Estate Planning Insights

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WHAT IS AN ESTATE?

Every one of us will have an estate, even if we don't have an estate already! The term "estate" is often confusing to people. In this newsletter, we are going to try to explain what an estate is. We are also going to discuss who should handle your estate when you die.

Your Estate While You Are Alive. While a person is living, his "estate" consists of every asset he owns. Typical assets that people own include real estate, mineral interests, stocks, bonds, mutual funds, money market accounts, bank, savings and loan, and credit union accounts, certificates of deposit, brokerage and investment accounts, household furnishings and personal effects, vehicles, burial plots, life insurance policies, 401(k) plans and other retirement plans, IRAs of every type, partnerships, limited liability companies, REITs, etc. Some people own more unusual assets, such as airplanes, yachts, race horses, patents, trademarks, copyrights, valuable art work, valuable collections, etc.

Sometimes a person only owns a partial interest in an asset. For example, three children may inherit their mother's house. Each of them will then own an undivided one-third interest in the house (rather than the entire house). Because Texas is a community property state, each spouse of a married couple owns an undivided fifty percent (50%) interest in all of the community property. Whatever a person owns, those assets, or interests in assets, are part of her estate. To repeat, all of the person's assets and interests in assets, taken together, comprise the person's estate. Thus, every person who owns anything needs to do estate planning because a primary goal of estate planning is to decide to whom your estate should be distributed upon your death. In other words, who should be the beneficiaries of your estate?

Your Estate After You Die. There are many different ways to define or describe an estate once a person has died. In its simplest form, an estate is a "placeholder." An estate represents a person who has died.

When a person dies, his estate is "born." An estate is a legal "person" under the law. An estate can also be thought of as an "entity."

The term "estate" also refers to all assets that a deceased person (a "decedent") owns at the time of his death. Whatever assets a particular decedent owned when he died are now assets of the decedent's estate. Thus, every person who owns at least one asset has an *estate*. You do not have to be wealthy to have an estate. Again, whatever you own comprises your estate and that's why everyone must do estate planning.

Particular Types of Estates. There are also particular types of estates, usually having a modifying word or words in front of the word "estate." Some are types of estates for tax purposes, including, in particular, the federal estate tax, while others are types of estates for state law purposes. Examples include:

The *gross estate* for federal estate tax purposes means all assets in which the decedent owned an interest at death that are being *transferred* to someone else due to the decedent's death. Since a transfer must occur, the burial plot that was owned by the decedent, in which he is now buried, is not an asset of his gross estate for federal estate tax purposes because it's not being transferred to anyone (i.e., the decedent "kept it" for himself). Other burial plots which the decedent owned at the time of his death (and which he is not using) would be assets of his gross estate because the ownership of those other burial plots will be transferred to someone else as a result of his death.

The decedent's *gross estate* includes both probate assets and non-probate assets. For federal estate tax purposes, the IRS doesn't care which method of transfer (i.e., probate or non-probate) a person uses to transfer her assets at death. All assets owned by the decedent at the time of her death being transferred to someone, regardless of *how* they are being transferred, are part of the decedent's gross estate for federal estate tax purposes. The method of transfer is irrelevant for federal estate tax purposes. And assets in the decedent's *gross estate* must be valued at fair market value, per IRS rules. This value applies for both estate tax and income tax basis purposes.

The *taxable estate* for federal estate tax purposes is the decedent's gross estate at death less certain allowable deductions. Allowable deductions include (i) the marital

and charitable deductions (for amounts passing in a qualifying manner to a spouse or charity, respectively), (ii) administration expenses, such as attorneys' fees, accountant's fees, appraisal fees, and executor's commissions, (iii) funeral expenses, and (iv) debts.

The *estate tax base* on which estate tax is calculated at death includes all assets in which the decedent owned an interest at death, less allowable deductions (i.e., the *taxable estate*), *plus* the total of all adjusted taxable gifts made by the decedent during his life. Adjusted taxable gifts are basically all "taxable gifts" that the decedent made during her life, added together (in general, taxable gifts are gifts exceeding the gift tax annual exclusion amount, which is currently $13,000 per person per year, and gifts which do not qualify for the medical or tuition exclusion). The estate tax is calculated on the *estate tax base*, with credit given for prior payments of gift tax, because all transfers made by an individual are taken into account at death for purposes of calculating the estate tax.

Both the estate tax and the gift tax are transfer taxes and an ultimate transfer tax (i.e., the estate tax) is imposed on the total of all transfers made by a particular individual when she dies, whether the individual made the transfers during her lifetime or at the time of her death (or both). In other words, it doesn't matter to the IRS whether you give away everything you own the day before you die or the day after you die–the result is basically the same under the transfer tax system. All transfers except for tax-free gifts are part of the *estate tax base*.

