

**AN INTRODUCTORY GUIDE
TO
TAX AND ESTATE PLANNING**

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I. INTRODUCTION TO ESTATE PLANNING

- A. **Purpose of This Outline.** This outline is intended to serve as an introductory guide to tax and estate planning and, thus, focuses on the practical application of the most relevant estate, trust, and tax laws to achieve real results, such as the successful transfer and protection of wealth, and reduced estate administration expenses and estate tax.
- B. **Purpose of the Estate Plan.** Every person should have an estate plan. The Will is the core of the estate plan, and may be supplemented with other estate planning documents, such as a trust, beneficiary designation form, durable power of attorney, medical power of attorney, advanced directive, and/or declaration of guardian. These documents should collectively provide for the disposition of property, make fiduciary appointments, reduce or eliminate estate tax, and reduce estate administration expenses.
- C. **Creation of Estate Plan; Frequency of Review.** An estate plan does not have an expiration date. A Will, trust, or other estate planning document is generally effective until revoked. The estate plan should be reviewed periodically to ensure that the testator's estate planning goals continue to be met. As a rule of thumb, an estate plan should be reviewed upon the happening of a significant life occurrence (such as the birth of a child, marriage, divorce, change of state or country of residence, or significant change of financial position), or every three to five years regardless of significant life occurrences. Periodic review is critical to determine when an estate plan without estate tax planning should be replaced with a plan with estate tax planning.
- D. **Attorney Should Prepare Will.** Although many advisors may be involved in the estate planning process, an attorney should prepare the estate planning documents. Non-attorney advisors are not licensed to practice law and, therefore, should not prepare estate planning documents. Forms found online or in form books should not be relied on because such forms do not typically address Texas law, tax planning, or the specific needs of the testator.
1. **Attorney Preparing Estate Plan Should Not Be a Beneficiary.** The attorney preparing the estate planning documents should not also be a beneficiary under the estate plan because a bequest to that attorney is generally void.¹ An exception exists if the attorney has a certain relationship with the testator (for example, the attorney is a child of the testator).²
- E. **Other Advisors Typically Involved in Estate Planning.**
1. **Accountant.** An accountant, such as a certified public accountant (or "CPA"), is often involved in the estate planning process because the

¹ TEX. PROB. CODE § 58a(a)(1).

² TEX. PROB. CODE § 58a(b)(1).

accountant may have knowledge of the testator's personal balance sheet and cash flow. Fees are typically charged based on an hourly rate. Solo accountants or accountants with small firms typically charge lower hourly rates, accountants with large firms (such as a "Big 4") typically charge the highest hourly rates, and mid-sized firm accountants typically fall somewhere in between.

2. **Financial Advisor.** A financial advisor, such as a certified financial planner (or "CFP"), is often involved in the estate planning process as an advisor. A financial advisor is usually associated with a wirehouse, an independent advisory firm, bank, insurance company, or accounting firm. Fees are typically charged based on an hourly rate, flat rate, commission, or percentage of assets managed.
3. **Insurance Agent.** Insurance agents (who are sometimes also financial advisors) are often involved in the estate planning process for purchasing life insurance. Insurance agents are typically associated with a financial planning firm or an insurance company. The insurance agent can act as an independent broker and offer insurance policies from multiple insurance companies or act as an employee of an insurance company and offer insurance policies from only one insurance company. Fees of an insurance agent are typically paid by an insurance company in the form of a commission.

II. TERMINOLOGY COMMONLY USED IN ESTATE PLANNING

- A. **Beneficiary Designation Form.** Document typically used to name primary and contingent beneficiaries of certain nonprobate property, i.e., life insurance and retirement plans.
- B. **Bequest.** Disposition of property under a Will. A "specific bequest" is a bequest of a particular piece of property identified under a Will.
- C. **Codicil.** Legal document executed under the same formalities of a Will that amends and/or supplements a Will; like a trust amendment for a trust.
- D. **Deceased Spouse.** For a married couple, the first spouse to die.
- E. **Decedent.** Person who has died and, thus, becomes "deceased."
- F. **Descendants.** A person's child, grandchild, and more remote persons of lineage.
- G. **Devise.** A bequest of real property.
- H. **Executor.** Person appointed by a court to administer a decedent's estate. An "independent executor" is a particular type of executor in Texas that is appointed in an independent administration.
- I. **Fiduciary.** Person appointed to act in a special role for another person and who owes fiduciary duties to that person; such as executors, trustees, guardians, and persons acting under a power of attorney.

- J. **Grantor.** Person who creates a trust (also known as a “trustor” or “settlor”).
- K. **Heir.** Person receiving property pursuant to intestate succession.
- L. **HEMS.** Distribution standard based upon the health, education, maintenance and support of the distributee.
- M. **Independent Administration.** An abbreviated form of estate administration (or “probate”) available in Texas.
- N. **Inter Vivos Trust.** Trust created during the grantor’s lifetime.
- O. **Intestate.** Person dying without a valid Will.
- P. **Intestate Succession.** Rules under Texas law controlling the disposition of probate property not controlled by a Will.
- Q. **Legacy.** Bequest of money.
- R. **Letters Testamentary.** Legal document issued by a probate court to an independent executor to evidence the person’s appointment and authority as such.
- S. **Per Capita.** Distribution method based upon the number of persons living.
- T. **Per Stirpes.** Distribution method based upon generational representation. See Section VI, H for further description.
- U. **Probate/Nonprobate Property.** See Section III, B for description.
- V. **Residue.** Portion of estate not subject to a specific bequest, legacy, or devise. Typically bequeathed pursuant to the “residuary clause” of a Will.
- W. **Surviving Spouse.** For a married couple, the second spouse to die.
- X. **Testamentary Trust.** Trust created under a Will.
- Y. **Testator.** Person who makes a Will.
- Z. **TOD account.** Also known as “POD account” or “trust account.” See Section IV, D for further description.
- AA. **Trust.** A relationship between trustee and beneficiary. See Section VII, B for further description.
- BB. **Trustee.** Person appointed to hold legal title to trust property according to the trust’s terms.
- CC. **Will.** Legal document for a person directing the disposition of his or her probate property at death, and the administration of his or her estate.

III. CHARACTER OF PROPERTY

A. Separate and Community Property.

1. **Character of Property.** A person's assets are characterized as either separate property or community property. The character is important for estate planning purposes because a person's Will controls the disposition of only that person's separate property and share of community property.
2. **Separate Property.** Separate property consists of (1) the property owned or claimed by a person before marriage; (2) the property acquired by a person during marriage by gift, devise or descent; and (3) the recovery of personal injuries sustained by a person during marriage, except any recovery for loss of earning capacity during marriage.³
3. **Community Property.** Community property consists of the property acquired by either spouse during marriage, other than separate property.⁴ Property⁵ possessed by either spouse is presumed to be community property.
4. **Marital Agreement.** At any time, spouses may partition or exchange between themselves all or part of their community property, then existing or to be acquired, and such property becomes a spouse's separate property.⁶ Similarly, at any time, spouses may agree that all or part of the separate property owned by either or both spouses is converted to community property.⁷

B. Probate and Nonprobate Property.

1. **Character of Property.** A person's assets are characterized as either nonprobate or probate property. The characterization is important for estate planning purposes because a person's Will controls the disposition of only probate property, and not nonprobate property.
2. **Nonprobate Property.** Nonprobate property consists of property owned by a person that is controlled by a contract-type document directing the disposition of that property upon that person's death. Examples of nonprobate property include life insurance, retirement plans, trusts, and accounts with rights of survivorship. The disposition of nonprobate property is controlled by a document other than a Will, such as a trust agreement or beneficiary designation form. Such documents should be reviewed as part of the estate planning process to confirm that such documents are consistent with other estate planning documents, such as the Will, and revised if necessary.

³ TEX. FAM. CODE § 3.001.

⁴ TEX. FAM. CODE § 3.002.

⁵ TEX. FAM. CODE § 3.003.

⁶ TEX. FAM. CODE § 4.102.

⁷ TEX. FAM. CODE § 4.202.

3. **Probate Property.** Probate property is all property that is not nonprobate property. Examples include real estate held in the decedent's name, motor vehicles titled in the decedent's name, tangible personal property, and stocks and bonds held outright or in an account (other than an account with rights of survivorship). The disposition of probate property is controlled by either a Will or intestate succession.

IV. NONPROBATE ASSETS

A. **Beneficiary Designation Form.** The disposition of certain nonprobate property, such as life insurance and retirement plans, is controlled by a beneficiary designation form rather than a Will. The form will typically list both primary and contingent beneficiaries. An estate should not generally be named as a beneficiary. Special care should be used in drafting a beneficiary designation form, particularly if the nonprobate asset is needed to fund a credit shelter trust or disclaimer trust (as discussed below).

B. **Life Insurance.**

1. **Life Expectancy.** A 30 year old male has a life expectancy of 42.8 years remaining (age 72.8), a 30 year old female has a life expectancy of 49.3 years remaining (age 79.3), a 40 year old male has a life expectancy of 33.6 years remaining (age 73.6), and a 40 year old female has a life expectancy of 39.8 years remaining (age 79.8).⁸
2. **Transfer of Risk.** At its core, a person who buys life insurance on his or her life essentially transfers risk of his or her death to the insurance company in exchange for a premium payment.
3. **Purpose of Life Insurance.** Life insurance is usually purchased to provide a cushion for economic loss caused at death, and/or to supply liquidity for estate administration expenses and taxes. Life insurance is often the largest asset of an estate. As a result, life insurance should be an integral part of an estate plan and should not be purchased in isolation without considering the estate plan.
4. **Two Types of Policies.** Two broad categories of life insurance exist: (1) term policies; and (2) permanent policies. Life insurance companies offer many other types of policies, which are variations or combinations of these two broad types of policies.
 - a. **Term Policies.** Term policies are the purest form of insurance because the premium amounts are determined solely on the risk of death. No portion of the premium amount is applied to investment or savings. Premiums for term policies are lower than permanent policies and, therefore, are popular with persons who want maximize the death benefit relative to the premium paid over a specified period of time.

⁸ Source: U.S. National Center for Health Statistics, National Vital Statistics Reports (NVSR), U.S. Decennial Life Tables for 1999-2001, United States Life Tables, Volume 57, Number 1, August 5, 2008. and, unpublished data.

