Estate Planning Insights

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Karen S. Gerstner & Associates, P.C.

Attorneys At Law
5615 Kirby Drive, Suite 306
Houston, Texas 77005-2448
(713) 520-5205

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BENEFICIARY DESIGNATION ISSUES

We have previously discussed the proper titling of accounts in relation to a person's estate plan. This newsletter will focus on another "problem" area that affects a person's estate plan: the completion of beneficiary designation forms for assets that are distributed on death pursuant to such forms. Because these assets can be significant in value, it is very important for people to coordinate the disposition of these assets with their overall estate plan.

Beneficiary Designation Forms. As our clients know, we provide instructions (and appropriate wording) for completing beneficiary designation forms for life insurance policies, company retirement plans, IRAs, and annuities owned by our clients (these assets are sometimes referred to as "non probate assets", but they are not the only type of non probate asset, so we will sometimes call them "beneficiary designation assets"). If you own any of these beneficiary designation assets, it is important for you to complete and submit beneficiary designation forms for them to the company administering them (i.e., insurance company, plan administrator, IRA custodian, etc.) because they are not distributed when you die according to what it says in your Will or Living Trust but according to the beneficiary designation form itself. Thus, the beneficiary designation form for each of these assets can be thought of as a "mini-Will" that applies to the disposition of that particular asset at death. Hence, completion of the beneficiary designation forms for these assets in the correct manner is just as important as signing your Will or Living Trust Agreement.

Sometimes clients fail to follow through with these beneficiary designation matters once they have signed their Will or Living Trust, resulting in an unintended or even harmful disposition of these beneficiary designation assets at death. Thus, the completion of beneficiary designation forms is important "homework" that clients must do following the execution of their estate planning documents. Further, sometimes clients initially complete these forms in the correct manner, but when they later move the asset to another financial institution (such as when they retire and roll over their qualified plan to an IRA rollover or when they move an IRA to another IRA custodian), they fail to pull out the written instructions we gave them regarding how to complete their beneficiary designation forms, and the new forms are completed incorrectly. In many cases, beneficiary designation form assets comprise a very large portion of a couple's or individual's total wealth, so incorrect beneficiary designation forms can destroy (or render ineffective) an otherwise well designed estate plan.

Community Property Issues Relating to Beneficiary Designation Assets. If beneficiary designation assets accumulate during a couple's marriage while residing in Texas, then these assets are community property (absent a Pre-Marital or Post-Marital Agreement). Even if a portion of these assets accumulates while a couple is living in a non-community property state, if the spouses now live in Texas and have been living in Texas for awhile, chances are that these assets have become (mostly) community property due to earnings, payments and contributions made to the assets during the couple's residence in Texas (if a married person wants to "rebut" the community property presumption, it takes "clear and convincing" evidence, a pretty tough, and sometimes expensive, standard to meet, often requiring a "forensic" accountant to do a "tracing"). Thus, married couples should consider community property issues when completing beneficiary designation forms. This is confusing to most people because only one spouse's name appears on most beneficiary designation assets, which makes it look like that spouse owns 100% of the asset. In Texas, the title on an asset is not definitive in determining ownership of the asset (Texas is not a "title" state). For the most part, assets accumulated by a couple during their marriage while living in Texas will be treated as community property, regardless of how the assets are titled. If a community property asset is titled only in one spouse's name, it simply means that that particular spouse is the "manager" of the asset on behalf of both spouses (and not the sole owner). Because qualified retirement plans and IRAs are created due to earnings of an

individual, the amounts accrued in them by a married person while living in Texas will almost invariably be community property. The premiums on life insurance policies insuring a spouse are also usually paid with community funds, or paid by an employer due to the spouse's employment, making the insurance policies community property as well.

Fraud on the Community. When a married person completes a beneficiary designation form for a beneficiary designation asset (such as an IRA or a life insurance policy) that is listed solely in his name but is technically community property under Texas law, he must at least name his spouse as the direct (outright) beneficiary of ½ of it. If he does not do that and names someone else as the beneficiary of his spouse's ½ interest, then the spouse may be able to make a post-death claim of "fraud on the community". If the surviving spouse is successful in making the fraud claim, her ½ interest in the participant's IRA or in the life insurance proceeds will be awarded to her. If the surviving spouse is unsuccessful in prosecuting that claim (which may be the case with a qualified retirement plan or an IRA due to the plan administrator's requirement that the spouse consent to the participant's alternate beneficiary), then she may be *making a taxable gift* at the time of the first spouse's death to the designated beneficiary of her ½ interest in the IRA or insurance proceeds (there is already a case where the IRS took that position and the Court upheld it).

