THE BASICS OF ESTATE PLANNING

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The world of estate planning is often much more comprehensive than people realize. Indeed, many clients are surprised to learn that a Last Will and Testament is simply one of a vast array of tools used by estate planners to prepare assets for inheritance, save taxes, achieve charitable goals, and craft plans that will promote family unity in the long-run. Each person is different, and each family is different; accordingly, each estate plan will demand the use of a different combination of the various tools and techniques discussed below.

I. BASIC ESTATE PLANNING DOCUMENTS

Every individual needs an estate plan. Having a basic estate plan in place can ensure that your assets pass upon death according to your wishes and in the most tax-efficient manner possible. The basic estate planning documents that everyone needs are a Last Will and Testament, a Power of Attorney, a Medical Power of Attorney, a Directive to Physicians/Living Will, a Declaration of Guardian, and a HIPAA Waiver.

A. *Last Will and Testament*. A Last Will and Testament controls what happens to your assets when you die. In your Will, you'll name someone to serve as the Executor of your estate. The Executor will be in charge of settling the affairs of your estate. In your Will, you can also appoint who will become the guardian of any minor children in your care.

1. *Assets Not Subject to Provisions of a Will*. Some types of assets are not controlled by a person's Will, including retirement plans and life insurance proceeds. At your death, these assets are distributed directly to the persons named on the beneficiary designations.

Similarly, bank or brokerage accounts with a POD or JTWROS designation will override the provisions of your Will. A POD (pay on death) account will pass to the named beneficiary at your death. An account between two people with a JTWROS (joint tenants with rights of survivorship) designation will become the sole property of the other person at your death.

B. *Power of Attorney*. A Power of Attorney (also called a Durable Power of Attorney or a Financial Power of Attorney) authorizes you to name a person to handle your financial and asset management matters.

The document can be written to enable the agent to act immediately (an "immediate power of attorney") or can be written to become effective only upon your disability (a "springing power of attorney").

C. *Medical Power of Attorney*. A Medical Power of Attorney (also called a Durable Power of Attorney for Health Care) allows you to name someone to make health care decisions for you if you are incapacitated and not able to do so.

D. *Directive to Physicians/Living Will*. A Directive to Physicians (also called a Living Will) gives you the opportunity to direct ahead of time for a physician to continue or discontinue artificial life support systems in the case of a terminal illness or an irreversible condition with imminent death. It is used when a person is incapacitated and not capable of making such a decision at that time. It is important to note that a Directive to Physicians is not the same as a DNR (do not resuscitate order), which is a form issued by a state's Department of Health.

E. *Declaration of Guardian in the Event of Later Incapacity*. A Declaration of Guardian in the Event of Later Incapacity is a document which gives you the ability to designate those persons you specifically want to serve as your guardian should you need one. The person you name to serve as your Guardian of the Person will be able to handle personal care matters, and the person you name as your Guardian of the Estate will be able to handle financial and asset management matters. This document prevents family squabbles over who will serve as guardian if one is needed.

F. *HIPAA Waiver*. A HIPAA Waiver (also called an Authorization to Release Medical Information) enables those persons you name to receive information from your health care providers.

II. ADDITIONAL DOCUMENTS TO CONSIDER

A. *Declaration of Guardian for Minor Children*. A Declaration of Guardian for Minor Children is a way for parents to formally identify the individual or individuals whom they would like to care for their children in the event both parents pass away or are incapacitated. This document provides clear instructions to the court charged with deciding the children's care and ensures the parents' wishes pertaining to guardianship will be carried out. The Declaration of Guardian for Minor Children may be a stand-alone document or may be included in the Last Will and Testament of the parents.

B. *Statement Regarding Anatomical Gift*. A Statement Regarding Anatomical Gift is a document specifying the manner in which you wish to donate your organs and/or other body parts at death. This document allows the option of donating only for transplant or also for research.

C. *Appointment of Agent to Control Disposition of Remains*. An Appointment of Agent to Control Disposition of Remains allows you to designate the person you would like to be responsible for carrying out your wishes with respect to the burial or cremation of your body. The person designated as agent must sign this document in acceptance of the obligation.

D. *DNR*. A DNR (Do Not Resuscitate) is a form issued by the Texas Department of State Health Services that must be prepared and signed by a person's attending physician. It differs from a Directive to Physicians in that it is a way to state your desire to prohibit health care professionals from administering any life-saving treatment (e.g., CPR, defibrillation, etc.) in an out-of-hospital setting.

