

# TEXAS ESTATE PLANNING

Henry C. McFadyen, Jr.

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## **Part I**

# **INTRODUCTION**

## **1 WHAT'S TEXAS ESTATE PLANNING? <sup>2</sup>**

Estate planning includes every aspect of your financial life. Part I of this presentation is an introduction. Part II covers estate planning subjects that apply to everybody in Texas. Part III is mostly for folks with larger estates and tax problems. Part IV deals with protecting assets from creditors.

### **1.1 Building Wealth**

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

### **1.2 Protecting your Wealth**

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

### **1.3 Retirement**

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

### **1.4 Disability**

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

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## **1.5 Death Planning**

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

## **1.6 Blessings**

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

## **1.7 When Someone Dies**

This presentation is about planning. If someone dies, see my companion presentation *Estates of Decedents in Texas*, which covers how estates work in Texas.

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

Estate planning often seems difficult and confusing.

## **2.1 Estates are Complicated**

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

## **2.2 Only Change is Certain**

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

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

Our society relies on many public and private bureaucracies for social and financial support. Organizations such as the state courts, the federal Social Security Administration, your pension plan, your banks, and your insurance companies, etc. support you in their own fields. But there's no agency to help you put it all together if you are disabled or die — you're on your own. It's hard for you to concentrate on an estate plan that may never be used! And if you are seriously ill, it's even harder. That's right, when the doctor tells patients to “get your affairs in order,” they rarely do. Medical concerns overwhelm everything else. So in the terminal illness situation, look for a healthy and hopefully younger person to focus on the estate planning of the patient.

# **3 HOW TO MAKE PLANNING EASIER**

## **3.1 Keep your Perspective**

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

## **3.2 Keep it Simple**

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

## **3.3 Plain Language Documents**

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

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

### **3.4 Coordinate Assets to Plan**

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

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

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

I've had good luck with putting copies of planning papers, insurance documents, beneficiary designation forms, account reports, and the like in big 3-ring student notebooks. This makes it relatively easy to review everything and reorganize papers as the situation changes. And above all, your original will is a document you do not want to lose! Keep the original will in the safest place you can find.

### **3.6 Stay in Touch**

Call to see if there's an update of *Texas Estate Planning*. You can reach me at 972.387.1828. My address is 7817 La Sobrina, Dallas, TX 74248. My email addresses are [hank@mywill.com](mailto:hank@mywill.com) or [hmcfadyen@tx.rr.com](mailto:hmcfadyen@tx.rr.com).

## **4 LOOK AROUND**

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

### **4.1 Parents**

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

## **4.2 Young Estate Owners**

If you have children who are single or just starting their families, estate planning is probably a low priority. But urge them to do at least the free estate planning discussed on [www.mywill.com](http://www.mywill.com).

## **4.3 Business Partners**

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

## **Part II**

# **TEXAS ESTATE PLANNING FOR EVERYBODY**

## **5 TEXAS MARITAL PROPERTY LAW**

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

### **5.1 Separate Property**

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

#### **5.1.1 Divorce**

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

#### **5.1.2 Death**

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

#### **5.1.3 Creditors**

If your spouse gets in trouble with creditors, it's difficult (but sometimes still possible) in Texas for your spouse's creditors to reach your separate property to collect.

### **5.2 Community Property**

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

### **5.2.1 Ouch!**

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

### **5.2.2 On divorce**

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

### **5.2.3 Death**

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

## **5.3 Marital Property Agreements**

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

### **5.3.1 Getting married?**

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

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

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

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

### **5.3.3 Records**

If you sell separate property and reinvest the proceeds, the new property is also separate. But remember, if you've married, everything is considered community unless you can prove it is separate. So if you have a marital property arrangement, you have to back it up day-by-day with good records. And from time to time you should transfer community income earned by separate property (if any) into a community account. This reduces the risk that you might accidentally convert separate property into community property through commingling.

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

- ▷ Make sure to title all your separate accounts something like this: "Mary Lamb Separate Property." If an account is titled "Mary Lamb Account," the law assumes it is community.
- ▷ As explained above, you should from time to time transfer any income earned by your separate property out of the separate property account to a community account. This tends to keep the separate property from being tainted with community earnings.
- ▷ Finally, have a bookkeeper set up a complete record of everything you do with your separate property. You are allowed to reinvest your separate all you like. But the trick is to be able to clearly trace your holdings back to the original assets that were separate.

## **6 DEATH WITHOUT WILL**

### **6.1 Intestate Succession**

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

#### **6.1.1 Pitfall**

What happens if a Texas husband dies with community property, children, and no will? The answer depends on who is the mother of the kids! The wife gets her half of the community property regardless. If the wife is the mother of the kids, she gets her husband's half of the community also. But if the husband has a child who is not the child of the wife, then hold the phone. The husband's share of one-half of the community goes not to the wife, but to the husband's kids! (In this step-child situation, the husband's kids also get one-half of the community property earned by the wife as well as one-half of the husband's community property.) So if you are married and there are step-children, you probably need to be sure your spouse has a will.