- b. **Permanent Policies.** Permanent policies have both a term component and a savings/investment component. Examples include whole life or universal life policies. In the early years of the policy, a portion of premiums are used to make investments that build cash value. Permanent policies can be used for income tax planning because the money invested inside the policy grows income tax free.
 - i. A second-to-die policy is a variation of a permanent policy that does not pay the death benefit until both of the insured persons have died.
- 5. **Amount.** All relevant facts and circumstances should be considered in determining the amount of death benefit needed. Insurance companies and financial advisory firms have developed models that can assist in determining the amount.
- 6. **Diligence.** Before life insurance is purchased from an insurance company, the contract and insurance illustrations should be carefully reviewed, and the financial soundness of the insurance company should be determined. Standard and Poor's, Moody's, and Weiss Research provide a rating system for insurance carriers.
- 7. **Estate Tax Planning.** Life insurance has a significant effect on the size of a taxable estate. Accordingly, consideration should be paid to who holds incidents of ownership and who is named as beneficiary. Further, an irrevocable life insurance trust (or "ILIT") may be used to exclude the death benefit of a life insurance policy from a person's taxable estate. However, a revocable trust holding incidents of ownership in life insurance policies does not provide estate tax planning benefits.⁹
- C. **Retirement Plans.** A retirement plan, such as a 401(k) or IRA, is a nonprobate asset. Its disposition is controlled by a beneficiary designation form rather than a Will. Planning with retirement plans involves additional complexity because retirement plans provide income tax benefits.
- D. **TOD Account.** A "transfer on death account," "TOD account," "POD account" or "trust account" is a nonprobate asset. An account (such as a savings, checking, brokerage, or money market account) may be a TOD account if such account is held with another person as joint tenants with rights of survivorship, or if a beneficiary designation form has been completed for the account. Often, a person unknowingly completes a beneficiary designation form when he or she opens a bank account. A testator should confirm with his or her bank whether each account is a TOD account.
- E. **Joint Tenancy With Right of Survivorship.** Property held by two or more people as joint tenants with rights of survivorship is nonprobate property. Ownership passes to the survivor of the joint tenants upon the death of one of the

⁹ I.R.C. § 2038.

joint tenants. Real estate and bank accounts are common examples of property that can be held in this manner.

- F. **Trusts.** The property of a trust is nonprobate property. The disposition of trust property is controlled by the trust agreement.

V. INTESTATE SUCCESSION

- A. **Summary Chart.** Please see Exhibit A for a summary chart of Texas Intestate Succession, which summarizes the rules discussed in this section.

- B. **Result of Dying Without a Valid Will.** When a person dies without a valid Will, that person dies “intestate” and all of his or her estate vests immediately in his or her heirs at law.¹⁰ In such a case, a court proceeding should be initiated to determine that person’s heirs under the rules of intestate succession.¹¹ The proceeding, called an “heirship proceeding” or “determination of heirship,” requires the satisfaction of certain requirements that causes the estate to incur additional estate administration expenses. Such expenses can be avoided with a well drafted Will.

- C. **Single Persons.** When an unmarried person dies intestate, his or her property passes to the following persons:¹²

1. First, to the intestate’s children and their descendants;
2. If the intestate has no children or descendants, then to the intestate’s father and mother, in equal portions;
3. If only the father or mother survive the intestate, then the intestate’s estate is divided into two equal portions, one of which passes to such survivor, and the other half passes to the brothers and sisters of the intestate, and their descendants;
4. If only the father or mother survive the intestate, and none of the intestate’s brothers or sisters, or their descendants, survive the intestate, then the whole estate passes to the surviving father or mother;
5. If neither the father nor mother survive the intestate, then the whole estate passes to the brothers and sisters of the intestate, and to their descendants;
6. If none of the above people survive the intestate, then the intestate’s estate is divided into two portions, one of which passes to the paternal kindred and the other to the maternal kindred in the following manner: To the grandfather and grandmother in equal portions; but if only one of these are living, then the estate shall be divided into two equal parts, one of which passes to such survivor, and the other passes to the descendant or

¹⁰ TEX. PROB. CODE § 37.

¹¹ TEX. PROB. CODE § 48, et al.

¹² TEX. PROB. CODE § 38(a).

descendants of such deceased grandfather or grandmother. If there are such descendants, then the whole estate passes to the surviving grandfather or grandmother. If there is no surviving grandfather or grandmother, then the whole of such estate passes to their descendants, and so on without end, passing in like manner to the nearest lineal ancestors and their descendants.

D. **Separate Property of Married Persons.** When a married person dies intestate, his or her separate property passes to the following persons:¹³

1. If the intestate has descendants, then the surviving spouse is entitled to one-third of the separate property personal estate of the intestate and a life estate in one-third of the separate property land of the intestate, and the balance passes to the children of the intestate, and their descendants;
2. If the intestate has no descendants, then the surviving spouse is entitled to all of the separate property personal estate of the intestate and to one-half of the separate property lands of the intestate, and the balance passes according the rules of rules of descent and distribution; provided, however, that if the intestate has no surviving parents or siblings, or their descendants, then the surviving spouse is entitled to intestate's entire separate property estate.

E. **Community Property of Married Persons.** When a married person dies intestate, his or her share of community property passes to the following persons:¹⁴

1. If the intestate has no descendants, or if all of the descendants of the intestate are also descendants of the surviving spouse, then the surviving spouse is entitled to all of the intestate's community property;
2. If the intestate has descendants that are not descendants of the surviving spouse (i.e., children from a prior marriage), then the surviving spouse is entitled to one-half of the intestate's community property, and the balance passes to the intestate's children or descendants.

VI. WILLS

A. **Who Should Have a Will?** Every person should generally have a Will. The Will is the cornerstone of the estate plan. The Will makes fiduciary appointments (such as naming an executor, trustee and guardian of minor children) and controls the disposition of probate property.¹⁵ A person is authorized to make a Will if that person is of sound mind and at least age 18, has been lawfully married, or has served in the US armed forces.¹⁶

¹³ TEX. PROB. CODE § 38(b).

¹⁴ TEX. PROB. CODE § 45.

¹⁵ TEX. PROB. CODE § 37.

¹⁶ TEX. PROB. CODE § 57.

- B. **Storage of Original Will.** The testator should ensure that the original Will is not lost. The original Will is typically stored at either (1) the testator’s home with other important documents in a place safe from fire and moisture; or (2) at a bank in a safe deposit box. If the original Will is stored at a bank, additional requirements may need to be satisfied before the bank will release the Will after the testator’s death, which may cause additional administration expense.¹⁷ Regardless of where the original Will is stored, the testator should inform his or her spouse and/or children of the location of the original Will.
- C. **Formalities of a Will.** A Will typically takes the form of a type-written document prepared by an attorney.¹⁸ Alternatively, a Will can be wholly in the handwriting of the testator, which is called a “holographic Will.” Holographic Wills are not generally recommended.
1. **Signature of Testator.** The Will should have a place for the testator to sign and date the Will.¹⁹ The signature block for the testator is typically located on the last or second to last page of the Will. There is no requirement for a testator to sign or initial each page of his or her Will.
 2. **Signature of Witnesses.** The Will should have a place for at least two witnesses to sign and date the Will.²⁰ The signature block for the witnesses is typically located immediately following the signature block of the testator.
 3. **Self-Proving Affidavit.** If the Will has a self-proving affidavit attached, then the witnesses of the execution of the Will should not be necessary at the probate hearing after the testator’s death.²¹ Although the self-proving affidavit is not required, a Will should have one attached to save administration expense. Please see Exhibit F for an example of the statutory self-proving affidavit in Texas.
- D. **Identify Testator.** The Will should state the first, middle and last names of the testator, as well as any other names the testator may have used (such as a maiden name or nickname), and the testator’s county and state of residence.
- E. **Identify Spouse.** The Will should state the first, middle and last names of the testator’s current spouse and identify him or her as such. This is particularly important if the testator or his or her spouse has been married more than once. The testator’s spouse is typically identified on the first page of the Will.
- F. **Identify and Define Children.** The Will should state the first, middle and last names of the testator’s children, and identify them as such. The children are typically identified on the first page of the Will, and in the definitional section of

¹⁷ See TEX. PROB. CODE §§ 36B, C, D & E.

¹⁸ TEX. PROB. CODE § 59.

¹⁹ TEX. PROB. CODE § 59.

²⁰ TEX. PROB. CODE § 59.

²¹ TEX. PROB. CODE § 59.

the Will. If the testator or his or her spouse has children not from their marriage, then the Will should clearly identify the natural children of the testator and his or her spouse, and expressly state whether the Will treats the spouse's children as the testator's children.

- G. **Adopted Descendants.** The Will should state whether adopted persons should be treated the same as natural descendants, and the criteria for such treatment (such as adoption by age 18). Adoption is typically addressed in the definitional section of the Will. If the Will is silent as to this point, then an adopted child should be treated as the natural child of the adopting parent, and such adopted child and its descendants inherit from and through the adopting parent as if such child were the natural child of the parent.²²
- H. **Define Per Stirpes.** Per stirpes is a term typically used to describe how property is distributed among descendants, i.e., "to my descendants, per stirpes." The allocation of property to descendants is based upon their ancestor's share.²³ For example, assume a testator is survived by a son, daughter, and two grandchildren who are children of the daughter. In such a case, a bequest to the testator's descendants, per stirpes, results in the daughter and son each receiving an equal share. As another example, assume the same facts but assume that the daughter does not survive the testator. In such a case, a bequest to the testator's descendants, per stirpes, results in one half passing to the son, and the daughter's one-half passing equally to her two children (one-fourth each).
- I. **Dispositive Provisions.** The dispositive provisions are some of the most important provisions of a Will, and are typically located in the first few pages of a Will. The dispositive provisions direct the disposition of the testator's property, and typically include the following dispositions:
1. **Bequest of Tangible Personal Property.** The Will should identify the property that constitutes tangible personal property and make a disposition of such property. "Tangible personal property" is typically defined to include motor vehicles, boats, clothing, jewelry, books, household furnishings, collectibles, plates, silverware, china, paintings, pictures and similar articles of personal or household use. The Will should address in a separate section the disposition of any such items that have significant sentimental or collectible value. Typically, tangible personal property is bequeathed to the testator's surviving spouse and, if the spouse does survive the testator, then to the testator's descendants, per stirpes.
 2. **Bequest of Residence.** A Will should set out the disposition of the testator's residence. Typically, the residence is bequeathed to the testator's surviving spouse, or as part of the residue if there is no surviving spouse.
 - a. **Homestead.** The testator may bequeath his or her residence to a

²² TEX. PROB. CODE § 40.

²³ See TEX. PROB. CODE § 43.

person other than the testator's spouse. However, if the residence qualifies as a homestead, then the testator's surviving spouse should have a homestead right to live in the residence during his or her lifetime.²⁴

- b. **Exoneration.** A Will should expressly state whether a residence passes subject to any debt secured by the residence. If the Will is silent as to this issue, then the residence passes to the beneficiary subject to any debt secured by the property that exists on the date of testator's death, and the beneficiary has no right to exoneration from the testator's estate for payment of the debt.²⁵
 - 3. **Charitable Bequests.** A testator may make charitable bequests in his or her Will. The legal name and location of the charity should be identified in the Will.
 - 4. **Other Specific Bequests.** The Will may make other specific bequests of property.
 - 5. **Residue.** The Will should set out the disposition of the rest, residue and remainder of the testator's estate. Typically, the residue is bequeathed to the testator's surviving spouse, or, if there is no surviving spouse, to the testator's descendants, per stirpes. Alternatively, the residue may be bequeathed to a trust.
- J. **Identify Trust If Pour-Over Will.** If a bequest is made to a trust, then the Will should state the name of the trust, the title of the instrument that created the trust, the effective date of the instrument, the grantor of the trust, and the initial trustee(s) of the trust.²⁶
- K. **Identify Takers of Last Resort.** The Will should provide for the persons or entities that should receive the testator's probate estate if all named persons in the Will do not survive the testator. The takers of last resort typically include heirs, friends, employees, charities, or a combination of such. If the Will is silent as to this issue, then the testator's probate estate passes according to intestate succession.²⁷
- L. **Payment of Debts, Administration Expenses and Taxes.** The Will should expressly state how debts, administration expenses, and taxes should be paid. With respect to taxes, the Will can provide that taxes be paid from the residue of the estate without apportionment, that some or all of the testator's property (whether probate or nonprobate) is apportioned its share of taxes, or a combination of such.