III. TRUSTS USED IN ESTATE PLANNING

A. *__Revocable Living Trust__*. A Revocable Living Trust is a trust that exists during life. The person creating the trust (called the trustor) typically names himself or herself as the initial trustee of the trust. During the trustor's lifetime, the trustor will transfer the ownership of assets to the trust. In the trust document, the trustor specifies who will inherit which assets at the trustor's death. While the trustor is alive, the trust is revocable and can be changed by the trustor in any way. If a person has a Revocable Living Trust, the Last Will and Testament will typically state that, upon the death of the trustor, any assets that are not already in the Revocable Living Trust will "pour over" from the Will to the Revocable Living Trust. This type of Will is called a Pourover Will.

One advantage of having a Revocable Living Trust is privacy. When a person dies and the family goes through the probate process to divide up the deceased person's assets as person specified in his or her Will, the Will is filed with the probate court and available to the public. A Revocable Living Trust, however, is not filed with the probate court and is not available to the public. The Pourover Will that the public would be able to obtain would simply state that all assets are left to the Revocable Living Trust. Information about what assets the deceased person owned and who inherited them would only be contained in the trust document and would be kept private.

Additional advantages of including a Revocable Living Trust in your estate plan include preventing the need for guardianship/conservatorship proceedings and possibly avoiding the need for your estate to go through the probate process. It is especially important to transfer out-of-state real estate to a Revocable Living Trust in order to avoid ancillary probate in the state where the real estate is located.

B. *__Retirement Accumulation Trust__*. If you have any retirement accounts, you may want to consider naming an Accumulation Trust as the beneficiary rather than naming family members. The Setting Every Community Up for Retirement Enhancement Act of 2019 ("SECURE Act") signed into law in December, changed the long-standing rules governing Required Minimum Distributions from an IRA to impose a 10-year payout rule for most beneficiaries, requiring that IRA amounts must be paid out within 10 years of the account owner's death. A surviving spouse may still withdraw retirement benefits based on his or her life expectancy.

Retirement assets left outright are susceptible to creditors, divorcing spouses, and estate tax. With an Accumulation Trust, IRA amounts received can be held in the trust rather than paid out immediately. So, although IRA amounts must be paid out from the IRA to the Accumulation Trust within 10 years, they can he held in the Accumulation Trust and dribbled out to the beneficiary over a longer period of time. By naming an Accumulation Trust as the beneficiary of your retirement assets, the retirement assets can be protected from a child's creditors, divorcing spouses, and estate tax.

C. *__Irrevocable Life Insurance Trust__*. If you own life insurance, consider owning it in an Irrevocable Life Insurance Trust ("ILIT"). Life insurance can be a good source of liquidity to provide for your family, the education of your heirs, and funds to pay estate tax. If you own a life insurance policy in your name and your assets exceed the estate tax exemption amount, the life insurance proceeds will be subject to estate tax when you die. A $1 million policy may only provide coverage of $600,000. If an ILIT owns the policy, you avoid the 40% federal estate tax.

D. *__Trusts for Your Children__*. Including trusts for your children in your estate plan provides protection for your children's inheritance. If your goal is to transfer appreciating assets to future generations tax-free and retain liability for income taxes so that Trust assets can grow without being depleted by income taxes, consider an Intentionally Defective Grantor Trust ("IDGT"), also known as a Defective Grantor Trust or simply a Grantor Trust.

If you leave an inheritance outright to your children, it is unprotected from their creditors, divorcing spouses, and estate tax. If desired, the child can be named as the trustee of the trust which benefits that child. With this planning, the trust assets are protected from a child's divorce. This may avoid the need for children to enter into premarital agreements because the child's inheritance will be owned by a trust and not by the child.

E. *Spousal Lifetime Access Trust*. If your goal is to transfer assets out of your estate by utilizing your lifetime gift tax exemption but allowing your spouse to continue to benefit from the assets, consider a Spousal Lifetime Access Trust ("SLAT"). With SLAT planning, each spouse can create a trust for the benefit of the other and gift assets equal to part or all of their lifetime exemption amount. For example, a Husband and Wife would first enter into a marital property agreement in which they agree to convert a portion of their community property into two separate property halves. Husband then creates a SLAT for the benefit of Wife and funds it with some of his separate property. Wife has access to her trust for her needs during her lifetime. Upon Wife's death, the remaining assets would be split into separate trusts for their children.