### **6.1.2 Different pitfall**

What happens if our Texas husband dies with separate property, children, and no will? Two-thirds will go to the kids and only one third to the wife, even if the wife is the mother of the kids! This is probably not what the poor guy had in mind. Many Texas spouses have separate property without knowing it because the couple recently moved to Texas from a common law state. Moral: If you are married, be sure your husband or wife has a will!

## **6.2 Will Substitutes**

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

### **6.2.1 Car titles**

Car titles in Texas can now be filled out in different ways to pass to survivors automatically without going through probate. But few people other than car dealers with expert "title clerks" know much about this. Even the Texas Department of Motor Vehicles seems to be having trouble with fancy car titles. So this may not be practical for you except when you are buying a new car.

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

Accounts at a bank, credit union, stockbroker, etc. are often used as will substitutes in Texas. If you set up one of these accounts, be sure you talk to an experienced person at the institution who knows how to use the different kinds of accounts correctly. Be aware, however, that burden of picking the right account for your needs rests on you, and not on the bank or financial house you are working with. If you try to make the bank legally responsible for giving you the account you need, they will probably ask you to get advice from your lawyer.

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



**6.2.2.2 Contrast to agency account** JTWR0S should be contrasted with an agency account. An agency account is typically used when an old person wants a younger relative or a friend to be able to write checks to pay the bills of the old person. But the old person wants his property on his death to pass to his relatives and not to the agent. So the account is set up so both the owner and the agent can both sign checks. When the owner dies, the account passes through the estate of the owner of the account (either by his will or by intestacy) and nothing belongs to the agent. But all too often in this situation, the parties mistakenly use the wrong form and establish a joint tenancy with right of survivorship. When the old person dies, the agent walks off with the money and the heirs get nothing.

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

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

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

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

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

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

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

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

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

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

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

## **7 BASIC ESTATE PLANNING**

### **7.1 Free Will**

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

“I, Mortimer Snerd, give all my property when I die to my wife, Modine Snerd, and she will be my independent executor to serve without bond. [Signed] Mortimer Snerd on January 1, 2018.”

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

#### **7.1.1 Legal will**

Mortimer’s will is legal in Texas because it is entirely in his handwriting. It would be hard to forge this much writing, so the court will accept it even though there are no witnesses. For more examples of free wills, see [www.mywill.com](http://www.mywill.com).

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

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

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

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

## **7.2 If Both Spouses Die**

What if both husband and wife should die leaving minor children as orphans? This calls for a will with a trust for the orphans. This is the most common type will used in Texas, so I will call it the John and Jane Doe estate plan. In John's will, everything goes to Jane. If something happens to both John and Jane, the will has a trust for the orphans until the youngest child is, say, age 21 and the children are ready (hopefully) to get their inheritance. The wills also name a trustee for the trust and a guardian for the orphans. If your children are grown, your will could be simpler. It would leave everything to your spouse; or if you are the second to die, to the children outright in equal shares.

## **7.3 Special Wills**

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

### **7.3.1 Several families**

If you have remarried, there may be step-children. If there are children from your new marriage, you have even more obligations! If you are in this situation, you probably need a thoughtfully-developed will coupled with a good insurance program. Most lawyers will try to write an estate plan for both spouses when there are step-children and things seem peaceful. But some of the most conservative and careful lawyers will only represent one of the spouses in a "blended" family. The idea is to avoid conflicts of interest by having a different lawyer for each spouse.

### **7.3.2 Elderly parents**

If your parents need help, you may want to have a trust for them in your will.

### **7.3.3 Charities or friends**

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

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

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

## **7.4 Independent Administration**

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

### **7.4.1 Avoid probate?**

High court costs and attorneys' fees associated with dealing with the probate court in many parts of the United States have given the probate process a much-dreaded reputation. In many states, costs and fees associated with the probate court in a substantial estate (valued at, say, one million dollars) can be more than \$25,000. In Texas, probate fear-and-loathing is rarely justified. For a Texas estate of equal value, probate costs might be something like \$1,500 to \$2,500 depending on how much work is required.

### **7.4.2 Texas independent administration**

Perhaps you are wondering why Texas probate is so reasonable. The engine of this drastic cost-differential is named: Texas independent administration. If your will calls for independent administration, all your executor has to do in the probate court is appear at one hearing (to prove that the document offered is your true will) and file an inventory (or perhaps an affidavit in lieu of the inventory) of your estate later (by e-filing). Your executor will receive from the county clerk a document called "Letters Testamentary." Then your executor will handle the rest of the administration of your estate with only minor further involvement of the probate court. In many other parts of the United States, you can save substantial amounts of money for your heirs by setting up your estate in a living trust (discussed in detail later in this paper) to avoid probate. But because the probate of a will in Texas is so simple, there is seldom an advantage in Texas in "avoiding probate" through the use of a living trust. In Texas, the costs of setting up a living trust will often be more than the expected savings from avoiding probate.