The *probate estate* refers to all assets being distributed by the decedent's Will at death. If a person dies with a valid Will, then the person dies "testate." If a person dies without leaving a valid Will, then the person dies "intestate." In that case, the State of Texas has written a Will for the person, which prescribes the beneficiaries of the person's estate. This Will for persons who die intestate can be found in the Texas Probate Code and is referred to as the "statutes of descent and distribution" (or the intestacy laws).

The *non-probate estate* refers to all assets in which the decedent owned an interest at death that are being distributed pursuant to a method other than a Will (or the intestacy laws). Typical non-probate methods of distribution include:

i. Beneficiary Designation Forms: This applies to life insurance policies, IRAs, 401(k) plans, other retirement plans, and annuities. Note, however, that if the "Estate" is listed as the beneficiary of any of these assets (or becomes the beneficiary through failure to complete or submit a valid beneficiary designation form), then the asset will become a probate asset at death.

ii. Certain Multi-Party Account Arrangements: Examples of this include (a) accounts titled in two or more names as "Joint Tenants with Right of Survivorship" (JTWROS); (b) accounts titled in one or more names having a "Pay on Death" (POD) beneficiary or beneficiaries; (c) accounts titled in one or more names having a "Transfer on Death" (TOD) beneficiary or beneficiaries; and (d) accounts titled in one or more names "as Trustee for" the benefit of one or more named beneficiaries where there is no actual trust–this is called a "Totten Trust" account. Some multi-party accounts (not listed here) are probate assets, and some (including those listed here) can be *either* probate or non-probate assets, depending on exactly how they are structured and the order of deaths of the persons named on the account. The definitive legal document that indicates the type of account is the signature card or account agreement that created the account (and *not* an account statement).

iii. Living Trust Assets. Assets placed in a Revocable (Living) Trust *prior to the death of the Grantor* (creator) of the trust are non-probate assets, assuming the trust has dispositive provisions, meaning provisions distributing the trust assets to the post-death beneficiaries upon the Grantor's death. Not all revocable trusts have dispositive provisions–some "pour back" the trust assets to the Grantor's probate estate upon the Grantor's death, making the trust assets probate assets in that case. It is not sufficient merely to *create* a Living Trust to avoid probate. Only those assets actually titled in the name of the Living Trust prior to the Grantor's death will avoid probate, assuming the trust has dispositive provisions.

Other Aspects of an Estate. After the death of the decedent, an estate also represents the combined interests of the beneficiaries of the decedent. Thus, these persons are beneficiaries of the decedent's estate.

An estate is a taxpayer and must file its own federal income tax return for each year of its existence. Estates file a Form 1041, United States Fiduciary Income Tax Return, for each year during which the estate has at least $600 in income. In our opinion, this tax return should always be prepared by a competent CPA.

With respect to federal income tax matters, an estate has some favorable options that most other taxpayers don't have: (i) an estate can elect to use a fiscal year, rather than a calendar year, for its tax year, and (ii) an estate does not have to make estimated tax payments for its first two (2) years. Estates earn income when the assets of the estate produce income (e.g., interest and dividends). Estates can take deductions against income, just like individuals, except that, with respect to certain types of miscellaneous itemized expenses, the deduction is limited to the amount that exceeds 2% of the estate's adjusted gross income.

In addition, the net income of an estate which is distributed out of the estate during its tax year to one or more beneficiaries of the estate is carried out to the beneficiaries, and each beneficiary then pays income tax on his/her share of the distributed net income, in his/her own income tax bracket. Thus, to the extent that the estate's income is distributed out to the beneficiaries, the estate does not pay any income tax on that income.

An estate should not continue forever. An estate should only last as long as necessary for the Executor or Administrator to conclude all state and federal law post-death requirements. Once an estate is closed or terminated, there should no longer be any assets titled in the name of the estate (or in the decedent's name either).

Activities Involving A Decedent's Estate. We are not going to repeat in this newsletter our discussion of the three parts of the post-death process (referring to the handling of a decedent's estate), which we described in detail in our newsletters dated July 31, 2004 ("The Who, What, When, Where, and Why of Probate"), October 31, 2004 ("Middle Matters: It's Not Probate and It's Not Fun"), and January 31, 2005 ("Handling an Estate, the Final Phase"), all of which can be found on the firm's website by clicking on the "Reference Center" button, http://www.gerstnerlaw.com. In general, the three parts are: (1) probate [this part can be skipped if you die with a *fully funded* Living Trust], (2) "middle matters," which includes federal estate tax matters, federal income tax matters, income tax basis matters, title issues, and, in some cases, dispute resolution, and (3) the estate closing (and, in some cases, trust funding) matters.

