Estate Planning Insights

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A DIFFERENT APPROACH

Not Your Usual Estate Plan. I have a good friend and colleague in Austin, Texas, who has a unique estate planning practice. Most of his clients have fairly large estates, say $20,000,000 and up. Many of those clients obtained their wealth through the sale of a business they created or through many years of hard work and thrift. The plan that most of my friend's clients create is this: they leave their entire estate to charity on the death of the surviving spouse and create an Irrevocable Life Insurance Trust ("ILIT") to provide a "modest" amount (ranging from $1,000,000 to $5,000,000) for each child on the second spouse's death. That's it. The beauty of the plan is that, under current estate tax laws, no matter how large the estate is at the time in question, (1) no estate taxes will be payable on the first spouse's death because of the unlimited marital deduction (assuming the surviving spouse is a U.S. citizen) and (2) no estate taxes will be payable on the second spouse's death because of the unlimited charitable deduction (assuming the charitable recipient is a qualified charity). Further, the insurance proceeds in the ILIT will pass to the children free of federal estate taxes and income taxes on the second spouse's death. But is there another reason, besides avoiding taxes, why these wealthy clients limit the amount passing to each child on the second spouse's death? According to my friend, there is.

Many people who have created their own wealth believe that there is no greater satisfaction in life than "making it on your own". Handouts do not usually promote financial independence in children (or other persons). We tend to appreciate most that which we have worked hard to achieve. The worst nightmare for some financially successful people is creating an estate plan that renders their children "trust babies"–people who are financially infantile their entire lives. Further, many wealthy clients never received much in the way of significant gifts or inheritances themselves–which caused them to have to work hard and become self-reliant. Perhaps it is the lack of these monetary gifts that was the best gift of all.

Here are some statistics from my friend in Austin:

1. Less than 1% of U.S. income tax returns filed each year reflect gross income of $200,000 or more.
2. Less than 10% reflect gross income of $120,000 or more.
3. Less than 50% reflect gross income of $60,000 or more.
4. 99% of the people in the U.S. die owning assets worth less than $1,000,000 at the time of their death. (Note that this is a different statistic than the average net worth of all persons living in the U.S.)

Thus, if a child were to inherit $1,000,000, assuming a 6% rate of return (which we are not seeing currently, but which is a conservative long-term rate), the "income" on that $1,000,000 would be $60,000/year, which would place the child in the top 50% of U.S. income taxpayers (without regard to other income)--see 3 above. Further, the child's estate at death would be in the top 1% of all U.S. estates--see 4 above.

Reportedly, many super wealthy people, like Warren Buffet, have decided not to leave the bulk of their wealth to their children, but to charity instead. This "different approach" is something that makes those of us who are less wealthy pause and think. That is the point of this newsletter.

Valuable Gifts (Continuing With The Same Theme). Everyone has heard that old adage: "Give a man a fish and you feed him for one meal. Teach a man to fish and you feed him for life". Perhaps the most significant "monetary" gift any of us can give our children and grandchildren is the gift of how to make a living, or the gift of education. If we are able to provide that gift, then we have given something truly valuable. There are other "gifts" we want to give our children and grandchildren, of course, such as moral guidance and family values. Those are important also (at my prior law firm, my partners and I wrote a newsletter about these other types of gifts called, "Leaving a Legacy Beyond Wealth"–this prior newsletter is maintained on this firm's website–*see* the Reference Center, newsletter dated 8/15/2001).

With respect to providing funds for education, in past newsletters published by this firm, we have encouraged parents and grandparents to place amounts they wish to give to children and grandchildren into 529 plans instead of into custodial accounts under the Uniform Transfers to Minors Act (UTMA) and instead of into educational trusts. 529 plans have many advantages over UTMA accounts and educational trusts, including, *but not limited to*, the following:

1. No legal fees are involved to establish a 529 plan–you just contact your financial advisor to establish the plan.
2. No income tax return has to be filed to report the income earned inside the 529 plan each year and that income is never subject to income tax if the plan funds are eventually used for educational purposes (tuition, room and board, books, etc.).
3. The creator of the 529 plan can control it without causing the plan to be included in the creator's estate upon death.
4. The child or grandchild for whom the plan is established does not automatically receive the money upon reaching age 21.

A Recurring Problem–Suddenly Single. When someone becomes single due to divorce or the death of a spouse, it is imperative that the newly single person thoroughly review his/her estate plan, *including all beneficiary designation forms*. Of course, in many cases involving the death of a spouse, the estate plan might still provide the desired result because the death of a spouse is one of the contingencies considered when the estate plan was created. However, in the case of a divorce, failure to review the estate plan and beneficiary designations can wreak havoc on the intended beneficiaries.

Although Texas has a statute that attempts to negate gifts made to (and fiduciary appointments of) a prior spouse due to a divorce, many situations are not covered. For example, if a divorce is still pending and not final when someone dies, the statute does not negate gifts to the spouse made in the Will or appointments of the spouse as a fiduciary, such as Executor. Further, the statute does not override specific requirements relating to qualified retirement plans. In a recent case, the ex-spouse of an employee still received a very large 401(k) plan when the employee died even though the ex-spouse agreed to waive that benefit in the divorce decree. The divorce decree did not meet the retirement plan's requirements for changing the beneficiary of the plan. Thus, on the employee's death, the 401(k) plan was distributed to the ex-spouse who was still listed as the beneficiary on the beneficiary designation form and not to the deceased employee's child.

Pending Tax Legislation. We are following several bills pending in Congress that have provisions relating to the federal estate tax. Those married clients with "old" Wills (Wills dated before 2002) who have a total estate (which is not expected to grow much) of approximately $1,000,000 do not need to wait for the legislation to pass to eliminate the Bypass Trust from their Wills (if so desired). Those married couples with old Wills who have estates between $1,000,000 and $7,000,000 may want to wait until the new legislation is actually passed to make changes to their Wills. We will keep you posted.

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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