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

To have independent administration of your estate, you should have a will which requests it. Mortimer Snerd's will simply says that his wife will be the independent executor, and that is enough.

The typical language that you will see in a typewritten Texas will include something like this: "No other action shall be had in the probate court in which this will is probated . . . than the probating and recording of this will and the return of an inventory . . . ." (Your will should also say that the independent executor will serve without bond.)

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

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

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

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

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

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

#### **7.5.1 Executor**

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

#### **7.5.2 Trustee**

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

### **7.5.3 Guardian**

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

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

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

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

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

### **7.5.6 Corporate fiduciary**

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

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

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

So do not think your estate plan is done just because you have signed a new will! Your beneficiary designations have to be coordinated to the will to be sure that the plan works well.

### **7.6.1 Insurance**

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

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

### **7.6.2 Retirement plans**

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

- ▷ Retirement plans here means arrangements where you have control over a fund for retirement. If money is left over after you and your spouse (or other beneficiary) have died, it can go to other members of the family. Examples of this kind of retirement plan include the IRA, 401(k), and Keogh Plan.
- ▷ The downside to all this is that you have complete responsibility for managing your retirement plans. This responsibility includes figuring out who inherits the plans. This typically do this by filling out beneficiary designation forms.

- ▷ When you reach 70½, you have to start taking money out of your retirement plans. These are the “Required Minimum Distributions.” If you don’t need the money to live on, you stick to the minimums and try to preserve the plan to be inherited by your heirs.
- ▷ Most people know that a surviving spouse usually can “roll over” a retirement plan she inherits so that it will be treated as if she made the money herself. This is a valuable right for most surviving spouses. Rollover has never been available to children or other non-spouses who inherit retirement plans. Recently Congress gave non-spouses who inherit retirement plans some new tools to “stretch out” the required distributions and thereby preserve the valuable tax shelter of the retirement plan. (This has been incorrectly called a “non-spouse rollover.” The new provisions work quite differently from a rollover.) If you are involved with a retirement plan passing to a non-spouse, get expert advice.

### **7.6.3 Financial accounts with will substitute features**

We discussed earlier a number of will substitute including financial accounts with right of survivorship, POD instructions, and the like. If you have a will with tax-saving or other special features, be careful not to put too much of your property into accounts with will substitute features; there might not be enough left in your estate to fund the gifts in your will.

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

### **8.1 The Problem**

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

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

Two other powerful tools are the Hospital Do Not Resuscitate Order and the Out-of-Hospital Do Not Resuscitate Order. These are more medical than legal documents. Lawyers rarely get involved with Hospital Orders. But sometimes lawyers will write special and unusual Out-of-Hospital Orders that with can be backed up with special necklaces and bracelets that warn medical first responders about the wishes of the patient.



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

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

### **8.2.1 Texas form**

The Texas Legislature has had a history for many years of changing the durable power of attorney law every time it meets. Every time they overhaul the statute, the rule is kept that older correctly signed durable power of attorney documents will remain valid. Then the Legislature will include in the new statute a “safe harbor” form to use going forward. Beginning September 1, 2017 the Legislature came up with the biggest changes ever to the Texas durable power of attorney for property. Now for the first time, it’s clear how you can name two or more agents and how they will share authority in working as agents. Now agents can be paid for the work they do. The accounting responsibilities of the agents are vastly increased. Finally, third parties whom the agent approaches with proper instructions are required by law to honor the orders of the agent or agents. But the law also gives third parties tools to resist the orders of the agents unless the agents provide adequate factual and legal proof that their orders are valid under the law.

All of this opens up the possibility that the durable power of attorney can be more effective in the future than before. In proper cases, the durable power of attorney may well function like an informal guardianship. All you have to do is to sign the correct form before a notary public.

Finally, you can still provide that the power of attorney will only be in effect after you actually have become disabled (a “springing” power of attorney). The trick for making this work is to find a medical doctor who will be willing to “pull the trigger” that causes the power of attorney to “spring” into life.

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

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

### 8.2.3 Disadvantages of durable power of attorney:

- ▷ Tremendous power is concentrated in the hands of the agent. There have been cases where agents stole money from principals. The new accounting rules reduce this risk. But there is no bond for security or regular governmental supervision of the agent. So the principal still must be absolutely sure about the honesty and loyalty of the agent before using the power of attorney tool.
- ▷ On the other hand, it appears that the agent still has no *duty* to do anything. If not, an agent may disappoint the principal by doing nothing.
- ▷ A Texas durable power of attorney may not be well received in other states because the law might be different there.
- ▷ The Texas durable power of attorney will still expire automatically on the death of the principal.