²⁴ TEX. PROB. CODE § 282, et al.

²⁵ TEX. PROB. CODE § 71A.

²⁶ TEX. PROB. CODE § 58a.

²⁷ TEX. PROB. CODE § 37.

- M. **Independent Administration.** The Will should expressly request independent administration. Independent administration is an abbreviated form of probate available in Texas that reduces court involvement in the estate administration process and, thus, saves significant administration expense. Typically, the Will requests independent administration by stating that no other action shall be had in the court in relation to the settlement of the testator's estate other than the probating and recording of the testator's Will, and the return of an inventory, appraisal, and list of claims of the testator's estate.²⁸
- N. **Independent Executor.** In an independent administration, the independent executor is the person appointed by a court to administer the testator's estate.²⁹
1. **Appointment.** If a Will names a person to serve as independent executor, then a court should appoint that person to serve as such.³⁰ Accordingly, the Will should name a person to serve as independent executor, and one or more persons to serve as successor executor. The executor may be either an individual or a corporation. Multiple persons may serve as co-executors. The independent executor cannot be incapacitated, a convicted felon, or a non-resident of Texas.³¹
 2. **Bond.** If the Will provides that an independent executor is not required to give bond for the management of the testator's estate, then a court should not require the independent executor to give bond unless he or she is mismanaging the estate, is or is about to betray his or her trust, or has in any other way become disqualified (such as becoming a nonresident of Texas).³²
 3. **Reimbursement.** The Will should expressly state whether the executor is entitled to reimbursement for out of pocket expenses in administering the testator's estate. Such expenses typically include travel, parking, postage, professional and other administration expenses. If the Will is silent on this issue, then the executor should be entitled to reimbursement for all necessary and reasonable expenses incurred in the preservation, safekeeping and management of the estate; the expenses incurred in collecting or attempting to collect claims or debts or property of the estate; and all reasonable attorney's fees necessarily incurred in connection with the proceedings and management of the estate.³³
 4. **Compensation.** The Will should address whether a person is entitled to compensation for serving as independent executor. If the Will is silent as to this issue, then the independent executor is generally entitled to receive

²⁸ TEX. PROB. CODE § 145(b).

²⁹ TEX. PROB. CODE §§ 146 & 250.

³⁰ TEX. PROB. CODE § 77(a).

³¹ TEX. PROB. CODE § 78 (An exception exists for nonresidents. A nonresident of Texas can qualify as independent executor if a Texas resident is appointed as resident agent, and the appointment is filed with the court.).

³² TEX. PROB. CODE § 149.

³³ TEX. PROB. CODE § 242.

compensation of 5% on all sums the executor may actually receive in cash, and 5% on all sums the executor may actually pay out in cash.³⁴

5. **Executor Self-Dealing.** The Will should address whether the executor is authorized to purchase property from the testator's estate for adequate consideration. Typically, a Will will permit self-dealing if the executor is a beneficiary under the Will, or if the estate is substantially comprised of illiquid assets (such as real estate). If the Will is silent as to this issue, then the executor is not permitted to purchase property from the estate.³⁵
- O. **Guardian of Minor Children.** If the testator has minor children, or anticipates having minor children, then the Will should appoint a person to serve as guardian of the person and guardian of the estate of the minor children. Typically, one person is named as initial guardian, and one or more persons are named as successor guardians.
- P. **Survival Period.** The Will should expressly state the length of time that a person must live after the death of another person to be considered a survivor of that person, which clarifies any issue upon a simultaneous death. A 30-day survival period is typically used. If the Will is silent as to this issue, then a 120 hour period is applicable.³⁶
- Q. **Effect of Divorce.** Under Texas law, an ex-spouse named in a Will is treated as predeceasing the testator.³⁷
- R. **Forfeiture Clause.** A "forfeiture clause" (or "no contest provision") under a Will that would cause a forfeiture of a bequest under the Will in favor of a person for bringing any court action, including contesting the Will, is unenforceable if probable cause exists for bringing the action, and the action was brought and maintained in good faith.³⁸
- S. **Revocation or Modification.** A testator may revoke, modify, or replace his or her Will. If the testator wants to revoke his or her Will, then he or she may do so by physically destroying the Will (such as tearing, shredding, or burning). If the testator wants to modify specific provisions of his or her Will, then he or she should execute a Codicil.³⁹ The Codicil and the Will operate as a single document. A Codicil is typically used to name newly born or adopted children, or to change fiduciary appointments. A Codicil is typically less expensive than replacing a Will. If the testator wants to replace his or her Will, then he or she should execute a new Will.

³⁴ TEX. PROB. CODE § 241.

³⁵ TEX. PROB. CODE § 352.

³⁶ TEX. PROB. CODE § 47.

³⁷ TEX. PROB. CODE § 69(b).

³⁸ TEX. PROB. CODE § 64.

³⁹ TEX. PROB. CODE §§ 63 & 69A.

VII. TRUSTS

- A. **Trust Purposes.** Trusts are commonly used in estate planning for the following purposes:
1. **Spendthrift and Creditor Protection.** A “spendthrift” is an antiquated term still used in estate planning for a person who spends lavishly and wastefully. A trust is commonly used by a grantor who anticipates that the beneficiaries may be spendthrifts or have issues with creditors. Creditors of a trust beneficiary cannot force the trustee to distribute trust property to the beneficiary or the creditors.⁴⁰ However, the creditors will have access to trust property once distributed to the beneficiary. It should be noted that spendthrift protection does not apply to a grantor who is also a beneficiary of the trust.⁴¹
 2. **Divorce Protection.** The assets of a trust are not generally subject to division on divorce. Further, a trust prevents commingling of separate property and community property. Thus, the trust provides divorce protection to its beneficiaries.
 3. **Probate Avoidance.** Trusts are commonly used to reduce estate administration expenses because trust property is nonprobate property and, thus, not subject to probate. Probate avoidance trusts are less popular in Texas than in other states because Texas has efficient probate options, such as independent administration, that significantly reduce estate administration expenses. Texas residents typically use probate avoidance trusts for real property located in another state to avoid ancillary probate in that state.
 4. **Privacy.** Trusts are commonly used for privacy reasons because neither the trust agreement nor an inventory of the trust property are required to be filed in the public records. In contrast, a Will usually becomes public record once it is filed for probate. Further, an inventory of the estate’s probate assets must be filed with the probate court and also becomes public record.
 5. **Pets.** A trust can include provisions for the care of animals alive during the grantor’s life, such as a dog or cat.⁴²
- B. **Trust Is a Relationship.** A trust is a relationship. A trust is not an entity (such as a corporation or a partnership). The person that creates a trust is called the “grantor,” “settlor” or “trustor.” The “trustee” is the person or corporation that holds legal title to trust property for the trust beneficiaries. The trust beneficiaries hold beneficial title to the trust property.
- C. **Who May Create a Trust?** The same persons that have capacity to create a Will may create a trust.⁴³

⁴⁰ TEX. PROP. CODE § 112.035.

⁴¹ TEX. PROP. CODE § 112.035(d).

⁴² TEX. PROP. CODE § 112.037.

- D. **How Is a Trust Created?** A trust can be created either during the grantor's lifetime (called an "inter vivos trust") or at the grantor's death (called a "testamentary trust"). The terms of an inter vivos trust are set out in a written document called a "trust agreement."⁴⁴ The terms of a testamentary trust are set out in a Will.⁴⁵ The facts and circumstances should be considered when deciding whether to use an inter vivos or testamentary trust. An inter vivos trust provides probate avoidance benefits that a testamentary trust cannot provide. However, a testamentary trust is typically less expensive than an inter vivos trust because it is contained in a Will.
- E. **Funding.** An inter vivos trust is funded during the grantor's lifetime, and may be further funded at his or her death. A schedule should be attached to the inter vivos trust agreement that lists the property transferred to the trustee. A testamentary trust is funded at the grantor's death. Regardless of whether the trust is testamentary or inter vivos, property may be added to an existing trust from any source in any manner unless the trust agreement prohibits such additions.⁴⁶
- F. **Storage of Original Trust Agreement.** The original trust agreement should be held by the trustee and kept in a place safe from fire and moisture.
- G. **Formalities of a Trust.** A trust should be in writing.⁴⁷ The mere transfer of property to a person as "trustee" does not create a valid trust.
1. **Signature of Grantor.** A trust should have a place for the grantor, or the grantor's authorized agent, to sign and date.⁴⁸ This is typically located on the last page of the trust agreement.
 2. **Signature of Trustee.** An inter vivos trust should have a place for the initial trustee to sign and date.⁴⁹ This is typically located immediately following the grantor's signature block.
 3. **Beneficiaries, Witnesses, or Notary.** A trust does not need to be signed by witnesses or the trusts' beneficiaries,⁵⁰ or notarized.
- H. **Each Trust Should Be Named.** The trust should clearly name each trust created under the trust agreement. A trust often incorporates the family's last name, such as the "Smith Management Trust" or "Smith Revocable Trust," or the name of the beneficiary, such as the "Bill Smith's Separate Trust." The grantor is free to

⁴³ TEX. PROP. CODE § 112.007.

⁴⁴ TEX. PROP. CODE § 112.001(2).

⁴⁵ TEX. PROP. CODE § 112.001(3).

⁴⁶ TEX. PROP. CODE § 112.006.

⁴⁷ TEX. PROP. CODE § 112.004.

⁴⁸ TEX. PROP. CODE § 112.004.

⁴⁹ TEX. PROP. CODE § 112.009.

⁵⁰ TEX. PROP. CODE § 112.010(a).

select the name as he or she prefers. Clarity and brevity are important because the trust name is used for correspondence, bank accounts, and title to property.

