Estate Planning Insights

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RECURRING MISUNDERSTANDINGS

Read each of the underlined, bold statements below and pretend this is a "True or False" Quiz. You may be surprised, but each bold statement below is False.

If Someone Dies with a "Good" Will, You Don't Have to Do Anything Because The Person Had A Will. All Wills must be "admitted to probate" in order to become effective. The idea of probate is to obtain a Court Judgment stating that the probated Will is valid and should be followed (i.e., the terms of the Will, including the distribution of assets per the Will, should be carried out). If the Will of a deceased person ("decedent") is *not* probated, then it will appear that the decedent died without a valid Will, and his assets will then be distributed according to state law (which may not be what the decedent would have wanted). If a Will is not probated, it will be difficult to sell the decedent's home later. Thus, all Wills should be probated to insure that the decedent's assets are distributed upon his death to the persons and in the manner the decedent specified in his Will. The only exception (which is *rare*) involves the case where a decedent established his estate plan via a revocable (living) trust and *fully funded the trust before death* (it is the full funding part that is so rare–we have seen only three (3) such cases out of 1,000 in our career).

If you have a Bypass Trust in your Will, you don't have to "Go Through Probate." There is nothing about having a *Bypass Trust* in your Will, which is an estate tax savings device, that gets you out of the probate process at death. The only time probate can be avoided is if there are no "probate assets" at death. The only desirable way to insure there are no probate assets at death is to create a revocable (living) trust and then re-title every single asset you own into the name of the trust before you die and name the trust as the beneficiary of all of your "beneficiary designation assets" (e.g., life insurance, 401(k) plans, IRAs) in beneficiary designation forms submitted before you die.

Probate Is A "Bad" Thing. People have the idea that the probate process is somehow "bad". *All transfer processes have advantages and disadvantages*, including the probate process (see our April 30, 2008 newsletter for a discussion of the four methods for transferring assets at death and the advantages and disadvantages of each). One of the advantages of the *probate* process is that it clears title to real estate in a clear and efficient way, especially compared to using a revocable (living) trust, which will require the preparation and filing of at least two (and sometimes more) deeds to get the real estate to the ultimate beneficiaries upon death. There are also protections for the decedent's surviving spouse and minor children when the probate process is utilized, which may not be available with some other transfer methods.

Attorneys' Fees relating to Probate Matters will amount to 6% of your Estate. This is truly false. Texas does not have state mandated attorneys fees for probate matters (like some states). Most reputable Texas attorneys who handle probate matters charge fees for their services on an hourly rate basis. Thus, in this way, the fees should bear some relation to the actual work involved.

Your Will Controls Everything You Own. A Will only transfers "probate assets" at death. Most people utilize more than one transfer method at death because of the type of assets they own (see our April 30, 2008 newsletter, which discusses the four (4) methods of transferring assets at death).

If You Avoid Probate, You Avoid Estate Taxes. There is nothing about avoiding probate that has any effect on avoiding estate taxes (sometimes also called "death taxes"). Probate is a state regulated post-death *transfer* process. Estate taxes are assessed by the federal government (and some states) on the transfer of assets at death by *any* process. The IRS does not care whether a decedent transfers all of his assets through a living trust, by beneficiary designation, by Will or by "multi-party account arrangement" (such as JTWROS, POD or TOD). *The method of transfer is irrelevant for federal tax purposes.* If an asset that was owned by the decedent ends up with someone else (i.e., the beneficiary) after his death, this transfer to a new owner (regardless of how it was accomplished) triggers the federal estate tax. The federal estate tax is an excise tax on the privilege of transferring assets to other persons at death. The estate tax is to be paid by the decedent's estate before any assets are distributed to the beneficiaries.

***Any* Attorney Can Handle Probate (and Estate Administration Matters).** This is about the same as saying that any doctor can perform open heart surgery. While most Texas attorneys can handle a straightforward probate matter, there are many other post-death matters that must be handled besides probating the Will (see the three newsletters we sent out describing the three parts of the post-death process, dated July 31, 2004, October 31, 2004, and January 31, 2005). We have ended up "cleaning up" incomplete or incorrect post-death legal work done by other attorneys many times. The biggest error we see is attorneys who handle the probate part of the post-death process but leave their clients high and dry when it comes to related tax and administration matters, such as helping the Executor fund the Bypass Trust (or other trusts) created in the decedent's Will. If someone has a Bypass Trust in his Will, that trust *must* be set up and funded after death by the Executor of the Estate. Once someone dies, it is not sufficient, for tax purposes, merely to have a trust on paper (i.e., in the Will)–it must actually be established. This is the type of legal advice and assistance we provide to all of our Executor clients. In other words, probate is only the first step in the post-death process and attorneys who stop after the first step are not fulfilling their responsibilities to the Executor of the Estate (and could be committing legal malpractice).