## 8.3 Revocable Living Trust for Property Management

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

### 8.3.1 Trusts in general

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

The main difference between a trustee and the agent under a power of attorney is that a trustee has the *positive duty to act* to take care of the property for the beneficiary. If the trustee fails to perform, he can be liable in damages. But if the principal suffers damage because the agent under the power of attorney did nothing, there may be no recourse. You get what you pay for.

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

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

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

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

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

- ▷ The living trust tends to be a formidable legal document that is expensive to write.
- ▷ Sooner or later, you have to put your property into the living trust for it to work. This is often quite expensive and time-consuming. You have to change your way of thinking and remember to maintain the trust as you go about your business. Some assets, such as a sole proprietorship business, cannot practically be placed into trust. The cost and hassle of funding a living trust and maintaining it correctly may be worthwhile in a state where probate costs are high; it is harder to justify these costs, however, in a state such as Texas where probate is efficient.
- ▷ It is rare that everything gets put into the trust. There will almost always be a will that is designed to "pour over" into the living trust any properties that are not placed in the trust before the grantor dies. So even though you put a living trust in place, usually you will have to probate the will anyway.
- ▷ The living trust can have tax disadvantages. Some of the literature on living trusts suggests that the living trust offers a way to save taxes. This is misleading. The various strategies used to save estate taxes can be put into effect with a plan based on a living trust or a will. But the IRS estate tax forms and procedures favor having an executor and discriminate against a trustee who has the duty to pay estate taxes. There are small, but nevertheless annoying, tax disadvantages to using the living trust. For example, an estate can have a fiscal year for income taxes, which can be advantageous to the beneficiaries. A living trust receives similar treatment only if you make a special election.

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

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

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

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

### **8.4.2 Typical plan**

I believe the living trust is the Rolls-Royce of estate planning. In an ideal world, perhaps everyone would have one. But a Rolls is costly to buy and maintain, and it requires a chauffeur. The standard plan for the Texas estate owner is and will likely remain a will coupled with a durable power of attorney for property. For most Texans, the additional benefits of a revocable living trust will not

be worth the extra cost, chiefly because probate in Texas is efficient. I could do a living trust for myself for free, but I don't have one — I just don't need the hassle.

### **8.4.3 No reliable child**

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

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

## **8.5 Medical Power of Attorney**

The Texas legislature has prescribed a statutory form for a medical power of attorney. The agent has broad powers to manage the medical treatment of the patient signing the power, but this goes into effect only when the patient cannot communicate with the doctors. These powers include the power to withhold life-sustaining procedures from a terminally ill patient.

## **8.6 HIPAA Authorization**

The law restricts medical providers from giving your medical information to others. So if you want family members to be able to discuss your case with the doctors, you may have to sign papers. Some lawyers include HIPAA authorization in the medical power of attorney documents and in a separate document as well.

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

The Texas legislature has also prescribed a statutory form for the directive to physicians. The directive to physicians is often called a "living will." The directive to physicians usually states that you don't want to be kept alive by heroic means if you are terminally ill or suffer from an irreversible condition leaving you in a coma. If you sign a medical power of attorney, do you need

also to sign a directive to physicians? Usually no. The medical power of attorney overlaps the directive to physicians. But you might not want to place the burden of the "pull-the-plug" decision on your agent under the medical power of attorney. You can relieve your agent from this by having a directive to physicians. If you are seriously ill, the directive to physicians clearly says what you want, and you might find that more comforting than the medical power of attorney alone. Finally, there are folks who don't have anyone they can appoint as agent for health care matters. They can use the directive to physicians without an agent.

## **8.8 Declaration of Guardian**

Some clients fear that a particular relative or associate may try to gain control by becoming guardian. There is a way to prevent this with a declaration of guardian in event of need. With this declaration you can pick your guardian and rule persons who should not serve.

# **9 SPECIAL PROBLEMS**

## **9.1 The Migrant Executive**

Have you moved to Texas from another state?

### **9.1.1 Update will**

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

### **9.1.2 Living trusts**

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

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

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

## **9.2 Divorce**

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

## **9.3 Non-Citizen**

The rules on estate taxes discriminate against spouses who are not citizens. If your spouse is an alien, you may need special provisions in your planning.

# **10 LIFE INSURANCE**

Insurance will play an important part in most estate plans.

## **10.1 Death Protection**

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

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

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

## **10.3 Protect Business**

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

## **10.4 Exemption from Creditors**

Under Texas law, the cash value and the proceeds of life insurance is generally immune from the creditors of the insured and the creditors of the beneficiary.