- I. **Identify and Define Spouse, Children and Descendants.** The trust should clearly identify and define the grantor's spouse, children and descendants. This is typically identical to the identification used in the grantor's Will.
- J. **Distributions.** The trust should set out the standards for the trustee to use in making distributions of income and principal to the trust beneficiaries.⁵¹ The standard can include (1) a fixed amount on a recurring basis, such as "as \$20,000 annually;" (2) a discretionary amount determined in the sole discretion of a beneficiary, such as "any amount as directed by the grantor;" (3) a discretionary amount determined in the sole discretion of the trustee, such as "any amount as determined in the sole and absolute discretion of the trustee," (4) an amount determined based upon an ascertainable standard, such as "an amount to or for the beneficiary's health, education, maintenance or support" (also known as the "HEMS standard"); or (5) a combination of such.
- K. **Spendthrift Provision.** The trust agreement should either provide that the interest of a beneficiary in the income or principal or in both may not be voluntarily or involuntarily transferred before payment or delivery of the interest to the beneficiary by the trustee,⁵² or state that the trust is to be held subject to a "spendthrift trust."⁵³
- L. **Termination.** The trust agreement should set out the circumstances triggering the termination of the trust. Examples include a specified date or the happening of a particular event (i.e., when a descendant reaches a specified age).⁵⁴ If the trust is silent as to the termination of an uneconomic trust, then the trustee may terminate a trust if the value of the trust property is less than \$50,000.⁵⁵
- M. **Rule Against Perpetuities.** The trust should provide that all trusts must terminate no later than 21 years after a life in being at the time of the creation of the trust dies.⁵⁶
- N. **Trustees.**
 1. **Appointment.** The trust agreement should name the persons who are to serve as trustee and successor trustees.⁵⁷ Such person can be either an individual or a corporation.⁵⁸ Such person can be the grantor,⁵⁹ and/or a

⁵¹ TEX. PROP. CODE § 112.032.

⁵² TEX. PROP. CODE § 112.035(a).

⁵³ TEX. PROP. CODE § 112.035(b).

⁵⁴ TEX. PROP. CODE § 112.052.

⁵⁵ TEX. PROP. CODE § 112.059.

⁵⁶ TEX. PROP. CODE § 112.036.

⁵⁷ TEX. PROP. CODE § 113.083(a).

⁵⁸ TEX. PROP. CODE § 112.008 (A corporation must have the power to act as trustee in Texas.).

trust beneficiary.⁶⁰ Multiple persons may serve as co-trustees. Common examples of co-trustees include a husband/wife, brother/sister, and descendant/corporate trustee. A court will appoint a successor trustee if all other appointed persons fails to serve as trustee.⁶¹

- a. **Avoid Conflicts.** If the grantor has been married more than once and/or has children that are not from the current marriage, then the grantor should pay special care to who is appointed as trustee to avoid conflicts between the trustee and beneficiary. For example, a grantor's current spouse should generally not be appointed as trustee of a trust where the grantor's children not from the current marriage are current or remainder beneficiaries, and vice versa.
 - b. **Grantor As Trustee.** If a grantor is trustee of a trust he or she created, then the trust is includible in the grantor's estate.⁶² Thus, as a rule of thumb, a grantor may serve as trustee a revocable trust that he or she creates because such trust is otherwise includible in the grantor's estate, but the grantor should not serve as trustee of an irrevocable trust if the irrevocable trust is intended to be excluded from the grantor's estate.
 - c. **Beneficiary As Trustee.** The grantor should consider whether a descendant who is beneficiary of a trust should become trustee of that trust at a particular age. This provides the descendant the benefit of having legal title to the trust property as trustee, and beneficial title to the trust property as beneficiary. In such a case, the trust will typically appoint the beneficiary as co-trustee at age 25 or 30, and then sole trustee at age 30 or 35. Such an arrangement eases the beneficiary into the responsibilities as trustee.
 - d. **Appointment Power For Successor Trustees.** The trust may provide a person named as trustee the power to appoint his or her successors as trustee.
2. **Bond.** The trust should state whether the trustee is required to provide a bond for the faithful performance of the trustee's duties.⁶³
 3. **Reimbursement.** The trust should expressly state whether the trustee is entitled to reimbursement for out of pocket expenses in administering the trust. If the trust agreement is silent on this issue, then the trustee should be entitled to reimbursement for all advances made for the convenience, benefit or protection of the trust or its property, and expenses incurred

⁵⁹ TEX. PROP. CODE §§ 112.001(1) & 112.008(c).

⁶⁰ TEX. PROP. CODE § 112.008(b).

⁶¹ TEX. PROP. CODE §§ 112.009(c) & 113.083(a).

⁶² I.R.C. § 2036; Treas. Reg. § 20.2036-1.

⁶³ TEX. PROP. CODE § 113.058.

while administering or protecting the trust or because of the trustee's holding or owning any of the trust property.⁶⁴

4. **Compensation.** The trust should expressly state whether the trustee is entitled to compensation. Compensation for corporate trustees is typically determined by using the corporate trustee's schedule of fees. If the trust is silent as to this issue, then the trustee is entitled to reasonable compensation for acting as trustee.⁶⁵
 5. **Trustee Duties and Powers.** The trust should set out the trustee's duties and powers. Broad powers are generally used because they provide the trustee flexibility in administering the trust.
 6. **Self-Dealing.** The trust should address whether the trustee is authorized to purchase property from the trust for adequate consideration, sell property to the trust, or loan trust funds to the trustee. Typically, a trust agreement will permit self-dealing if the trustee is a beneficiary under the Will, or if the trust is substantially comprised of illiquid assets (such as real estate). If the trust agreement is silent as to this issue, then the trustee is not permitted to purchase property from the trust, sell property to the trust, or to loan trust funds to the trustee.⁶⁶
- O. **Trust Situs.** The trust should establish the state of the trust's situs, such as Texas, and state whether the trustee has the power to change the trust situs.
- P. **Effect of Divorce.** Unlike a Will, an ex-spouse is not treated as predeceasing a grantor. Thus, a revocable trust should be modified by a grantor upon his or her divorce to remove any distribution to, or fiduciary appointments of, an ex-spouse.
- Q. **Forfeiture Clause.** A "forfeiture clause" (or "no contest provision") under a trust that would cause a forfeiture of an interest in favor of a person for bringing any court action, including contesting the trust, is unenforceable if probable cause exists for bringing the action, and the action was brought and maintained in good faith.⁶⁷
- R. **Modification and Revocability.** The trust should state whether it is revocable or irrevocable. If the trust is silent as to this issue, then the trust agreement is revocable.⁶⁸ A revocable trust can be modified by the grantor at any time, by either replacing the trust agreement with an amended and restated trust agreement, or by modifying specific provisions with a trust amendment.⁶⁹ Revocable trusts are typically used for asset management and/or probate avoidance. An

⁶⁴ TEX. PROP. CODE § 114.063(a).

⁶⁵ TEX. PROP. CODE § 114.061(a).

⁶⁶ TEX. PROP. CODE §§ 113.052 & 113.053.

⁶⁷ TEX. PROP. CODE § 112.038.

⁶⁸ TEX. PROP. CODE § 112.051(a).

⁶⁹ TEX. PROP. CODE § 112.051.

irrevocable trust cannot generally be modified without court approval.⁷⁰ Irrevocable trusts are typically used for gift tax planning purposes.

- S. **Taxpayer Identification Number.** The trustee should obtain a taxpayer identification number (a “TIN” or “EIN”) for the trust. The trustee applies for an EIN by filing with the IRS a Form SS-4. The EIN is used to open the trust’s bank account, and file the trust’s federal tax returns.

VIII. TAX PLANNING

- A. **The Tax Players.** The US federal tax system consists primarily of an income tax system and a transfer tax system. The transfer tax system is comprised of three taxes: (1) estate tax; (2) gift tax; and (3) generation skipping transfer tax (or “GST tax”).

B. **Overview of Estate Tax.**

1. **Purpose.** The estate tax is neither a property tax nor an inheritance tax; it is a tax imposed on the *transfer* of a taxable estate.⁷¹
2. **Payment of the Estate Tax.** For persons dying in 2011 and 2012, the maximum estate tax rate is 35%.⁷² The executor is responsible for paying the estate tax.⁷³ If the executor pays a debt due by the decedent’s estate or distributes any portion of the estate before all the estate tax is paid, then the executor is personally liable for the estate tax to the extent of the payment or distribution, for so much of the estate tax as remains due and unpaid.⁷⁴
3. **The Gross Estate.** The first step in calculating the amount of estate tax due is to determine the value of the decedent’s gross estate.⁷⁵ The gross estate includes the value of all property held by a person to the extent that person held an interest in that property.⁷⁶ Stated another way, the gross estate includes the value of all property, whether real or personal, tangible or intangible, and wherever situated, beneficially owned by the decedent at the time of his or her death.⁷⁷ The value of such items is generally the fair market value at the time of the person’s death.⁷⁸ “Fair market value” is generally the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts.⁷⁹ A

⁷⁰ See TEX. PROP. CODE § 112.054.

⁷¹ I.R.C. § 2001; Treas. Reg. § 20.0-2(a).

⁷² I.R.C. § 2001(c); Treas. Reg. § 20.0-2(b)(4).

⁷³ Treas. Reg. § 20.2002-1.

⁷⁴ Treas. Reg. § 20.2002-1.

⁷⁵ Treas. Reg. § 20.0-2(b)(2).

⁷⁶ Treas. Reg. § 20.0-2(b)(2).

⁷⁷ I.R.C. § 2031; Treas. Reg. § 20.2033-1(a).

⁷⁸ Treas. Reg. § 20.2031-1(b).

⁷⁹ Treas. Reg. § 20.2031-1(b).

taxable estate may be very different from a probate estate for Texas probate purposes.⁸⁰ The following property is included in the gross estate:

- a. **Real Property.** Real property held in the decedent's name should generally be included in the gross estate.⁸¹ This typically includes the primary residence, second home, ranch, investment property, rental property, and mineral interests.
- b. **Stocks, Bonds, and Ownership Interests.** Stocks and bonds, whether held outright or in account, and entity ownership interests should generally be included in the gross estate.⁸² This includes interests in partnerships and limited liability companies.
- c. **Cash and Bank Accounts.** Cash, whether held outright or in an account, should be included in the gross estate.⁸³
- d. **TOD Accounts.** A TOD Account should generally be included in the gross estate to the extent the decedent held an interest as a joint tenant with a right of survivorship.⁸⁴
- e. **Life Insurance.** Life insurance on the life of a decedent should generally be included in the gross estate if (1) receivable by the decedent's estate,⁸⁵ or (2) receivable by another beneficiary if the decedent held incidents of ownership of the policy.⁸⁶
- f. **Tangible Personal Property.** Tangible personal property should generally be included in the gross estate.⁸⁷ This typically includes motor vehicles, boats, clothing, jewelry, books, household furnishings, collectibles, plates, silverware, china, paintings, pictures and/or similar articles of personal or household use.
- g. **Retirement Benefits.** The assets of a decedent's retirement plan, such as a 401(k) or IRA, should generally be included in the gross estate.⁸⁸
- h. **Trusts Created By Decedent.** The assets of a trust created by a decedent should be included in the gross estate depending upon the powers retained by the decedent.⁸⁹ If the decedent retained the use, possession, right to income, or other enjoyment of the property transferred to the trust, or the right, either alone or in

⁸⁰ Treas. Reg. § 20.0-2(b)(2).

⁸¹ I.R.C. §§ 2031 & 2033; Treas. Reg. § 20.2031-1(a)(1); Treas. Reg. § 20.2033-1(a).

⁸² I.R.C. §§ 2031 & 2033; Treas. Reg. § 20.2031-1(a)(1); Treas. Reg. § 20.2033-1(a).