For Married Persons: You Own 100% Of All Assets Titled Solely In Your Name. Texas is not a "title" state, it is a community property state. The general idea of community property is that marriage is a partnership and both spouses are contributing to the success and welfare of the marital partnership, even if only one spouse works outside the home and receives a salary or other form of compensation. Thus, all assets acquired during the marriage while a couple is living in Texas (excluding gifts and inheritances and property received in exchange for separate property) are community property. Some community property, such as funds held in an account titled in both spouses' names, is considered "joint management" community property (both spouses have the right to manage the account). Other community property (such as a married person's paycheck) is "sole management" community property. Thus, frequently, in Texas, the title on an asset merely tells us the "manager" of the asset (not the owner). When managing his or her sole management community property, the spouse whose name is on the asset has unilateral management authority over the asset, but the asset is still community property, owned ½ by each spouse. A spouse who manages community property is a *fiduciary* as to the other spouse and cannot ignore the other spouse's ownership interest in the asset. Typical sole management community property assets include IRAs and 401(k) plans accumulated while the spouses were living in a community property state. Again, just because certain assets are titled only in one spouse's name does not mean that spouse owns 100% of these assets. If these assets were acquired during the marriage while the couple was living in Texas, they are community property, owned 50% by each spouse.

If you Inherit Something (or if you owned something prior to marriage), it will *Always* be your Separate Property. While an asset owned prior to marriage as well as an asset received as a gift or inheritance during marriage *starts out* as separate property, it is very easy for separate property to become "commingled" with community property in Texas and many years of commingling can result in the asset eventually being deemed to be community property. In Texas, the *earnings* (interest, dividends, etc.) on separate property are community property. Usually, it is the earnings on separate property that causes commingling (and not actual deposits of other assets). Some people who own separate property believe it is sufficient to place their separate property in a separate account titled solely in their own name. **THIS IS NOT SUFFICIENT TO MAINTAIN THE PROPERTY AS 100% SEPARATE PROPERTY.** Most likely, interest, dividends and other earnings (community property) will be placed in that same account, making the account a commingled account (i.e., it will have both separate property and community property in it). It may be possible to trace and separate out the income later, but why incur a very expensive accounting bill? The safest course to keep separate property held in a separate account separate is to have all income paid to another account (or paid out of the account) *from the beginning*. Further, if someone is the participant in a 401(k) plan prior to marriage and continues participating in that plan during the marriage, both the earnings in the plan and the contributions made to the plan during the marriage are community property. Thus, it is not legally correct to take the position that the entire 401(k) plan is the participant's separate property because it was in existence prior to the marriage (and is titled solely in the participant's name). Again, people are placing too much weight on how an asset is *titled* as far as who owns the asset. Remember, Texas is NOT a title state! It is a community property state and how and when an asset was acquired is more important in determining who owns it than its title.

If I give *All* (or substantially all) of my Assets away during my Life, I will avoid the Estate Tax. This statement overlooks the federal gift tax, which applies to transfers made during life. The federal gift tax is also an excise tax on transfers. The estate tax would be pretty easy to avoid if all someone had to do was transfer all of their assets on their death bed the day *before* they died, instead of allowing those assets to be transferred upon their death. Thus, for the most part, the federal government does not care whether someone transfers all of his assets the day before or the day after he dies. If there is a transfer of assets (or anything of value), it is subject to the excise tax on transfers (the gift tax or estate tax, as applicable). Transfers made during life implicate the gift tax, rather than the estate tax. The *person making the transfer* is responsible for reporting the gifts made and paying the gift tax (if any). For transfers made during life there are some important exclusions from the federal gift tax. Each year a person can give to as many other persons as she wishes an amount not exceeding, in the aggregate for that year, the "annual gift tax exclusion". For 2008, this amount is $12,000. Thus, gifts of $12,000 (or less) in 2008 to each person will be "tax-free gifts" not reportable to the IRS. There are also exclusions for gifts made directly to medical providers and educational institutions on someone else's behalf. If a person makes a gift to someone in a particular year in an amount greater than the annual gift tax exclusion, however, then the person is making a "taxable gift" that must be reported to the IRS on a US Gift Tax Return (Form 709). Even if a taxable gift is made, no gift tax actually has to be paid to the IRS until a person exceeds his lifetime gift tax exemption amount, $1,000,000. All taxable gifts use up some of this amount and also use up some of the estate tax exclusion amount that will be available to avoid estate taxes at death.

If I've Already Paid Income Taxes on Something, There's No Tax If I Give it to Someone Else. Sounds good, but not true. The income tax and gift tax are two different things. Anything you own that you give to someone else is a gift. Even some things you don't "own" can be the subject of a gift. An example of this would be if you guarantee a loan for a child. Another example of a gift would be if you let your adult child live in your garage apartment, rent-free. In both examples, you have given your child something of value, which means you have made a gift (taxable if the value is over $12,000 this year).