## **10.5 Fund for Death Taxes**

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



## Part III

# SAVING TAXES WITH ESTATE PLANNING

## 11 FEDERAL TAXES

### 11.1 Four Federal Taxes that Applied to the Wealth of Individuals:

1. **Income Tax.** A tree yields fruit, and the income tax is paid from the fruit of the tree each year. This tax is levied on the individual while he is alive and on the income of his estate after he dies. The income tax on estates is a different tax from the estate tax. The income tax on estates used to be less than the income tax on individuals, and there was a tendency to keep estates running a long time as a shelter from income tax. Today, estates pay more income tax than an individual. Now it may save income taxes to close out the estate promptly. We should also note that trusts pay income tax the same as estates, so trusts are also not tax shelters (except when they are retirement fund trusts, like, for example, IRAs, with tax shelter benefits built in by special exemption statutes).
2. **Estate Tax.** This is a tax on the tree itself; it is paid after the owner of the tree dies. Beginning in 2018, the threshold for possible imposition of estate tax is \$11,400,000. This means a married couple in Texas with community property can, generally speaking, protect up to \$22,800,000 from the estate tax by doing proper estate planning.
3. **Gift Tax.** The gift tax applies to gifts the property owner makes during his lifetime. The threshold is the same as for the estate tax, i.e., \$11,400,000.
4. **Generation-skipping Tax ("GST").** This tax is vexing to wealthier folks who want to include grandchildren in their estate plans. Example: Many wills leave property in trust for children for life, and then the trust goes to grandchildren. Under the GST, there may be a tax when the children die. Further example: a large estate is given in a will to grandchildren. Both the estate tax and the GST will apply.
5. Let's focus for a moment on the relationship of those four federal taxes to each other in respect to very large estates:
  - (a) The gift tax supports the estate tax. You can't escape the estate tax by giving away all your property.
  - (b) The gift tax also supports the income tax. If there were no gift tax, wealthy parents could shift assets to lower-bracket children to reduce income tax.
  - (c) The GST works to support the estate tax. The rough idea is for there to be a death tax on each generation no matter how matters are arranged.
  - (d) Because the Gift Tax, the Estate Tax, and the GST no longer apply to middle-class estates, this paper will only touch briefly on them.

## 11.2 Basis of Inherited Property

But there is one important tax benefit available to every estate owner (not just the very wealthy). Property (this includes all kinds of property and not just real estate) has a "basis" for income tax purposes of the value of what you paid for the property. If the property goes up in value and you sell it, you pay income tax on your gain. If the property goes down and you sell it, you have a loss. When property changes ownership by being inherited at death, the law does not consider this a "sale or exchange" to generate an income tax gain or loss. But even though there's no doomed sale, the tax law generally gives the estate beneficiary an income tax basis in the property equal to the fair market value of the property when the estate owner died.

### 11.2.1 Basis boost

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

- ▷ The reason why a new basis is given at death is primarily for convenience. It would be difficult for heirs in many cases to know what the true basis of the property was in the hands of the persons from whom they inherited it.
- ▷ Basis boost at death has been a huge benefit for both middle class and wealthy families who own capital assets passed down by inheritance. But the values of assets can also drop, especially in a recession. This can result in "basis bust" at death, i.e., the children may inherit less basis in the property than what the parents paid.

### 11.2.2 Illustration of basis boost at death

- ▷ Example: Jiggs and Maggie have a Texas community property warehouse worth \$3,000,000 that they bought in 1965 at a low price. There is practically no basis for income tax purposes; if they sold the warehouse, there would be \$3,000,000 of income to be taxed. Jiggs dies in 2018 and his half of the warehouse goes to Maggie. Because the estate is of modest value, there will be no estate tax.
- ▷ Maggie doesn't want to worry about keeping the warehouse rented. She promptly decides to sell her half of the community and Jiggs' half she inherited. Everything will be reinvested in income-producing bonds.
- ▷ How much income tax will be due when Maggie sells the warehouse? Answer: None! Both Jiggs' half and Maggie's half of the community warehouse receive a new basis for income tax purposes equal to the fair market value of the property at Jiggs's death. This basis boost or step-up in basis at death applies, and the built-in income tax liability disappears, even though no estate tax was paid.

- ▷ The basis boost works just the same for stocks or other low-basis property. Because of this basis boost at death, it has been estimated that the true rate of taxation on profits on capital type properties in the U.S. as a whole is far less than 15%. In the next paragraphs are some other ramifications of the basis boost at death.

### **11.2.3 Carry-over basis for gifts**

Gifts to children of low-basis property may save estate taxes, but the children lose ground later when they sell the property. A gift just carries its old basis with it; and when the donor dies, there is no basis boost. If you are going to make a gift to a child, maybe cash is the better choice. Let the appreciating assets pass through an estate to get the basis boost.