⁸³ I.R.C. §§ 2031 & 2033; Treas. Reg. § 20.2031-1(a)(1); Treas. Reg. § 20.2033-1(a).

⁸⁴ I.R.C. § 2040.

⁸⁵ I.R.C. § 2042(1); Treas. Reg. § 20.2042-1(a)(1).

⁸⁶ I.R.C. § 2042(2); Treas. Reg. § 20.2042-1(a)(1).

⁸⁷ I.R.C. §§ 2031 & 2033; Treas. Reg. § 20.2031-1(a)(1); Treas. Reg. § 20.2033-1(a).

⁸⁸ I.R.C. §§ 2031 & 2033.

⁸⁹ Treas. Reg. § 20.2031-1(a)(2).

conjunction with any other person or persons to designate the person or persons who can possess or enjoy the transferred property, or its income, then the property of the trust should be included in the gross estate.⁹⁰ Further, if the decedent had at the time of his death the power to change the beneficial enjoyment of the trust property, or the power to alter, amend, revoke or terminate the trust, then the property of the trust should be included in the decedent's gross estate.⁹¹ This should include an inter vivos revocable trust, such as a probate avoidance trust.

- i. **Trusts Created By Persons Other Than Decedent.** The assets of a trust created by a person other than the decedent should be included in the gross estate if the decedent has a general power of appointment.⁹² A "general power of appointment" provides a person the power to appoint the property of a trust for the benefit of that person, his or her estate, his or her creditors, or creditors of his or her estate.⁹³
 - j. **Property Previously Subject to Marital Deduction.** Property that was previously subject to a marital deduction should be included in the gross estate.⁹⁴
 - k. **Property Located Outside the US.** Property of a US citizen located outside the US should be included in the gross estate.⁹⁵
 - l. **Community Property Interest.** A decedent's separate property and one-half share of community property should be included in his or her gross estate.⁹⁶ The decedent's surviving spouse's separate property and one-half share of community property should not be included in the decedent's gross estate.
4. **The Taxable Estate and the Unlimited Marital Deduction.** The estate tax is calculated based upon a taxable estate. The taxable estate is determined by reducing the gross estate by authorized exemptions and deductions.⁹⁷ Such deductions include the unlimited marital deduction. The marital deduction reduces a gross estate by the amount of property that passes to a surviving spouse (outright or in trust) to the extent it is later included in the surviving spouse's gross estate.⁹⁸ The marital deduction is unlimited and, thus, has the potential of reducing a gross estate of a deceased spouse so that his or her taxable estate is zero.

⁹⁰ I.R.C. § 2036; Treas. Reg. § 20.2031-1(a)(2); Treas. Reg. § 20.2036-1(a).

⁹¹ I.R.C. § 2038; Treas. Reg. § 20.2031-1(a)(2); Treas. Reg. § 20.2038-1(a).

⁹² I.R.C. § 2041(a)(2); Treas. Reg. § 20.2041-1(a)

⁹³ Treas. Reg. § 20.2041-1(c)(1).

⁹⁴ I.R.C. § 2044; Treas. Reg. § 20.2044-1(a).

⁹⁵ Treas. Reg. § 20.2031-1(a).

⁹⁶ I.R.C. § 2033.

⁹⁷ Treas. Reg. §§ 20.0-2(b)(3) & 20.2051-1(a).

⁹⁸ I.R.C. § 2056(a).

5. **The Unified Credit.** The amount of estate tax due is determined by reducing the gross estate tax by authorized credits available.⁹⁹ Such credits include the unified credit. The unified credit is calculated based upon the applicable exclusion amount. Each person dying in 2011 or 2012 has an estate tax applicable exclusion amount equal to \$5,000,000, indexed for inflation beginning in 2012.¹⁰⁰ Any applicable exclusion amount that remains unused as of the death of the deceased spouse generally is available for use by the surviving spouse as an addition to the surviving spouse's applicable exclusion amount. This feature is often referred to as "portability," and essentially provides a married couple an applicable exclusion amount of \$10,000,000. If the surviving spouse is predeceased by more than one spouse, then the amount of unused applicable exclusion amount that is available for use by such surviving spouse is limited to the lesser of \$5,000,000 or the unused applicable exclusion amount of the last such deceased spouse.¹⁰¹ In order for the surviving spouse to use the deceased spouse's unused applicable exclusion amount, the executor of the deceased spouse's estate must make an election on a timely filed estate tax return of the predeceased spouse.¹⁰² Most estates do not have an estate tax due because the estate's gross estate tax is below the unified credit.

C. Overview of Gift Tax.

1. **Purpose.** The gift tax is a tax on the lifetime transfer of property by gift.¹⁰³
2. **Payment of Gift Tax.** For gifts made in 2011 or 2012, the maximum gift tax rate is 35%.¹⁰⁴ The donor is responsible for paying the gift tax.
3. **Annual Exclusion Amount.** For 2011, each person has an annual exclusion amount of \$13,000. The annual exclusion amount causes the first \$13,000 of gifts of present interests to any one donee during a calendar year to be excluded in determining the total amount of taxable gifts.¹⁰⁵ A "present interest" is an unrestricted right to the immediate use, possession, or enjoyment of property or the income from property.¹⁰⁶
4. **Lifetime Exemption Amount.** In addition to the annual exclusion amount, each person has a gift tax lifetime exemption amount of \$5,000,000 for 2011 and 2012.¹⁰⁷ The donor may apply all or a portion of the gift tax lifetime exemption amount to reduce taxable gifts made during the donor's lifetime. The unified credit against estate tax will be reduced

⁹⁹ I.R.C. § 2010(a); Treas. Reg. § 20.0-2(b)(5).

¹⁰⁰ I.R.C. § 2010(c).

¹⁰¹ I.R.C. § 2010(c)(4).

¹⁰² I.R.C. § 2010(c)(5)(A).

¹⁰³ Treas. Reg. § 25.501-1.

¹⁰⁴ I.R.C. § 2001.

¹⁰⁵ I.R.C. § 2503(b); Treas. Reg. § 25.2503-2(a); Treas. Reg. § 25.2503-3(b).

¹⁰⁶ Treas. Reg. § 25.2503-3(b).

¹⁰⁷ I.R.C. § 2505.

by the amount of the gift tax lifetime exemption amount applied during the donor's lifetime.

5. **Gift Tax Planning.** The gift tax applies to transfers made by gift. A "gift" of property generally requires the release of dominion and control of the property.¹⁰⁸ The vast majority of persons prefer to retain or accumulate property rather than release dominion and control of property and, therefore, gift tax planning is less frequently incorporated into an estate plan.

D. **Overview of Generation Skipping Transfer Tax.**

1. **Purpose.** The generation skipping transfer tax (or "GST tax") is a tax on generation skipping transfers.
2. **Payment of the GST Tax.** For generation skipping transfers made in 2011 and 2012, the maximum GST tax rate is 35%.
3. **Generation Skipping Transfers.** A generation skipping transfer can take the form of a direct skip, a taxable distribution, or a taxable termination.¹⁰⁹ Typically, a generation skipping transfer will occur when a grandparent transfers property to a grandchild outright or in trust.¹¹⁰
4. **GST Exemption.** Each person has a GST exemption of \$5,000,000 for 2011 and 2012, indexed for inflation beginning in 2012, that can be allocated against any transfer that is, or may later be, subject to GST tax.¹¹¹ The GST exemption can be allocated to a trust. The trust will have an "inclusion ratio" that is determined based upon the amount of GST exemption so allocated.
5. **GST Tax Planning.** Basic GST tax planning should (a) provide that trusts for descendants that will be allocated GST exemption should exist as long as possible (commonly called "dynastic trusts"); and (b) provide a trustee the power to divide a trust and allocate GST exemption to the trusts so that the trusts have an inclusion ratio of zero or one.

IX. **TAX PLANNING WITH MARITAL AND CREDIT SHELTER TRUSTS**

- A. **Summary Chart.** Please see Exhibit E for a summary chart of a Will with marital and credit shelter trusts, which is discussed in this section.
- B. **Components.** The type of estate plan discussed in this section is often called an "AB plan" and incorporates tax planning with the following components:
 1. Will;
 2. marital trust; and

¹⁰⁸ Treas. Reg. § 25.2511-1(a).

¹⁰⁹ Treas. Reg. § 26.2611-1

¹¹⁰ See Treas. Reg. § 26.2612-1

¹¹¹ I.R.C. §§ 2631, 2632 & 2010(c).

3. credit shelter trust, which is also known as a “family trust” or “bypass trust.”
- C. **Threshold.** An AB plan should be used by married couples that have or will have a combined taxable estate more than the applicable exclusion amount. The ever changing estate tax rules make it difficult to anticipate the future status of the unified credit and applicable exclusion amount. If it is uncertain whether a married couple will meet this threshold, then a disclaimer trust plan should be used instead, as discussed below. A single person should not use an AB plan.
- D. **Purpose of Marital Trust.** A marital trust is commonly used for the following reasons:
1. The marital trust provides the deceased spouse ultimate control over the disposition of the marital trust property because the terms of the trust, as set out in the deceased spouse’s Will or a separate trust agreement executed during the deceased spouse’s lifetime, control the disposition of that property upon the surviving spouse’s death. If, however, property is bequeathed to the surviving spouse outright, then the surviving spouse controls the disposition of that property by his or her Will.
 2. The marital trust provides estate tax planning opportunities after the death of the deceased spouse because the executor of his or her estate may elect to apply the marital deduction to the property passing to the marital trust.
- E. **Requirements for Marital Trust to Qualify for Marital Deduction.** A bequest to a surviving spouse generally qualifies for the unlimited marital deduction whether the bequest is outright or in trust.¹¹² Additional requirements must be satisfied for a bequest in trust to qualify for the marital deduction.
1. **Executor Must Make Election.** The executor of the deceased spouse’s estate is required to make an election whether to apply the marital deduction to the property passing to the marital trust.¹¹³ This is referred to as the “QTIP election.” A Will should direct the executor to make the QTIP election in his or her discretion.
 2. **Income Should Be Payable Only to Surviving Spouse.** The income of the marital trust should be payable only to surviving spouse annually or more frequently.¹¹⁴ Further, any undistributed income of the marital trust after the death of the surviving spouse should be payable only to the surviving spouse’s estate. If the income of the marital trust is payable to any person other than the surviving spouse, then the property passing to the marital trust is not eligible for the QTIP election and, thus, should not qualify for the marital deduction.¹¹⁵

¹¹² I.R.C. § 2056.

¹¹³ I.R.C. § 2056(b)(7)(B)(v).

¹¹⁴ I.R.C. § 2056(b)(7)(B)(ii)(I).

¹¹⁵ I.R.C. § 2056(b)(7)(B).

