “Terminal Condition”. A “terminal condition” is (i) an “incurable condition” (which appears to be different from an “irreversible condition”), and (ii) that will produce death within six months even *with* life-sustaining treatment. Tex. Health & Safety Code § 166.002(13). If a patient is admitted to hospice care, he or she is presumed to have a terminal condition. *Id.*

(2) “Irreversible Condition”. An “irreversible condition” is one: (i) that may be treated but is never cured or eliminated, (ii) that leaves the patient unable to care for or make decisions for himself, and (iii) that will be fatal without life-sustaining treatment. Tex. Health & Safety Code § 166.002(9).

(3) “Life-Sustaining Treatment”. “Life-sustaining treatment” is treatment that sustains the life of a patient and without which the patient will die. The treatment specifically includes artificial life support, dialysis, and artificial nutrition and hydration

(i.e., so called “tube feeding” and I.V.s), but specifically does *not* include pain medication or other care to alleviate pain. Tex. Health & Safety Code § 166.002(10).

(4) The Six Month Distinction. The obvious distinction between “terminal” and “irreversible” conditions is the six-month timeframe. One could almost say that both refer to conditions that are definitely going to cause death, with the only difference being that the former refers to conditions with less than a 6 month life expectancy and the latter refers to conditions with a 6 month or longer life expectancy.

ii. Life-Sustaining Treatment Decision if No Directive Signed. Section 166.039 of the Texas Health and Safety Code provides that, if an adult patient has not executed a Directive and is incompetent to make a treatment decision, then the patient’s physician and a court-appointed guardian or the agent under the patient’s medical power of attorney, has the authority to make the decision. In other words, if you are not under a guardianship but you do have a medical power of attorney and you want your medical attorney-in-fact to make your final life and death treatment decisions (if and when you are unable to decide), you do not have to have a Directive.

If you do not have a Directive, a medical power of attorney or a legal guardian, the statute gives the right to make the decision whether to terminate life-sustaining treatment to the following family members, in the following order and in conjunction with the attending physician: the spouse, then the “reasonably available adult children,” then the parents, then the nearest living relative. Tex. Health & Safety Code § 166.039(b). Keep in mind that a Directive to Physicians is not the same as a “do not resuscitate” or “DNR”, which is governed by Sections 166.081 *et seq.* of the Texas Health and Safety Code.

d. HIPAA Authorizations. Some estate planners feel that a medical power of attorney should be adequate to enable the named agent to gain access to medical information of the principal to make medical treatment decisions. However, the Health Insurance Portability and Accountability Act of 1996 (“HIPAA”) can be read to require an express

authorization for disclosure of confidential information about a patient. The use of this separate document can also alleviate concerns that some medical professionals may have about relying upon a medical power of attorney, (e.g., the authority set forth in the HIPAA authorization is effective in all events, while a medical power of appointment is effective only when the principal cannot communicate his or her wishes). In addition, by expressly referring to HIPAA requirements in the HIPAA authorization itself, medical providers may feel more comfortable disclosing patient information to the persons named in the authorization. Furthermore, HIPAA is federal law which may trump any perceived rights under state law.

e. "Out-of-Hospital DNR". A "do not resuscitate" or DNR order is a separate directive authorized under the Advanced Directives Act. It can be signed by any competent person at any time and *requires the signature of an attending physician to be effective*. It directs health care professionals acting in an out-of-hospital setting to withhold cardiopulmonary resuscitation and certain other life-sustaining procedures. If the patient is comatose or incompetent to have signed such an order, then the person named as the agent to make health care decisions for the patient, two qualified relatives, or a guardian appointed by the court may sign such an order. However, a decision to execute an out-of-hospital DNR order by someone other than the patient must be based on knowledge of what the person would desire, if known. Clients that have strong feelings about a DNR order should make their wishes known to their physician and consider signing a DNR form. Additional information and the required statutory form may be found on the Texas Department of Health website at <http://www.dshs.state.tx.us>.

f. Declaration of Guardian for Children. If one parent survives the other, the surviving parent is the natural guardian of his or her minor children. However, in the event that both of the child's natural parents die, individuals who have children who are under the age of legal majority need to insure that their estate plan includes a Declaration of Guardian for minor children pursuant to Texas Estates Code § 1104.151 *et seq.* Sections 1104.153 and 1104.154 of the Texas Estates Code contains a form that may be

used for this purpose. Each parent must decide who should be asked to assume the responsibilities of raising the minor child, both as to the guardian of the child's person and of the child's estate, taking into consideration the age of the proposed guardian (and any of the guardian's children), the age and number of minor children which the individual has and the health and financial situation of all the parties being considered as potential guardians. The individual's choice regarding guardian designations will be considered by the court in naming the guardian who is ultimately appointed for the minor child, but will not be completely dispositive of the issue.

g. Declaration of Guardian for Oneself. Section 1104.201 *et seq.* of the Texas Estates Code authorizes a person to designate a guardian of the person and/or estate for himself or herself in case the person later becomes incapacitated to the extent that a court supervised guardianship is required. The document that makes these designations is called a "Declaration of Guardianship in the Event of Later Incapacity or Need of Guardian," and a statutory form is provided in Texas Estates Code §§ 1104.204 and 1104.205.

Good estate planning generally attempts to avoid the need for a guardianship of the client via a statutory durable power of attorney or revocable trust and a medical power of attorney. However, many practitioners will also prepare a declaration of guardian for their clients, so that a person other than the agents designated by the client cannot preempt a client's power of attorney by being appointed as the client's guardian. In addition, the declaration of guardian may be used to specifically disqualify an individual who might otherwise have priority to serve as guardian under Texas law.

h. Appointment of Agent for Disposition of Remains. If a person does not designate otherwise, Texas law provide a priority list of persons who have the right to control the disposition of a decedent's remains. The right of each of these persons to control the disposition is limited in time, as set forth in the statute. These persons include the person's spouse, followed by an adult child, a parent, an adult sibling, and then an heir. Tex. Health & Safety Code § 711.002. If the decedent designated someone in writing to dispose of the remains, however, then that person controls. The written designation is

commonly called an "Appointment of Agent to Control Disposition of Remains," and a form may be found at Texas Health and Safety Code § 711.002(b). Although this document is often not considered to be part of the "standard" estate planning package, it can be extremely important to persons who do not want a member of their biological family in control of their burial arrangements, who want to give special instructions as to their burial or cremation, or who have not made pre-paid funeral arrangements.

i. Organ and/or Body Donation. Clients should also make known to their family members any desire for organ and/or body donation. The donor's family does not pay for the organ and tissue donation. All costs related to actual organ donation are paid by the organ procurement organization and/or transplant center and eventually by the recipients of the organs and tissues. Almost anyone of any age can be considered for donation. While some age guidelines exist for organ donation, tissue and bone donation is not as limited. Most religions support organ and tissue donation on the basis that it is essentially a gift of life from one human to another. Clients may wish to register with a donor registry and carry a donor card. One of the most important elements of becoming an organ donor is making sure that the client discusses his or her wishes with next of kin and family. Additional information and registration forms can be found at www.donatelifetexas.org.

8. CONCLUSION

The foregoing material highlights some conventional estate planning techniques that remain important even in a setting of high federal gift and estate tax exemptions. The goal of the material has been to cover these fundamental concepts in a fairly straightforward fashion, without becoming bogged down in too many technical details. While far from being a "tool box" of exotic estate planning techniques, it provides an overview of the basic issues and potential problems encountered in estate planning.