**11.2.3.1 High appraisals** When someone dies, it may pay to appraise property high. Why? To save income taxes later. Caution: IRS has penalties to combat grossly inaccurate appraisals.

**11.2.3.2 Til death do us part** The older a property owner is, the greater the incentive to hang on to the low-basis property rather than sell it.

## **12 STATE TAXES**

Texas has no general income tax on individuals. Texas had an inheritance tax (and a generation-skipping tax). But this amounted to a kind of tax-sharing device where the Federal government used to cede some death taxes to the state of Texas. This tax-sharing was repealed a few years ago, and the Texas inheritance tax was abandoned.

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

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

## **14 WHAT'S YOUR ESTATE FOR ESTATE TAX PURPOSES?**

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

## **14.1 Insurance**

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

## **14.2 Community Property**

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

## **14.3 Rule of Thumb**

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

## **14.4 Gift Tax**

Minor gifts are not counted at all for death tax purposes. In 2018, you can make a gift of \$15,000 to anyone without any gift tax concern. Spouses can make gifts of \$30,000 in a year to any recipient. The tax-free amount for major gifts is now \$11,400,000.

## **14.5 GST tax**

The GST tax will have the same tax-free amount as the estate tax.

# **15 DEATH PLANNING**

## **15.1 Basic Themes**

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

### **15.1.1 Tax-free amount**

Because of the tax-free amount, one can make a case that tax-saving estate planning today is of interest only to a person or couple whose estate is considerably larger than \$11,400,000. On the other hand, this threshold amount is the highest in history. Persons with substantial estates less than 11,400,000 may want to keep in mind the fact that the threshold could easily be reduced in the future.

### 15.1.2 Unlimited marital deduction

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

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

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

## 15.2 Classic Tax-Saving Plan for \$22,360,000 estate

With the basic themes in mind, let us work through the classic Texas tax-saving estate plan (some-what simplified). Consider a couple, Jiggs and Maggie, with a community estate of \$22,360,000 and several children. Let’s say it’s 2018 and the tax-free amount \$11,180,000. (You’re right, it’s now 2019 and the tax-free amount has gone up a bit. But we will stick with our 2018 example because we are too lazy to refigure the exact numbers every year.)

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

Tax	
Gross estate	\$22,360,000
Less tax-free amount	-11,180,000
Taxable estate	<u>11,180,000</u>
Tax (approximate)	\$4,425,800

Distribution	
Maggie’s estate	\$22,360,000
Tax on her estate	<u>-4,425,800</u>
To the children	\$17,934,200

On these simplified numbers, the tax rate is about 19.7%. This is not the end of the world, but this tax of \$4,425,800 could have been entirely avoided. Let's see how.

On Jiggs' death, Maggie has her half of the estate in her own account. From Jiggs' part of the estate, the tax-free amount of \$11,180,000 goes to a trust set up in his will for the benefit of Maggie, i.e. the family trust. Maggie is the sole trustee of the trust. Maggie is the only beneficiary of the trust for the rest of her life; on her death, the trust will go to the kids. There is no tax now on Jiggs' estate because of the tax-free amount of \$5,000,000; when Maggie dies, there will be no tax either on this trust because it will go directly to the kids. When Maggie dies, here is the picture:

#### Tax

Maggie's estate	\$11,180,000
Less tax-free amount	<u>-11,180,000</u>
Taxable estate	0
Tax	\$0

#### Distribution

Maggie's estate	\$11,180,000
From Jiggs' estate	<u>11,180,000</u>
To the children	\$22,360,000

The family trust in Jiggs' will bypasses Maggie's estate. The kids get the whole \$22,360,000 estate. They are \$4,425,800 better off than under the simple will plan.

### 15.3 Advantages and Disadvantages of Classic Tax-Saving Plan with Family Trust

The key to avoiding the estate tax altogether for the children of Jiggs and Maggie was the Family Trust. This kind of trust has been used in many Texas will in the past when the threshold for getting involved with estate tax was lower than it is now. This kind of trust was also called a "bypass trust" because it let Jiggs's half of the estate bypass Maggie's estate. In other words the two halves of the community estate were kept separate. Each person has a enjoys a tax-free amount under the law. The threshold or tax-free amount was used twice: once by both Jiggs and once by Maggie. This is obviously a neat trick. So now let's look a bit closer at more about the advantages and disadvantages of using classic bypass trust estate plan:

#### 15.3.1 Advantages of family trust

- ▷ Can save a lot of estate tax.
- ▷ Can yield modest income tax savings through the flexibility of the family trust in making distributions in proper cases.

- ▷ Tends to secure the inheritance of the children from Jiggs' half of the estate. So if Maggie re-marries, she cannot later give Jiggs' property to her new husband!
- ▷ Protects estate from wife's creditors.
- ▷ The widow or widower can be the trustee of family trust.