3. **Power to Make Assets Income Producing.** The property of the marital trust should be income producing, or the surviving spouse should have a power to require that such assets be made income producing.¹¹⁶
4. **Restriction on Withdrawal.** No persons should have a power to appoint any of the marital trust property to anyone other than the surviving spouse during his or her lifetime.¹¹⁷

F. **Purposes for Credit Shelter Trust.**

1. **Utilize Deceased Spouse's Unified Credit.** Historically, the primary purpose of the credit shelter trust was to fully utilize the unused unified credit of the deceased spouse that would otherwise be unused. This was accomplished by structuring the credit shelter trust so that its assets were not included in the estate of the surviving spouse. The portability feature of the unified credit available in 2011 and 2012 reduces, but does not eliminate, the need for a credit shelter trust for this purpose. Today, the credit shelter trust can be used to fully utilize the unused unified credit of the deceased spouse when and if the portability feature is no longer in effect (please note the portability feature under the current tax rules exists only in 2011 and 2012); and to fully utilize the unused unified credit of the deceased spouse if the portability feature is not properly applied (i.e., the executor of the deceased spouse's estate fails to properly elect to allow the surviving spouse to use the unused unified credit of the deceased spouse).
2. **Income Excluded From Estate of Surviving Spouse.** Income on the assets of a credit shelter trust from the deceased spouse's date of death to the surviving spouse's date of death should be excluded from the surviving spouse's gross estate.
3. **GST Tax Planning.** The portability feature of the estate tax unified credit does not allow a surviving spouse to use the unused GST exemption of a deceased spouse. However, the GST exemption of the deceased spouse can be applied to the assets of a credit shelter trust. Thus, the credit shelter trust can be used for GST tax planning purposes.

G. **Funding of Credit Shelter Trust With Nonprobate Property.** The nonprobate assets of the deceased spouse, such as life insurance, may need to be used to fully fund a credit shelter trust. Special care should be taken in drafting the beneficiary designation form for the nonprobate property.

H. **General Trust Terms for Marital and Credit Shelter Trusts.** The marital and credit shelter trusts should include the general trust provisions as discussed in Section VII above, and include the specific provisions discussed in this Section IX.

I. **Funding Formula.** The marital and credit shelter trusts are typically funded according to a formula that allocates the residue of an estate between the two

¹¹⁶ Treas. Reg. § 20.2056(b)-5(f).

¹¹⁷ I.R.C. § 2056(b)(7)(B)(ii)(II).

trusts, which is commonly called a “minimum tax” or “zero tax” formula. Good drafting requires the use of a formula because the unified credit may change year to year. The goal for the formula, regardless of its type, is to allocate to the credit shelter trust the smallest amount possible needed to reduce the estate tax to zero after utilizing all available deductions (such as the marital deduction) and credits (such as the unified credit). Practically, the formula should result in the credit shelter trust being funded with an amount equal to the deceased spouse’s remaining applicable exclusion amount, and the marital trust being funded with the balance.

1. **Three Types of Formulas:**

- a. **Fractional Share Formula.** Under a fractional share formula, the residue of an estate is allocated to the marital and credit shelter trusts according to a fraction. The fractional share formula is typically the preferred formula.
- b. **Pecuniary Marital Formula.** Under a pecuniary marital formula, or “pecuniary formula,” the residue of an estate is allocated first to a marital trust, and the balance to a credit shelter trust.
- c. **Pecuniary Credit Shelter Formula.** Under a pecuniary credit shelter formula, or “reverse pecuniary formula,” the residue of an estate is allocated first to a credit shelter trust, and the balance to a marital trust. This is the mirror of a pecuniary marital formula.

2. **Preferred Formula.** The fractional share formula is typically the preferred formula because it avoids income tax recognition issues caused by the pecuniary formulas. If a fractional share formula is not used, then the decision of which pecuniary formula should be used typically depends upon the facts and circumstances; but, as a rule of thumb, can generally be based upon which trust is anticipated to be smaller. For example, if the credit shelter trust is anticipated to be significantly smaller than the marital trust, then the pecuniary credit shelter formula should be used.

J. **Surviving Spouse May Be Both Trustee and Beneficiary.** Subject to the requirements of a marital deduction, the surviving spouse can generally be both trustee and beneficiary of the marital trust. With careful planning, the surviving spouse can also generally be both trustee and beneficiary of the credit shelter trust.

K. **Ascertainable Standard For Distributions.**

1. **Credit Shelter Trust.** The surviving spouse and/or other persons, such as descendants, may be beneficiaries of the credit shelter trust. Distributions of income and principal should be based upon an ascertainable standard, such as the HEMS standard, so that a beneficiary is not treated as holding a general power of appointment over the trust.¹¹⁸

¹¹⁸ I.R.C. § 2041(b)(1)(A).

2. **Marital Trust.** The surviving spouse should be the sole beneficiary of the marital trust. Income should be distributable only to the surviving spouse.¹¹⁹ Principal may be distributable to surviving spouse and should generally be based upon an ascertainable standard, such as the HEMS standard, so that the surviving spouse is not treated as holding a general power of appointment.¹²⁰

L. **Power of Appointment.**

1. **Credit Shelter Trust – No General Power of Appointment.** The surviving spouse should not have a general power of appointment over the credit shelter trust because such a power causes the property of the trust to be included in the surviving spouse's gross estate.¹²¹ A general power of appointment is a power that permits the surviving spouse to appoint the credit shelter trust to the surviving spouse, his or her estate, his or her creditors, or creditors of his or her estate.¹²² Instead, the surviving spouse may have a *special* power of appointment that permits the surviving spouse to appoint the credit shelter trust for the benefit of a limited group of persons, such as descendants. This is one of the critical mechanical characteristics of the credit shelter trust that causes it to be excluded from the surviving spouse's gross estate.
2. **Marital Trust – General Power of Appointment Immaterial.** A marital trust should be includable in the gross estate of the surviving spouse regardless of whether the surviving spouse has a general power of appointment.¹²³ Accordingly, the surviving spouse may have a general power of appointment. However, the surviving spouse typically has a special power of appointment over the marital trust so that the surviving spouse is limited to exercising such power for the benefit of the descendants of the deceased spouse.

M. **Marital Trust Should Provide For Payment of Estate Taxes.** The marital trust, whether in a Will or separate trust agreement, should provide that the estate taxes attributable to the marital trust may be paid from the property of the marital trust.

N. **Termination and GST Tax Planning.** Both the marital and credit shelter trusts should terminate upon the death of the surviving spouse. The terms of the trust should set out the disposition of the trust property. Typically, the assets are transferred upon termination to dynastic trusts for the benefit of the spouses' descendants, which will then be allocated GST exemption.

X. **TAX PLANNING WITH DISCLAIMER TRUST**

A. **Summary Chart.** Please see Exhibit D for a summary chart of a Will with a disclaimer trust, which is discussed in this section.

¹¹⁹ I.R.C. § 2056(b)(7).

¹²⁰ I.R.C. § 2041(b)(1)(A).

¹²¹ I.R.C. § 2041(a)(2); Treas. Reg. § 20.2041-1(a).

¹²² I.R.C. § 2041(b)(1); Treas. Reg. § 20.2041-1(c)(1).

¹²³ I.R.C. § 2044.

- B. **Components.** The type of estate plan discussed in this section incorporates tax planning with the following components:
1. Will; and
 2. a variation of a credit shelter trust known as a “disclaimer trust.”
- C. **Threshold.** An estate plan with a disclaimer trust should be used by married couples that do not meet the threshold for an AB plan, but anticipate their combined gross estate will be close to (either over or under) the applicable exclusion amount. The ever changing estate tax rules make it difficult to anticipate the future status of the unified credit and applicable exclusion amount. Accordingly, the disclaimer trust should also be used by couples that anticipate their combined gross estate will be under the applicable exclusion amount but are concerned that the unified credit and applicable exclusion amount may be reduced or modified for political reasons. A disclaimer trust should not be used by a single person.
- D. **Purpose of Disclaimer Trust.** The purpose of the disclaimer trust is similar to a credit shelter trust – the goal of both is to fully utilize the deceased spouse’s unified credit, and to structure the trust so that its assets are not included in the gross estate of the surviving spouse. The difference between the two trusts is the way the disclaimer trust is funded.
- E. **Funding of Disclaimer Trust.** The disclaimer trust is funded with assets to the extent a surviving spouse disclaims such assets. For example, the Will should provide a residuary bequest to a surviving spouse outright, and provide that property disclaimed by the surviving spouse, if any, passes to the disclaimer trust. This plan leaves the decision of whether the disclaimer trust should be funded, and the amount of such funding, to the surviving spouse; whereas the funding of the credit shelter trust under an AB plan occurs automatically.
- F. **Nonprobate Property.** Extra attention should be paid to nonprobate assets, such as life insurance. The nonprobate property of the deceased spouse may be needed to fully fund a disclaimer trust and, thus, fully utilize the deceased spouse’s unified credit. In such a case, special drafting will be needed for the beneficiary designation form of the nonprobate property.
- G. **No Power of Appointment.** The disclaimer trust should not provide the surviving spouse a general or special power of appointment.
- H. **Trust Terms.** The terms of the disclaimer trust should generally be the same as the terms of a credit shelter trust in an AB plan, as discussed above, except for the terms with respect to funding and powers of appointment.

XI. ANCILLARY ESTATE PLANNING DOCUMENTS

- A. **Statutory Durable Power of Attorney.** A statutory durable power of attorney appoints an agent to make business and financial decisions on behalf of the principal. The power given may take effect immediately, or when the principal becomes incapacitated. This document is a valuable and powerful addition to an estate plan. The agent may deal with the principal's property in his discretion. Special care should be paid in selecting the agents to serve under this document. Please see Exhibit G for an example of a Texas statutory durable power of attorney.
- B. **Medical Power of Attorney.** A medical power of attorney appoints an agent to make medical decisions on behalf of a principal if the principal is unable to make such decisions. This document is particularly valuable for unmarried persons who want to provide a significant other or close friend with such authority.
- C. **Directive to Physicians, Family and Surrogates.** This document is the Texas "living will," and is a statement regarding whether life sustaining treatment should be administered or withheld under certain circumstances.
- D. **HIPAA Authorization.** This document provides the named persons access to protected health information. The people named in this document should typically be the same people named in the medical power of attorney.
- E. **Appointment of Guardian in Advance of Need.** This document is a statement as to the preferred persons for appointment as guardian of the property or person, or both at a time the principal may need a guardian. This document allows a principal to choose who should serve in that function and, perhaps more importantly, specify who should not serve in that role.