Who Should Serve as the Executor of your Estate? Your estate needs to be handled correctly when you die. Therefore, if you are not going to appoint a professional to serve as Executor of your estate (or as successor Trustee of your Living Trust–hereafter, the successor Trustee of a Living Trust will be included in the term "Executor"), you should carefully evaluate the personal qualities of the friend or family member you intend to name as Executor in your Will.

Serving as the Executor of an Estate can be almost a full time job, at least for a period of months (and, sometimes, years). It is a position of serious responsibility, involving personal liability and risk. Doing the job right requires a lot of time and attention.

Over the years, we have observed some very good and also some "not-so-good" Executors. Presumably, we have not observed the worst possible Executors because most people who make a Will do not name as Executor persons they know are incapable of handling the job. However, even among those Executors personally selected by the Testator (the person writing a Will) who agreed to perform the job, many have not handled their duties very well. You should NOT name as the Executor of your estate a person who:

1. Is Inattentive to Detail. No matter how smart a person is, if he is not *way above average* in his ability to deal with details, he won't be a good Executor. When it comes to dealing with estate matters, details are very important.

2. Is a Procrastinator. A person who is a procrastinator should NEVER be named as an Executor. This is a recipe for disaster. Again, it doesn't matter how smart the person is, she just shouldn't be appointed Executor if she cannot stay on task and meet deadlines.

3. Won't Follow Instructions. Serious problems can develop when an Executor won't follow the advice and instructions of his lawyer, CPA, financial and other advisors. Most lay people do not have sufficient legal, tax and investment knowledge to make their own decisions–they need professional help. Thus, a person whose standard mode of operating is exemplified by the song, "I did it my way," would not be a good Executor.

4. Cannot Make Decisions. You know the type–a person who cannot ever make a decision. This is similar to a procrastinator. There are many decisions that must be made by an Executor–some with serious consequences. Don't name an indecisive person as Executor. On the other hand, you also don't want to name a decisive person described in #3–someone who makes decisions, but without regard to the law or good advice!

5. Is Not a Good Communicator. An Executor must communicate important information to the beneficiaries of the estate. A person may be doing everything that needs to be done, timely and well, but if she isn't keeping the beneficiaries reasonably informed of the status of the estate, that's just asking for trouble.

6. Is Dishonest (or, Not Totally Honest). It is always shocking when a person in a fiduciary position, like an Executor, does something dishonest, like steal money from the estate. To date, we have not had this issue with any of the Executors we have represented, but Texas law books are full of cases involving dishonest Executors and other fiduciaries. If you do not know the person well enough to know about his actual honesty and integrity, think twice about appointing him as Executor of your estate. And, sometimes, even people who are "mostly honest" can do dishonest things when under pressure. Don't select a person who might succumb to financial or other pressure by losing sight of her moral compass. Your estate is too important to hand over to a potential crook. There are plenty of qualified professionals out there.

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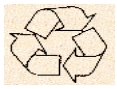

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Karen S. Gerstner & Associates, P.C. **July 31, 2011**

We Have the Neatest Clients! We are really impressed with our clients. We learn a lot from them, too. For example, we have at least two clients who have recently published non-fiction books, one about a "reluctant rebel" in the Civil War and one about one of the well recognized "originators" of plastic surgery (the father of the author's late wife). We also have at least one client who has published several fiction books--what an imagination!

One of our clients is a former Miss USA–she still has beauty queen looks and charm and a sharp mind to boot (she is a master bridge player). We have some clients who are elected officials and some who are "famous" radio personalities. And many are CEOs, CFOs and top executives with local and national companies.

Of course, many of our clients have created successful businesses of various types (a lot related to the "ol bidness"). It's amazing how many types of things can be produced through ingenuity and know-how.

Some of our clients are doing "cutting-edge" bio-medical research and development. We expect to hear great things from these folks soon–new drugs and devices that will really help people fight diseases and live longer.

We also have many, many clients who are donating their time and energy to worthwhile charitable causes and we salute them for that. Some of our clients are founders or directors of non-profit organizations.

Many of our clients have interesting hobbies, such as collecting things like porcelain dolls, cut glass, sports cars, antique fire arms, coins, etc. And one client and his son are visiting every baseball park in the US together! Now that sounds like a really fun hobby to us.

In Our Next Newsletter we will discuss the recently enacted changes to Texas probate, estate and trust laws.

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 above. You can also reach us by email addressed to:

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