To Give Someone Access To Your Account, You *Must* Add their Name to the Account and Style the Account As "Joint Tenants With Right of Survivorship" ("JTWROS") While banks, brokerage firms and other financial institutions may say this, this is NOT legally correct. Texas law specifically authorizes a "convenience account" in which a depositor can add another person to her account for convenience (i.e., to assist the depositor with transactions involving that account). One problem with the JTWROS account arrangement is that 100% of the account passes to the surviving joint tenant(s) (the other person(s) on the account) when the first joint tenant (assume it's the depositor) dies. This may not be what the depositor of the funds wanted. Some institutions (those that are not particularly customer-service oriented) may require *all* joint accounts to be titled as "Joint Tenants With Right Of Survivorship". Because JTWROS accounts pass completely outside a person's estate plan in her Will, these funds may not pass to the correct persons in the correct amounts or form. This may cause a big problem for those clients who are doing tax, trust and creditor protection planning in their Will. In other words, the JTWROS form of titling overrides the Will. This may be all right if the account is a small checking account but this is potentially disastrous, and could lead to the payment of hundred of thousands of dollars in "unnecessary" estate taxes, in the case of a large brokerage or investment account. If you are doing any tax or trust planning in your Will, you MUST avoid these forms of account titling/arrangements: JTWROS, POD, TOD and "Totten Trust accounts". Most institutions offer other forms of account titling, even for joint accounts. We have a Titling Accounts FAQ on our website that indicates which forms of titling are OK for persons doing tax and trust planning in their Will. Further, our last newsletter, dated April 30, 2008 (also on our website), discusses these matters in more detail.

It is a good idea to place a POD beneficiary on bank accounts, CDs and the like. Same problem described immediately above.

It is a good idea to use TOD for your brokerage account. Same problem described above.

Everything you own (except real estate) should have a beneficiary listed. Same problem, plus other problems (see our April 30, 2008 newsletter for more information).

If one Annuity is "Good," Several Annuities are Better. There are many problems with annuities when it comes to estate planning. For the most part, annuities cannot be used to fund most tax-advantaged trusts without causing an acceleration of all deferred income taxes. This is because a trust (other than a grantor trust) is not a "natural person" and the beneficial income tax consequences of annuities depend on natural persons owning them. Some clients we have worked with turned out to own so many annuities that the Executor could not fund the Marital Trust at all and had to under-fund the Bypass Trust (which could ultimately result in too much estate tax being paid on the death of the surviving spouse). We admit that we are suspicious of situations in which clients have numerous annuities. We have considered adopting a policy of not doing estate planning for clients who own more than two annuities or for clients with the bulk of their estate in annuities. It is just too hard to do optimal estate planning for persons with multiple annuities.

If you create a trust, the income will be taxed at the highest income tax rate. While trusts reach the highest income tax bracket very quickly (in 2008, at $10,800 of annual income), many trusts do not pay *any* income taxes because all "ordinary income" is distributed out of the trust to one or more of the current trust beneficiaries. When trust income is distributed to a trust beneficiary, the beneficiary pays the income tax on that income, in the beneficiary's own tax bracket (and the trust does *not* pay income taxes on the distributed income). If a trust has capital gains, the trust will pay capital gains taxes at the same rate as individuals (no difference). Depending on the type of trust and its purpose, the Trustee can invest the trust assets for growth, so that little ordinary income is earned by the trust. The trust could also own some tax-free municipal bonds, reducing the trust's taxable income. Also, many trusts allow the Trustee to retain *or* distribute the trust income. A Trustee may decide to retain the trust income in the trust in a particular year, despite the trust's high income tax rate, if the Trustee is trying to protect the income from a creditor who is suing the trust beneficiary (if income is retained in the trust, the creditor cannot reach it).

Brokerage Firms Must Freeze a "Tenants in Common" Account Upon One Tenant's Death. We hear from clients all the time that the tenants in common account they had with their spouse was frozen by the brokerage firm upon their spouse's death. Freezing a married couple's tenants in common account is not legally required (or correct) as the assets in the account are presumed to be community property under Texas law. This means the surviving spouse *owns half of the account in her own right.* Thus, how can a financial institution legally prevent a depositor from accessing her own funds in the account merely because her spouse has died? Unfortunately, this happens all the time and often causes a hardship for the surviving spouse (and, because of arbitration provisions in the account agreement, the brokerage firm cannot be sued for damages). The deceased spouse's *half* of the account *can* be frozen, pending receipt of Letters Testamentary from the Executor of his estate (although, again, legally, the account doesn't have to be "frozen" under Texas law, which allows the surviving joint tenant to continue using the account). Our advice to our married clients: if you have a tenants in common account, don't tell the financial institution your spouse has died and continue using the account until Letters Testamentary are issued by the Probate Court to you (or other person) as the Executor of your spouse's Estate, at which time, the account can be divided and/or re-titled.

Welcome to Lynn and Heather. We have a new legal assistant/office administrator, Lynn Brooks, and a new associate attorney, Heather J.E. Laureles. We hope to have their photos on the firm's website soon.

Contact Us:

If you have any questions about the material in this publication, or if we can be of assistance to you or someone you know regarding estate planning or probate matters, feel free to contact us by phone, fax or traditional mail at the address and phone number shown below.

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