### **15.3.2 Disadvantages of family trust**

- ▷ The family trust based on the threshold amount tends to be quite tricky to write because Congress has a habit of changing the estate tax law so much.
- ▷ A will with a tax-saving trust is hard for the survivors to understand.
- ▷ There will be legal and accounting fees to set up the trust. The trust is a separate taxpayer, so there must be separate books, etc.
- ▷ The children have a legal interest in the trust. They may come snooping around.
- ▷ Some widows find the trust confusing. Some widowers find the trust interferes with their business.
- ▷ Because of these problems and due often to lack of leadership, a lot of family trusts called for in wills never get set up. Then on the second death, the survivors may be faced with estate taxes that easily could have been avoided. (What happened to that trust under Daddy's will!?)

## **15.4 Disclaimer Will**

There is another type of family trust that is now popular with families with larger estates—the disclaimer trust. The idea is for each spouse to leave everything to the survivor. When the first spouse dies, the surviving spouse has the power to turn down all or part of the inheritance by a special document called a “disclaimer.” Then things are arranged so that the disclaimed property falls into the family trust in the will of the first spouse to die. If there's no disclaimer, the family trust will probably not receive anything, i.e. stay “unfunded.” But if it appears, based on the facts and circumstances present after the first death, that a funded family trust will save death tax later, then the surviving spouse will disclaim.

### **15.4.1 Advantages of the disclaimer will:**

- ▷ The will itself can be relatively simple and easy for survivors to understand.
- ▷ Decisions can be made based on the facts that exist at the time of death. If it appears the surviving spouse will not have an estate tax problem herself, she can relax and receive her inheritance.

### 15.4.2 Disadvantages of the disclaimer will

But, of course, there are also disadvantages that flow from important technical rules about disclaimers that must be followed.

- ▷ The disclaimer must be made on time, which is likely to be within 9 months after the death of the decedent
- ▷ The surviving spouse cannot exercise dominion over an asset and then disclaim it later. This means the surviving spouse must get good advice promptly after the death involved.
- ▷ There is special paperwork required to disclaim that must be correctly prepared and filed according to law.
- ▷ For this plan to work, the surviving spouse must have the ability to function promptly after the first death to meet the technical requirements of the disclaimer law.
- ▷ The surviving spouse can't direct the disposition of the asset disclaimed. It must fall into the family trust according to the plan.

## 15.5 QTIP Plan

If you have a larger estate, sooner or later you likely will hear something about a "QTIP trust." "Q-tip" is a famous trademark. "QTIP" is tax jargon dreamed up by Congressional tax code drafters at a happy hour. (It stands for "qualified terminable interest property.") Here are situations that might call for a QTIP trust:

- ▷ You built up a business through decades of hard work. Now you are married to a much younger woman. If you leave everything to her, she could leave the business to another man and cut out your children.
- ▷ You inherited ancestral property that you wish to keep in the bloodline. If you leave it to your husband outright, he might not leave it back to your family.

In situations like this, you can use a QTIP trust. With a typical QTIP trust, all the income goes to your spouse for life. Then on the spouse's death, the trust goes to your children or other beneficiaries you specify. If you use a QTIP trust, you can defer the death taxes until your spouse's death the same as if you had left the property to your spouse outright. But when the spouse dies, the taxes will fall due. (Sorry, if you want the trust to stop paying income to your surviving spouse on his or her *remarriage*, the QTIP doesn't work.)

A QTIP trust is usually a important arrangement with a built-in conflict of interest that applies to a lot of money that must be managed for a long time. This is a petri dish for trust litigation. I'm sure there are exceptions, but in my book, if the situation calls for a QTIP trust, it also calls for a trust company or bank trust department as executor and trustee. (I see a lot of QTIP trusts thrown into wills like routine boilerplate, usually with the surviving spouse as executor and trustee. These wills are asking the fox to guard the chicken coop.)



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

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

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

### **16.1 Gifts**

#### **16.1.1 Annual exclusion**

You can give \$15,000 to each child (or anybody else) each year. (A husband and wife can give \$30,000.) This escapes permanently from the gift and estate tax, and no gift tax return is filed. The easy way to do this is for you to make gifts outright to older children. For younger children, you can make gifts easily to a custodian under the Texas Transfer to Minors Act. The custodian will take care of the gift and turn it over to the child at age 21. If you want the money to go to the child later than 21, you can use a trust.

#### **16.1.2 Use tax-free amount**

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

### **16.2 Irrevocable Life Insurance Trust**

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

#### **16.2.1 Estate siphon**

One approach is to siphon funds into the life insurance trust each year with gifts that are covered by the \$15,000 annual exclusion for beneficiary (no gift tax return). When you die, the trust is owned by the children, not you, and there is no estate tax. The buildup of cash values inside is tax-free. The eventual receipt of the insurance is also income tax-free to the children.