At a later date (perhaps several months or a year later), Wife creates a separate SLAT for the benefit of Husband and funds it with some of her separate property. In order to avoid violating the reciprocal trust doctrine, the second SLAT will not be identical to the first SLAT. Husband has access to his trust for his needs during his lifetime, and the remaining assets would be split into separate trusts for their children upon Husband's death. While both Husband and Wife are living, the couple retains access to all the assets in their respective trusts.

F. *678 Trust*. If your goal is to transfer appreciating assets out of your estate while continuing to retain access to the trust assets and control of trust investments, consider a 678 Trust (named after the Internal Revenue Code Section upon which it is based). Essentially, a 678 Trust allows a beneficiary to be treated as the owner of the trust for income tax purposes, provided all the requirements of the code section are met.

With a properly structured 678 Trust, you may continue to have the access to the trust's funds for health, education, maintenance, and support purposes and can serve as trustee of the trust. Moreover, upon your death, the assets owned by the trust will not be subject to estate taxes. Assets owned by the trust are also not subject to the claims of your creditors. The most obvious use of a 678 Trust is for those who own assets that have high appreciation potential and/or own assets subject to valuation discounts (such as interests in a limited partnership).

G. *Qualified Personal Residence Trust*. If your goal is to retain your interest in your residence for a term of years with the residence passing to heirs at the end of the term at a dramatically lower tax cost, consider a Qualified Personal Residence Trust ("QPRT"). Planning with a QPRT involves transferring your personal residence to a trust and retaining a right to live in the residence for a term of years (usually 10-15), with the remainder interest passing to other beneficiaries (typically children). The retained interest reduces the value of the gift for gift tax purposes because the value of the gift is equal to value of the residence minus the value of the retained income interest. Upon the expiration of the income interest, there is no transfer tax imposed. After the retained interest term ends, then you must pay rent in order to continue occupying the house, but the value of the residence, the rent you pay, and any future appreciation is transferred outside of your estate.

For example, if a house is worth $1 million, appreciates to $1.8 million, and is owned outright, then at death, the estate tax on the house will be $720,000 (at a 40% rate). If the $1 million house were transferred to a QPRT by a 65 year old owner for 15 years, the value of the 15-year term is $530,000 (using the March

2020 rate), so the taxable gift is only $470,000. (The actual value would need to be determined at the time of the transaction based on then current rates). The house ultimately passes to the children at a transfer tax value of $470,000 instead of $1.8 million.

H. _Charitable Lead Trust_. A charitable lead trust ("CLT") is a trust that makes an annual payout, either a fixed amount (a "CLAT") or a variable amount (a "CLUT"), to a charity for a fixed term such as 10, 15, or 20 years. At the end of the term, the trust assets pass to the donor's family (typically to the donor's children) free of estate or gift tax.

The CLT removes assets from the donor's estate so that the donor avoids the estate tax on the assets, but when the term ends, the assets pass to the donor's children. With careful planning, a CLT can be structured so there is no estate or gift tax on the portion of the assets passing to the children.

The best time to create a CLT is when interest rates are low. Low interest rates serve to reduce the present value of the remainder interest that passes to the children, making it easier to avoid paying gift tax on this amount.

The income tax consequences of a CLT depend on whether the CLT is structured as a grantor trust or a non-grantor trust. If the CLT is a grantor trust, the donor receives an income tax charitable contribution deduction when the CLT is created but pays income tax each year on the trust's entire taxable income (with no deduction for the amount passing to charity each year). If the CLT is a non-grantor trust, the donor receives no up-front income tax deduction, but the CLT gets a deduction each year for the amount passing to charity.

I. _Charitable Remainder Trust_. If your goal is to provide income to you or other family members during life or for a set number of years, with assets ultimately passing to charity, and to receive a current income tax deduction, consider a Charitable Remainder Trust ("CRT"). When an individual creates and funds a CRT, the trust makes an annual distribution back to the donor, and at the death of the donor, the remaining principal passes to the named charity. Alternatively, the CRT can be structured to continue after the donor's death for the benefit of the donor's family members (for either their lives or a fixed period of time), and at the death of the named family members, the remaining principal passes to the named charity. When a CRT is established, the grantor receives an income tax deduction for the value of the remainder interest.