EXHIBIT A
Texas Intestate Succession
(No Will)

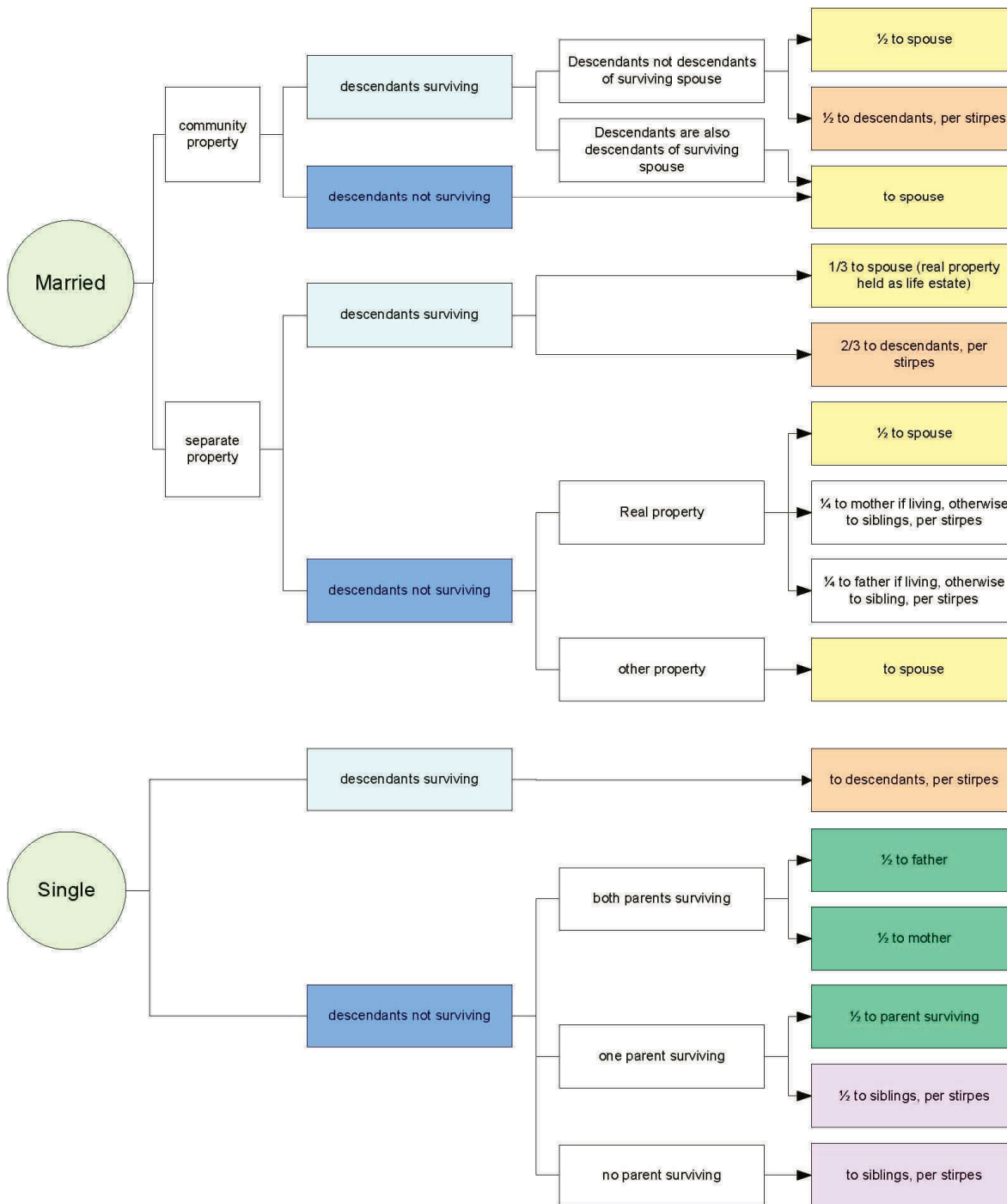
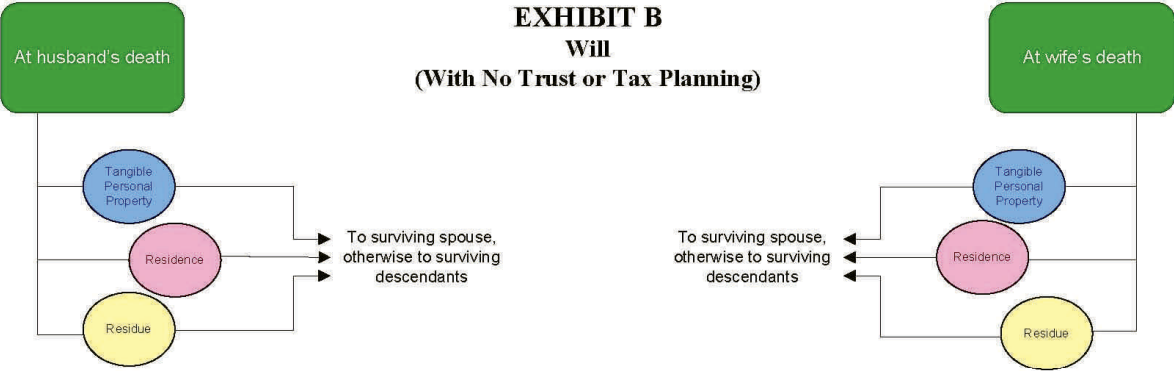
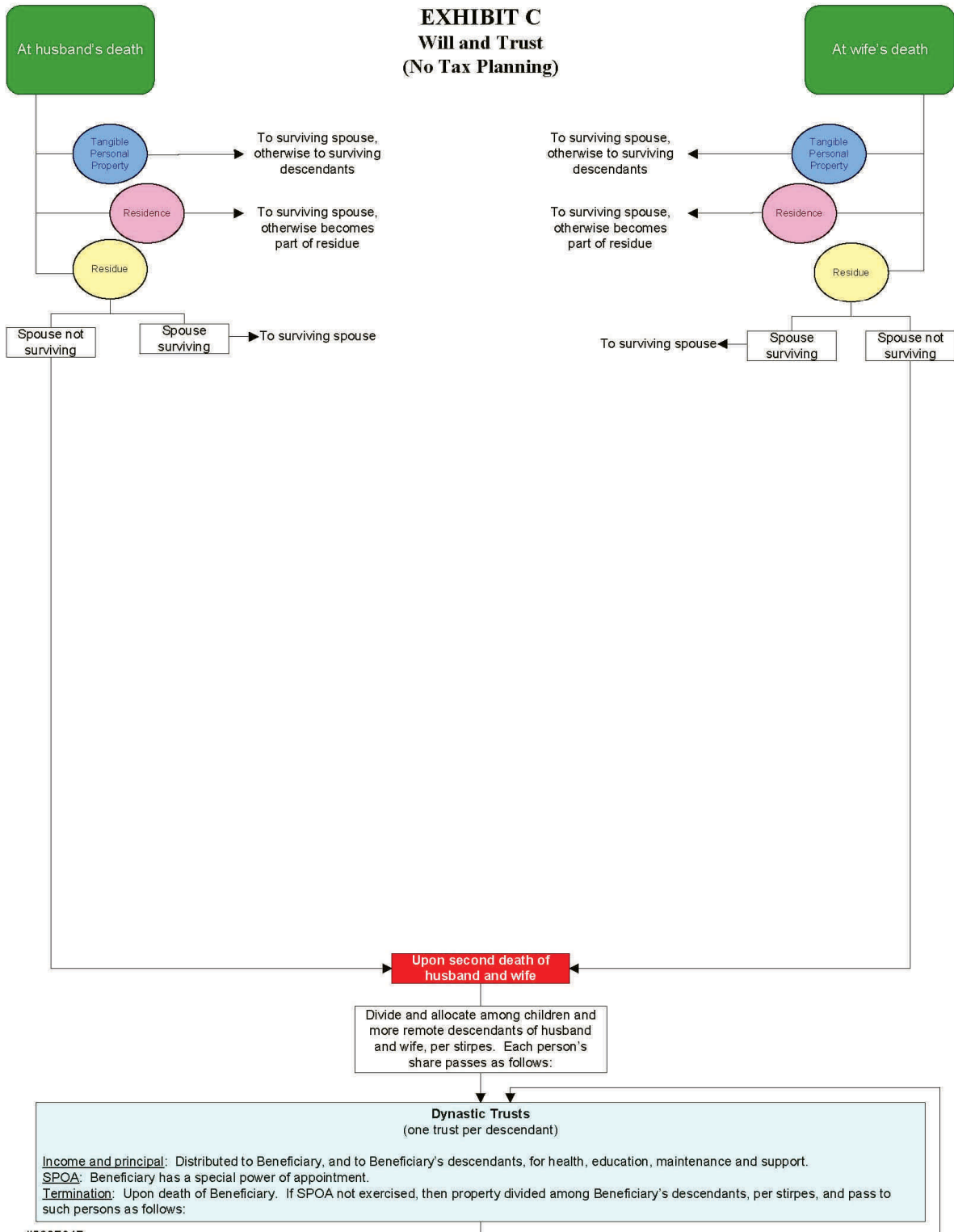


EXHIBIT B
Will
(With No Trust or Tax Planning)