Trusts as Beneficiaries of IRAs. A number of our clients have received a marketing piece in the mail touting the benefits of having IRAs pass to "special" trusts as the beneficiary. We have been doing this type of planning for clients for a long time. The only thing that is "new" with respect to this type of planning is that the Treasury Department finally finished writing the rules regarding the income tax effects of doing this, which were published in April 2002. Trusts *can* be the beneficiaries of qualified plans and IRAs under the federal tax laws without resulting in a big acceleration of income taxes. *However*, some qualified plan documents and IRA agreements do not follow the maximum income tax deferral period allowed by federal law for plans/IRAs passing to trusts (a plan/IRA may require a faster distribution). This is something that the participant of the qualified plan or IRA should research *prior to naming a trust as the beneficiary* of his plan/IRA. There is no point naming a trust as the beneficiary of a qualified retirement plan or IRA if the plan administrator or IRA custodian is going to accelerate the income taxes per their more restrictive plan/account documents. It is not unusual for a qualified plan to provide that if a trust is the beneficiary of your qualified plan benefits, then the plan will make a 100% distribution to the trust within a relatively short period of time after your death (e.g., within 5 years).

Under the federal tax laws, if a trust that is named as the beneficiary of a qualified plan or IRA qualifies for "look through" treatment, then the oldest individual beneficiary of the trust will be treated as the "Designated Beneficiary" for purposes of the federal minimum required distribution rules, and a life expectancy payout to the trust will be allowed after the participant's death. If a participant's qualified plan or IRA allows the maximum income tax deferral allowed to qualified trusts per the federal tax laws, then this option (naming a trust as beneficiary) should be explored. There are both advantages and disadvantages of naming trusts as beneficiaries of qualified retirement plans and IRAs, however, even if the plan/IRA allows the maximum income tax deferral per federal law (every estate planning technique has both advantages and disadvantages, despite what slick promoters say, and this is especially true with respect to naming trusts as beneficiaries of qualified plans and IRAs). Some of the potential disadvantages are loss of "separate account" treatment and loss of the "stretch IRA" upon termination of a trust for a spouse. So this is not something that everyone will want to do once all of those advantages *and* disadvantages are discussed with a knowledgeable specialist.

Funding a Bypass Trust with Beneficiary Designation Assets. Sometimes we use IRAs and other beneficiary designation assets to fund a Bypass Trust on the death of the first spouse. It is easy to use life insurance to fund a Bypass Trust because there are no income taxes payable with respect to life insurance proceeds. A proper beneficiary designation form for life insurance policies can result in ½ the proceeds passing directly to the Bypass Trust (the other ½ of the proceeds should pass to the surviving spouse per community property law, as discussed above). Commercial annuities are "horrible" trust assets and should seldom be placed in a trust (or be purchased by a trust). With respect to community property IRAs, if the spouse who is listed as the IRA participant is concerned about fully funding a Bypass Trust that he has created in his Will or Living Trust, he may want to designate the Bypass Trust as the primary beneficiary of his 50% interest in the IRA. This may be the preferred method in a second marriage situation, due to the ability to take care of the surviving spouse, but yet control the disposition of the trust assets on the spouse's death. An alternative approach that is frequently used in a "traditional" marriage situation is for the participant to designate his spouse as the 100% beneficiary of the IRA, but then "build in" the option for the spouse to make a "qualified disclaimer" to fund the Bypass Trust. A qualified disclaimer is a legal technique that allows a surviving spouse to "move" assets that are passing directly to her into the Bypass Trust without being treated as making a taxable gift. To make a qualified disclaimer, the surviving spouse must not have changed the gifted

asset into her name already and must complete the necessary paperwork within 9 months of the first spouse's death. The advantages of the disclaimer approach as a "default" method (i.e., naming the spouse as the 100% designated beneficiary of the IRA but setting up the disclaimer option) are (i) if the spouse decides *not* to do the disclaimer, at least no federal estate tax will be payable on the participant's death with respect to the IRA due to the marital deduction (assuming the spouse is a U.S. citizen) and (ii) all of the very favorable income tax options available to a spouse designated beneficiary, including the spousal IRA rollover option (which sets up the "stretch" IRA for the children after the spouse's death), will be preserved as to the entire IRA. When the participant names the Bypass Trust as the beneficiary of his 50% interest in the IRA, the spousal IRA rollover option will usually be precluded as to ½ of the IRA. Of course, to build in the disclaimer option for the surviving spouse, "the Trustee in the participant's Will" or "the Trustee in the participant's Living Trust" (or other appropriate wording based on the particular terms of the client's Will or Living Trust) should be named as the Contingent (or Secondary) beneficiary of the IRA *on the beneficiary designation form*. If the couple's children are named as the contingent beneficiaries of the participant's IRA on the beneficiary designation form, however, then the surviving spouse will not be able to transfer any part of the participant's interest in the IRA to the Bypass Trust because a disclaimer will result in the disclaimed portion passing directly to the children.