CRTs can be structured as "annuity trusts" or "unitrusts." In an annuity trust, the annual payout is a fixed dollar amount. In a unitrust, the annual payout is equal to a fixed percentage (minimum of 5%; maximum of 50%) of the value of the trust's assets, determined annually. In order to qualify as a CRT, at the CRT's inception, the actuarial present value of the remainder interest must be at least 10% of the value of the original gift.

The CRT is exempt from tax, so it does not pay capital gains tax or income tax as a result of its transactions. If appreciated assets are contributed to a CRT, the CRT can sell them with no tax due at the time of the sale. This provides an excellent opportunity to convert assets to cash without an immediate capital gains tax.

When the donor (or other beneficiary) receives annual distributions from the CRT, the distributions are subject to income tax based on a WIFO (worst in, first out) tiering system. Distributions first carry out any ordinary income accumulated in the CRT, then capital gain, then tax exempt income, then return of principal. The tiering system tax treatment is determined by the original character of the income when it was generated inside the trust. For example, if the CRT distributed income to the donor that was generated when the CRT sold stock owned for more than one year, and assuming there was no other income earned by the CRT, the donor would pay tax on the distribution at long-term capital gain rates.

IV. ADVANCED ESTATE TAX PLANNING TECHNIQUES TO CONSIDER

A. *Planning to Reduce the Estate Tax*. If you own assets totaling more than $11,580,000, you need to consider advanced estate tax planning techniques. When you die, the federal government will take 40% of the assets above the federal estate tax exemption level (for 2020: $11,580,000 if single, $23,160,000 if married), except for any assets that are going to charity. There are a variety of very effective techniques available to move assets out of your taxable estate. The estate tax has been called a "voluntary tax" because it is possible to completely avoid it.

The tax act doubled the estate and gift tax exemption, but it cuts back in half at the end of 2025. To lock in the benefit of the doubled exemption, a couple has to transfer $23.16 million out of their estate. Note that if a couple only transfers a total of $11.58 million in an effort to lock in the extra exemption, they've actually only used the original/old exemption amount. After 2025, that couple would have zero exemption remaining. To lock in the extra exemption amount, each spouse has to transfer $11.58 million. The preferred way to take advantage of the extra exemption amount before it sunsets is for each spouse to create an $11 million SLAT for the benefit of the other spouse. This is a "use it or lose it" situation.

B. *Family Limited Partnership*. Holding assets owned by the family in a family limited partnership ("FLP") provides asset protection and, through the use of valuation discounts, can be a useful tool to shift wealth outside of the taxable estate.

1. *Asset Protection*. A creditor has limited access to assets held within an FLP. Under Texas law, if a creditor has a judgment against a partner, the creditor can petition a court to issue a "charging order." The charging order entitles the creditor to the debtor's partnership distributions for so long as the charging order is in place, but does not allow the creditor to reach the assets remaining within the partnership and does not allow the creditor to acquire any rights to affect the management or operation of the partnership. In other words, the creditor can take the partner-debtor's share of the distribution if and when any distribution is made, but he has no ability to control the amount or timing of any distributions.

An important aspect of an FLP is that the general partner is liable for all partnership liabilities. This means that if a partnership is unable to pay its debts or judgments, the creditor can go after all of the general partner's assets. Because of this, we generally recommend that the general partner be an entity with limited resources, such as a limited liability company.

In addition to providing asset protection, FLPs are favored because they: (i) provide a great deal of flexibility in how they are formed and operated; (ii) are taxed on a pass-through basis; and (iii) can be used as a tool to achieve estate and gift tax savings. This third extra benefit—estate and gift tax savings—can be substantial.

2. *Valuation Discounts*. A limited partnership interest is worth less than a proportionate share of the underlying assets because of restrictions placed on the limited partners by the partnership agreement. A limited partner generally has no voting rights and cannot influence or control the operations of the FLP. Further, a limited partnership interest is not easily disposed of—there is no established market for limited partnership interests and partnership agreements often contain transfer restrictions that further impede sales. As a result, the fair market value of a limited partnership interest often reflects discounts for lack of control and lack of marketability. These discounts can result in estate tax savings upon death, or gift tax savings during life, when a limited partnership interest is transferred to the next generation.

For example, if a partnership is formed and funded with $10 million in assets, the limited partnership interests associated with such assets might be valued at only $6.5 million, representing a 35% discount for lack of marketability and lack of control. As a result, holding the assets in a limited partnership rather than holding them outright would result in an estate tax savings of approximately $1.4 million using the current estate tax rate of 40% ($10 million x 40% estate tax = $4 million; $10 million less 35% discount x 40% estate tax = $2.6 million).