### **16.2.2 One-pay trust**

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

### **16.2.3 Second-to-die policy**

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

## **16.3 Charitable Trusts**

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

## **16.4 Liquidity**

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

## **Part IV**

# **PROTECTING ASSETS**

## **17 BIG PICTURE**

Would you like to take steps to protect your assets from unanticipated future claimants? The basic idea is to give away assets or invest in properties that a claimant with a court judgment against

you cannot reach under Texas law. But there's more to it than that. If you are faced with big debt, you may want to go through bankruptcy. Your goal then will be to keep as much of your assets as possible while emerging from bankruptcy free of debt to your judgment creditor or others.

## **17.1 Fraud on Creditors**

It is fraud under Texas law and bankruptcy law for you to transfer an asset to a protected place if you do this with an actual intent to defeat an existing or contingent creditor you have at the time you make the transfer. Even if you have no such specific intent, it is also fraud if you transfer an asset for less than its value while you are insolvent.

If a transfer is fraudulent, your judgment creditor can reach the protected property or get a judgment for its value. In bankruptcy, the judge can refuse to give you the all-important discharge from debts if he feels you have acted in bad faith to abuse the laws. For example, in a Texas case, a debtor used cash to pay off the mortgage on his homestead shortly before he filed bankruptcy. The Judge couldn't force the sale of the homestead, but he denied the debtor his discharge. Any comment I make in this presentation about protecting assets from creditors assumes that you don't have claimants breathing down your neck now and you don't expect this to happen. We are talking about protecting against unforeseen creditors.

## **18 WHAT CAN YOU DO?**

### **18.1 Retirement Plans**

In Texas, all retirement plans and IRAs are exempt from creditors.

### **18.2 Pay off Home Mortgage**

If you pay off the home mortgage, you will always have a free place to live. A paid-for house is also a tax shelter since you enjoy the benefits of an easily rentable asset without having to declare income. Under Texas law, the homestead is completely protected from creditors (who didn't lend money on the house).

### **18.3 Insurance and Annuities**

Texas law extends strong protection to insurance products. The cash value of permanent insurance on your life is exempt from your creditors. Many estate owners may find it convenient to stash away cash in insurance products that are, in addition to being exempt from creditors, safe, liquid, tax-advantaged, and available to the owner at any time. Also, individual tax-deferred annuities (which are used as savings vehicles and do not have an additional death benefit if you die) purchased from insurance companies are exempt from creditors.

### **18.3.1 Insurance Proceeds on Your Life**

If you die, the proceeds of all your insurance should, with proper planning, normally be exempt from your creditors. For example, your insurance papers should name your loved ones (or trusts for them) as beneficiary rather than your estate. If family members receive the proceeds, it usually will be safe from your creditors.

### **18.3.2 Insurance Proceeds You Get as Beneficiary**

If you get insurance proceeds as a beneficiary on the death of someone else, those proceeds may be exempt from your creditors. If you have a creditor problem, you may be able to leave the funds with the life insurance company and have the best possible arrangement. The money can't be reached by your creditors even though you can draw it down, all or in part, anytime at your pleasure.

## **18.4 Don't Inherit Outright**

Are you going to inherit property outright? Could this become a juicy plum for your creditors? Would it be better for your relatives to leave your inheritance in a trust for you which your creditors could not reach? This theme has three major variations:

If you expect an inheritance from your parents, perhaps they should put some of it in a trust for you for a term of years or for your life. The trustee could be empowered to withhold trust funds from you in a time of trouble. The estate-tax-saving family trust discussed above can protect assets. If your wife should die before you, part of the community estate can be dedicated to a trust for you and the children which your creditors could not reach. Do you have a child in a risky business? Rather than leave money to the child outright in your will, you should consider a trust for the child that would run as long as there is a danger from his potential creditors.

## **18.5 Separate Estate for Spouse**

Are you a husband in a risky business? Maybe it is best to keep your wife out of the business to keep her separate estate obscure from creditors. Maybe you should partition community property so your wife can have a separate estate that your unforeseen creditors cannot reach. If you have separate property, children from a prior marriage, and a new wife, you may be able to set up a special trust to help your wife for the rest of her life and then go to your children (inter vivos QTIP); neither your creditors nor the creditors of your wife would be able to reach that trust.

## **18.6 Gifts to Children**

If your children own property, your creditors cannot reach it. Outright gifts and gifts into trust such as the irrevocable life insurance trust discussed above protect assets from unforeseen creditors. It is harder now than before to save income taxes by giving assets to trusts for younger children. But such trusts can put assets beyond reach of creditors, and, for example, insure a college education for your children.