Other Beneficiary Designation Issues. There are many other "tricky" issues relating to the disposition of beneficiary designation assets, such as not listing a minor (a person under age 18) on a beneficiary designation form and the difficulty of doing "contingency" planning on such forms (due to the small space available for such provisions). With respect to qualified retirement plans and IRAs, which are subject to both estate tax and income tax, there are additional tax coordination issues to consider, such as not creating an estate plan where the beneficiaries who are inheriting the assets passing under the Will must pay the estate taxes due on the IRA passing to other beneficiaries outside the Will (i.e., the beneficiaries who are listed on the beneficiary designation form). Of course, good estate planning attorneys are aware of all these issues and take them into account in advising clients regarding how to complete their beneficiary designation forms. The important point to remember is that the beneficiary designation form controls the disposition of beneficiary designation assets, so great care should be taken to make sure these forms are completed correctly.

Is it Time for an Estate Planning "Check Up"? If your estate planning documents are more than 5 years old and you have not had a "check up" within the past 5 years, then it is definitely time for a "check up". There have been significant changes in the tax laws, such as the increase in the estate tax exclusion amount and the adoption of final rules relating to trusts as beneficiaries of qualified retirement plans and IRAs. There have also been significant changes to Texas probate laws and trust laws. Further, most people have experienced some changes in their assets (type and value) over the last 5 years, and especially over the past 10-15 years. Perhaps even more significant are the changes that have occurred in the personal situation of you and your family members (such as marriages, divorces, births, deaths, completion of school, job changes, moves, etc.). All of these changes impact your estate plan.

Lately, we have worked with several surviving spouses who have been unhappy with the result of the estate plan they created with their deceased spouse, and yet, their estate planning documents were 10 or 15 years old! Estate planning documents don't last that long anymore (the pace of changes has accelerated drastically). These couples could have made some changes to their estate plan if they had come back for a "check up" in a timely fashion. The biggest complaint from surviving spouses relates to the requirement of funding the Bypass Trust created in the Will of the deceased spouse. As many readers will recall, the exemption from the estate tax used to be relatively low 10-15 years ago, and the amount changed only slightly over a long period of time (stagnating in the $500,000 to $600,000 range for many years). For persons who die in 2006 (who have not made "taxable" gifts during their lifetime), the estate tax exclusion amount is now $2 million. Thus, a Bypass Trust may not be needed anymore by couples with less than $2 million in total assets. If the existing estate planning documents create a Bypass Trust, then the Executor of the estate of the first spouse to die (who is usually the surviving spouse) will have a *fiduciary obligation* to fund the trust, even if such a trust is no longer necessary from an estate tax standpoint. Of course, there are other benefits to a Bypass Trust besides estate tax savings, such as controlling the disposition of the trust assets so that they will pass to the desired beneficiaries upon the death of the surviving spouse, providing creditor protection for the assets held in the trust, and, frequently also, the ability to make distributions to descendants that aren't treated as taxable gifts, through the use of "sprinkle/spray" powers.

Another change in thinking has occurred with respect to how we deal with the principal residence as part of the estate plan. We often used to allow the deceased spouse's ½ of the home to pass into the Bypass Trust because the home was one of the more valuable assets in the estate, and with the very low estate tax exemption amount (around $500,000) and very high estate tax rates

(up to 55%), we did not want to "waste" any of the first spouse's exemption. There are definitely some disadvantages to having ½ the home in the Bypass Trust, however, so it would be better now, for couples with modest estates, to add a specific bequest to their Wills leaving their ½ interest in their home directly to the surviving spouse. If married couples do not periodically update their estate plan and the first spouse dies with an "old, outdated" Will, unfortunately, the surviving spouse, as the Executor, must carry out the terms of the Will anyway. We cannot recommend that a fiduciary breach his/her fiduciary obligation by failing to fund the Bypass Trust as called for by the Will of the deceased spouse and, thus, many surviving spouses are disappointed with what they perceive to be an unnecessarily complex estate plan (and the "disadvantages" of having certain assets, such as ½ the home, held in the trust). The obvious solution is for couples to re-evaluate their estate plan on a regular basis, preferably at least once every 3 to 5 years.

Single people should re-evaluate their estate plan periodically, too. Although the Bypass Trust does not apply to single people, all of the other matters that affect a person's estate plan (changes in the tax laws, state laws, one's financial situation and one's personal situation) affect single people, too. We are not going to know about the changes in your financial and personal situation unless you come in to discuss your current situation with us. We cannot over-emphasize the need for an estate planning "check up" on a regular basis. Please call us to schedule a check up if your estate plan is more than 5 years old. It may take 4 - 8 weeks to make any necessary changes, so plan ahead!

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.

You can also reach us by e-mail addressed to:

Karen S. Gerstner* karen@gerstnerlaw.com

Kathryn Miller Connelly kathryn@gerstnerlaw.com
General delivery gerstnerlaw@yahoo.com

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KAREN S. GERSTNER & ASSOCIATES, P.C.
A Professional Corporation
Attorneys At Law
5615 Kirby Drive, Suite 306
Houston, Texas 77005-2448

Telephone (713) 520-5205
Fax (713) 520-5235

www.gerstnerlaw.com

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