C. _Basis Bump Planning_. With the higher exemption amount, the estate planning focus for many is less on saving estate tax (as most estates are no longer subject to estate tax) and more on getting a basis bump to avoid a 23.8% long-term capital gains tax when inherited assets are later sold.

1. _Swap Assets Back into Estate_. For years, advisors have urged clients to transfer assets out of the estate, typically to a grantor trust so the gift is super-charged because the grantor continues to pay the income tax generated by the assets. The problem is that at the grantor's death, the assets in the trust won't receive a basis step-up.

Grantor trusts commonly give the grantor a swap power, allowing the grantor to remove assets from the trust and swap them with assets of equal value. The grantor would exercise that power to remove the low-basis assets from the trust and replace them with cash or high-basis assets. The low-basis assets would be in the estate at death and receive the step-up.

2. _Upstream Planning_. If an individual has appreciated assets, they should look "upstream" to a parent for obtaining a stepped-up basis, especially if the parent is ailing.

a. _By Gift_. If the client has low-basis assets and the client's parent has unneeded exemption, the client could gift the assets a parent outright or, even better, to a trust for the parent and give the parent a General Power of Appointment ("GPOA") over the assets.

For example, the client creates a trust benefitting the parent and gifts low-basis assets to the trust. In drafting the trust, the client gives the parent a GPOA over the trust assets. The GPOA will cause the assets to be included in the parent's estate under IRC Section 2041(a)(2). In the parent's Will, they exercise the GPOA and leave the assets to a trust for the client. When the parent dies and the assets come back to a trust for the client, the assets will have a new stepped-up basis.

Caution: IRC Section 1014(e) denies the basis step-up if the assets come back to the child or the child's spouse within one year. This potential limitation may be avoided if the assets pass (i) to a trust for the benefit of the client and/or the client's spouse with a trustee other than the client or client's spouse or (ii) to the client's child or a trust for the child's benefit.

b. _By Sale_. The previous technique requires using up exemption for both the client and the client's parent. What if the client or the parent doesn't have enough lifetime exemption? Or, what if we don't want to use up their exemptions? Instead of the client making a gift to the parent, consider a sale to the parent's trust.

For example, the client sells low-basis assets to a grantor trust, taking back a note secured by the assets. By selling instead of gifting the assets, the client's exemption won't be used up. And, because the trust is a grantor trust, there is no income tax on the sale. When the parent dies, the assets included in the parent's estate will be offset by the secured debt owing by the trust. So, the parent's estate would only increase by the amount of any appreciation on the assets between the date of sale and the date of death, less any interest paid on the note.

The assets get a stepped-up basis, but the net increase to the parent's estate is zero (assuming there was no appreciation between the date of sale and the date of death). Therefore, none of the parent's exemption is used. We've obtained the same result as the previous planning idea, but neither the client nor the parent used up any exemption to get it.

D. *Utilizing a "FAST" (Family Advancement Sustainability Trust) to Keep the Family Strong*. Often the patriarch and matriarch of a family begin activities to prepare the heirs to be responsible inheritors, pay for them, and make them happen. A problem is that after the patriarch and matriarch are gone, the children drop the ball and don't want to pay for these activities or take the time to do them. It takes more than G-1's hopes and dreams for future generations to succeed. Hope is not a strategy. G-1 needs to be intentional and implement a practical solution.

There's a new type of trust dedicated to saving the family called the Family Advancement Sustainability Trust ("FAST"). Essentially, the FAST does two things.

(1) **A FAST provides funds**. The FAST provides funds for future generations to use to prepare heirs to be able to successfully manage an inheritance. It can fund family enrichment activities to keep the family together after the elder generation dies, such as family retreats, family meetings, and family travel. The FAST can also provide funds to train future generations on concepts like philanthropy, entrepreneurship, and being responsible stewards. Consider dedicating a life insurance policy to provide funds for the FAST.

(2) **A FAST provides leadership**. The FAST creates a leadership structure to ensure these activities happen, using a system of trustees and committees who are paid to run the FAST and charged with the responsibility for carrying out these tasks.

A FAST is an add-on to traditional estate plan. A traditional plan is still needed to provide for: health, education, maintenance, and support; investment management; tax savings; and asset protection (creditors/divorces). However, the FAST can be bolted on top of an existing estate plan as an entirely separate piece, without disrupting the existing plan.