#5937847

**EXHIBIT C
Will and Trust
(No Tax Planning)**



#5937847

EXHIBIT D Will and Disclaimer Trust With Tax Planning

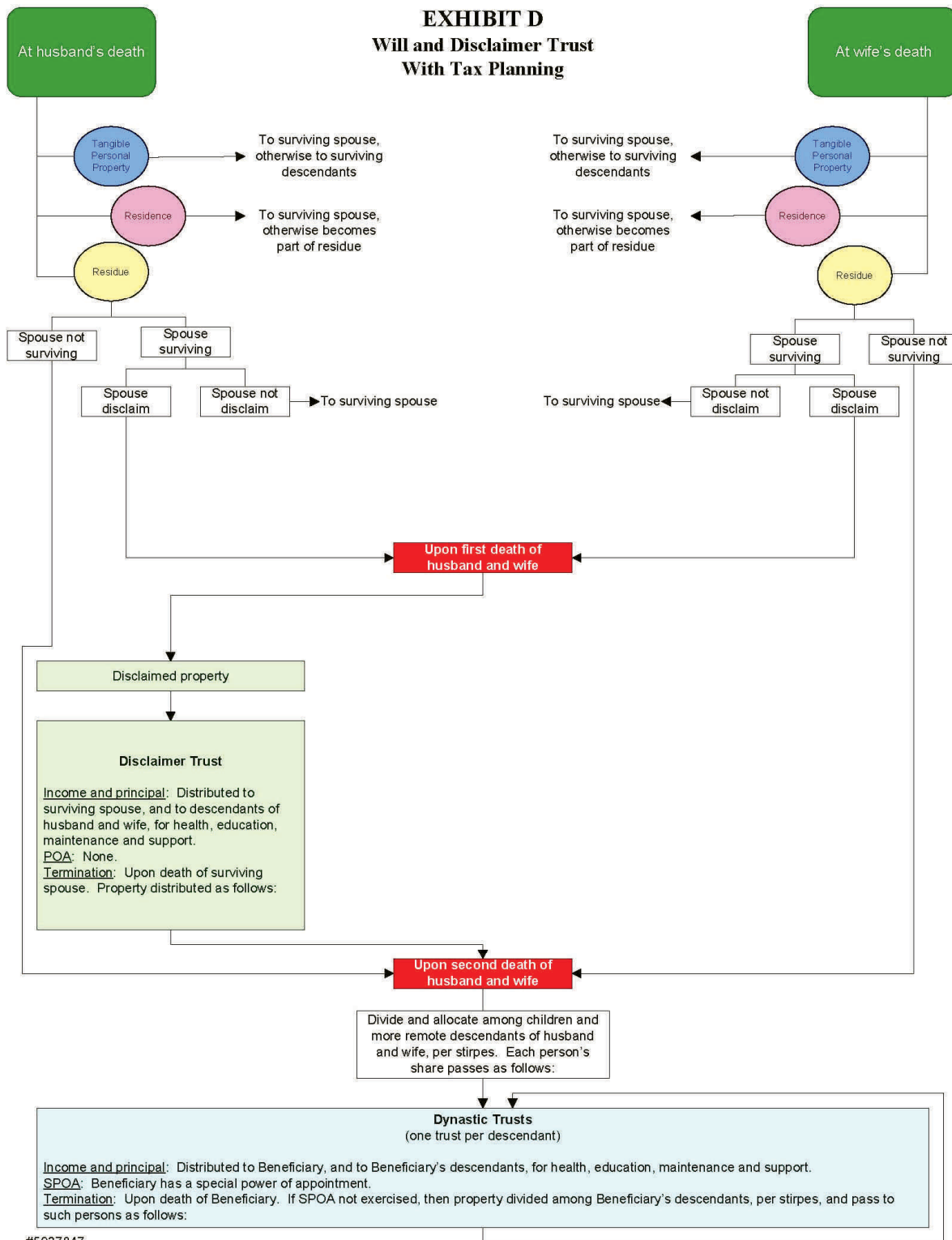
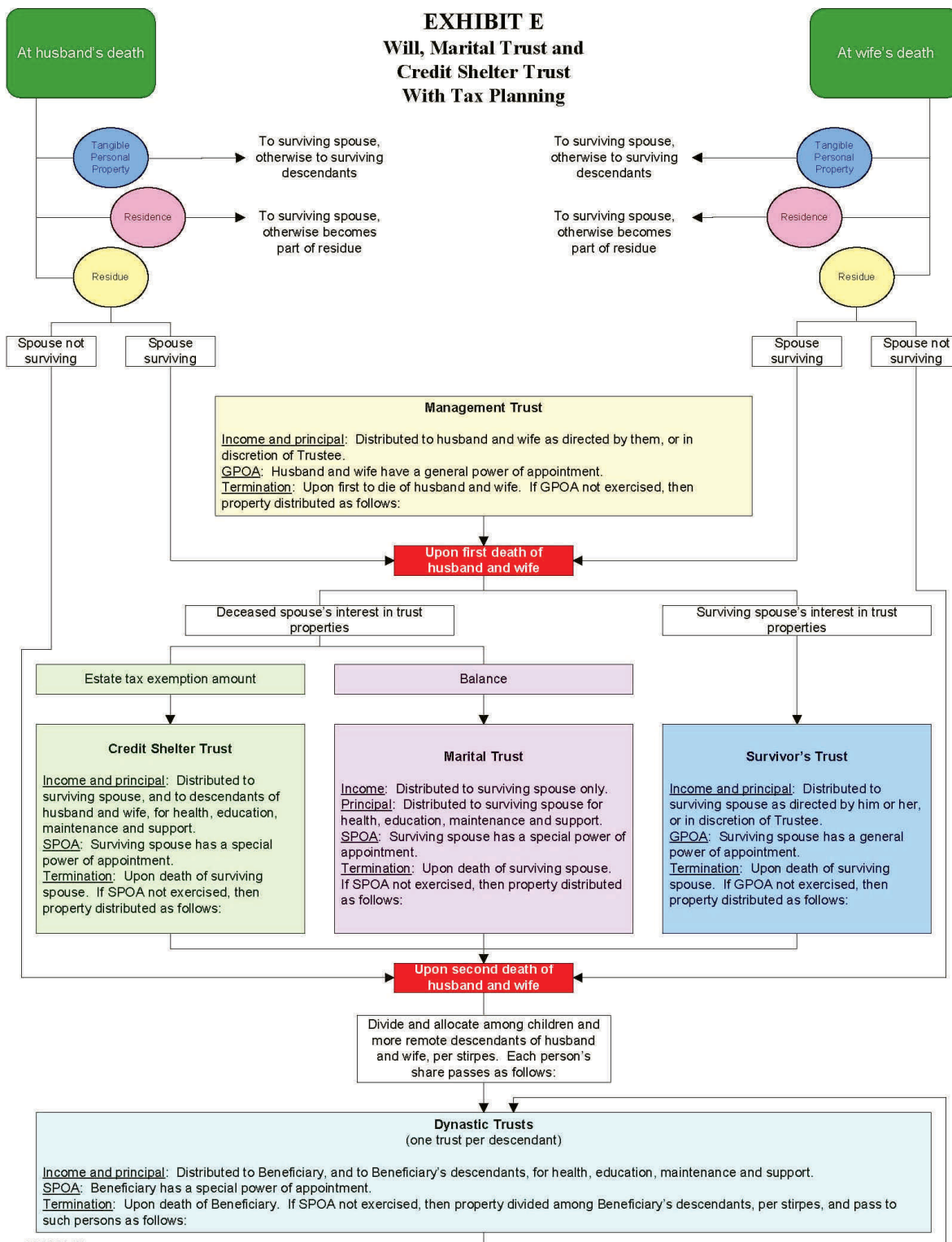


EXHIBIT E Will, Marital Trust and Credit Shelter Trust With Tax Planning



#5937847

EXHIBIT F
Self-Proving Affidavit

THE STATE OF TEXAS
COUNTY OF _____

Before me, the undersigned authority, on this day personally appeared _____, _____, and _____, known to me to be the testator and the witnesses, respectively, whose names are subscribed to the annexed or foregoing instrument in their respective capacities, and, all of said persons being by me duly sworn, the said _____, testator, declared to me and to the said witnesses in my presence that said instrument is his last will and testament, and that he had willingly made and executed it as his free act and deed; and the said witnesses, each on his oath stated to me, in the presence and hearing of the said testator, that the said testator had declared to them that said instrument is his last will and testament, and that he executed same as such and wanted each of them to sign it as a witness; and upon their oaths each witness stated further that they did sign the same as witnesses in the presence of the said testator and at his request; that he was at that time eighteen years of age or over (or being under such age, was or had been lawfully married, or was then a member of the armed forces of the United States or of an auxiliary thereof or of the Maritime Service) and was of sound mind; and that each of said witnesses was then at least fourteen years of age.

Testator

Witness

Witness

Subscribed and sworn to before me by the said _____, testator, and by the said _____ and _____, witnesses, this _____ day of _____ A.D. _____.

(SEAL)

(Signed) _____
(Official Capacity of Officer)

EXHIBIT G
Statutory Durable Power of Attorney

STATUTORY DURABLE POWER OF ATTORNEY

NOTICE: THE POWERS GRANTED BY THIS DOCUMENT ARE BROAD AND SWEEPING. THEY ARE EXPLAINED IN THE DURABLE POWER OF ATTORNEY ACT, CHAPTER XII, TEXAS PROBATE CODE. IF YOU HAVE ANY QUESTIONS ABOUT THESE POWERS, OBTAIN COMPETENT LEGAL ADVICE. THIS DOCUMENT DOES NOT AUTHORIZE ANYONE TO MAKE MEDICAL AND OTHER HEALTH-CARE DECISIONS FOR YOU. YOU MAY REVOKE THIS POWER OF ATTORNEY IF YOU LATER WISH TO DO SO.

I, _____ (insert your name and address), appoint _____ (insert the name and address of the person appointed) as my agent (attorney-in-fact) to act for me in any lawful way with respect to all of the following powers except for a power that I have crossed out below.

TO WITHHOLD A POWER, YOU MUST CROSS OUT EACH POWER WITHHELD.

Real property transactions;

Tangible personal property transactions;

Stock and bond transactions;

Commodity and option transactions;

Banking and other financial institution transactions;

Business operating transactions;

Insurance and annuity transactions;

Estate, trust, and other beneficiary transactions;

Claims and litigation;

Personal and family maintenance;

Benefits from social security, Medicare, Medicaid, or other governmental programs or civil or military service;

Retirement plan transactions;

Tax matters.

IF NO POWER LISTED ABOVE IS CROSSED OUT, THIS DOCUMENT SHALL BE CONSTRUED AND INTERPRETED AS A GENERAL POWER OF ATTORNEY AND MY AGENT (ATTORNEY IN FACT) SHALL HAVE THE POWER AND AUTHORITY TO PERFORM OR UNDERTAKE ANY ACTION I COULD PERFORM OR UNDERTAKE IF I WERE PERSONALLY PRESENT.

SPECIAL INSTRUCTIONS:

Special instructions applicable to gifts (initial in front of the following sentence to have it apply):

I grant my agent (attorney in fact) the power to apply my property to make gifts, except that the amount of a gift to an individual may not exceed the amount of annual exclusions allowed from the federal gift tax for the calendar year of the gift.

ON THE FOLLOWING LINES YOU MAY GIVE SPECIAL INSTRUCTIONS LIMITING OR EXTENDING THE POWERS GRANTED TO YOUR AGENT.

UNLESS YOU DIRECT OTHERWISE ABOVE, THIS POWER OF ATTORNEY IS EFFECTIVE IMMEDIATELY AND WILL CONTINUE UNTIL IT IS REVOKED.

CHOOSE ONE OF THE FOLLOWING ALTERNATIVES BY CROSSING OUT THE ALTERNATIVE NOT CHOSEN:

(A) This power of attorney is not affected by my subsequent disability or incapacity.

(B) This power of attorney becomes effective upon my disability or incapacity.

YOU SHOULD CHOOSE ALTERNATIVE (A) IF THIS POWER OF ATTORNEY IS TO BECOME EFFECTIVE ON THE DATE IT IS EXECUTED.

IF NEITHER (A) NOR (B) IS CROSSED OUT, IT WILL BE ASSUMED THAT YOU CHOSE ALTERNATIVE (A).

If Alternative (B) is chosen and a definition of my disability or incapacity is not contained in this power of attorney, I shall be considered disabled or incapacitated for purposes of this power of attorney if a physician certifies in writing at a date later than the date this power of attorney is executed that, based on the physician's medical examination of me, I am mentally incapable of managing my financial affairs. I authorize the physician who examines me for this purpose to disclose my physical or mental condition to another person for purposes of this power of attorney. A third party who accepts this power of attorney is fully protected from any action taken under this power of attorney that is based on the determination made by a physician of my disability or incapacity.

I agree that any third party who receives a copy of this document may act under it. Revocation of the durable power of attorney is not effective as to a third party until the third party receives actual notice of the revocation. I agree to indemnify the third party for any claims that arise against the third party because of reliance on this power of attorney.

If any agent named by me dies, becomes legally disabled, resigns, or refuses to act, I name the following (each to act alone and successively, in the order named) as successor(s) to that agent:

_____.

Signed this ____ day of _____, 20__

(your signature)

State of _____

County of _____

This document was acknowledged before me on

_____ (date) by _____

(name of principal)

(signature of notarial officer)

(Seal, if any, of notary) _____

(printed name)

My commission expires: _____

THE ATTORNEY IN FACT OR AGENT, BY ACCEPTING OR ACTING UNDER THE APPOINTMENT, ASSUMES THE FIDUCIARY AND OTHER LEGAL RESPONSIBILITIES OF AN AGENT.