Estate Planning Insights

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HOW ASSETS PASS AT DEATH MAKES A DIFFERENCE

Methods For Transferring Assets at Death Have Changed. Seven hundred years ago, life was simple from an estate planning standpoint. If you owned anything of value, you could make a Will, saying who should become the owner(s) of your assets upon your death, and that took care of everything. At that time, no assets had been "invented" yet that didn't pass under your Will at death.

Approximately six hundred fifty years ago, someone "invented" individual life insurance policies. Whoever invented individual life insurance policies decided that they did not want the insured's Will to say who should be paid the insurance proceeds on the insured's death, so they also "invented" the "beneficiary designation form." Thus, six hundred fifty years ago, you would have needed to sign a Will to dispose of all of your assets *except* your individual life insurance policies, and you would have needed to complete and submit a beneficiary designation form to each insurance company for each life insurance policy on your life.

Since that time, other assets have been "invented" that take this same approach. In addition, you now have the *option* of taking this approach on nearly everything you own. As a result, estate planing is much more complicated today than ever before. PLEASE NOTE: Your Will may not dispose of much, if anything, that you own when you die.

Many Assets Pass Outside the Will. First, there are basically 2 categories of assets: probate and non-probate. Upon your death, probate assets pass according to your Will, while non-probate assets pass outside your Will. Remember that your Will does more than provide "who's in charge" and "who gets what." For example, you may be creating trusts in your Will to hold the shares passing to certain beneficiaries. Trusts are used for various reasons, such as tax avoidance/deferral, asset management and/or control. In addition, in a Will you can create a highly customized (i.e., non-standard) estate plan. Further, most Wills address various contingencies, such as who receives the share of a beneficiary who predeceases you. It takes ***space*** to say these things. That space requirement is one of the biggest drawbacks of using non-probate methods of transfer.

Within the non-probate category, there are basically 3 sub-categories:

1. Beneficiary Designation Assets.
2. Multi-Party Arrangements.
3. Revocable (Living) Trusts.

Beneficiary Designation Assets. This category includes assets that are transferred at death *only* pursuant to a beneficiary designation form. The only assets in this category are: (i) IRAs, (ii) employee benefit plans, (iii) life insurance, and (iv) annuities. Employee benefit plans include qualified and non-qualified retirement plans and other employee benefits, including, but not limited to, 401(k) plans, profit-sharing plans, thrift plans, stock option plans, etc. Note that *some* employee benefit plans do not allow employees to designate a beneficiary because the plan itself provides for a beneficiary on the employee's death. We cannot avoid having these assets, so estate planning with respect to beneficiary designation assets focuses on completing the beneficiary designation forms in a manner that is coordinated with the estate plan in the Will.

Multi-Party Arrangements. This category of non-probate assets should be AVOIDED as much as possible because these arrangements *override your estate plan* in your Will. We have written many

newsletters on this topic, but, apparently, no one really understands why these arrangements are bad because we keep seeing them all the time. If you have a Will with an estate plan that you like, you should NOT be using these arrangements. These arrangements remove assets from your estate plan and cause lots of problems. The assets in this category would be transferred by your Will in the absence of these arrangements. In other words, there is no need to use these arrangements.

Two examples of multi-party arrangements are:

1. JTWROS. In this arrangement, two or more persons are named on an account or asset (e.g., real estate) as "Joint Tenants with Right of Survivorship." Some variations of this wording would be "Multi-Party Account with Right of Survivorship," "Joint with Right of Survivorship," "Joint Tenants," "JT TEN," "JTWROS," and "Community Property with Right of Survivorship."

2. TOD and POD. TOD stands for "Transfer on Death" and POD stands for "Pay on Death." When this type of arrangement is placed on an account or other asset, the account/asset passes directly to the named beneficiary upon the death of the account owner. This may or may not be what the account owner wants, considering the estate plan as a whole.

We have previously explained, in more detail, the many different problems caused by these arrangements. Briefly, *som*e (but not all) of the problems are as follows:

i. The "wrong" person ends up inheriting the entire account/asset. The person named on the JTWROS account who survives the account owner inherits the entire account to the exclusion of the beneficiaries named in the account owner's Will.

ii. Trusts created in the Will end up not being funded as planned. This can lead to additional problems, such as ultimately paying too much in estate taxes, disqualifying a beneficiary from receiving government benefits, allowing a beneficiary to lose his inheritance due to a judgment in a lawsuit, etc.

iii. The Executor may not have sufficient funds in the Estate to pay the decedent's debts, funeral expenses, final income taxes, estate taxes, estate income taxes, administration expenses and other charges.

Non-Probate Assets and the Estate Plan. In most cases, it is impossible to provide in your Will for the disposition of *all* of your assets. In a Will, you can only provide for the disposition of your *probate* assets–i.e., the assets that are passing under the Will.

Let's consider an example. Mrs. Widow, who has an estate worth $900,000, wants to create an estate plan as follows:

1. She wants to leave $20,000 to each of her grandchildren (she currently has 6);
2. She wants to leave 10% of her estate at death to her church;
3. She wants to leave her home to her unmarried daughter (who lives with her and helps her with her financial and medical matters); and
4. She wants to leave the rest of her estate to her three children, in equal shares.

Mrs. Widow has 2 married sons and 1 unmarried daughter. She assumes that each child will receive a sizeable amount, despite the "specific gifts" she is making to her grandchildren and the church.

Mrs. Widow's estate plan seems fairly straightforward and easy to accomplish, but let's look at a breakdown of Mrs. Widow's assets.

Home (with no mortgage)	$350,000
IRA rollover[1]	$350,000
Checking account[2]	$50,000
Savings account[3]	$100,000
Car & household furnishings	$50,000
Total	$900,000

[1] Mrs. Widow was the beneficiary of her husband's IRA rollover when he died and she did a rollover.
[2] This account at ABC Bank is titled in Mrs. Widow's name and her daughter's name as "Joint with Right of Survivorship."
[3] This account at XYZ Bank is titled in Mrs. Widow's name and her daughter's name as a "Multi-Party Account with Right of Survivorship."

Looking at the breakdown of the assets, it is going to be *very* difficult to accomplish Mrs. Widow's estate planning goals.

First, if the checking account and savings account titles are not changed, 100% of those funds will pass

to Mrs. Widow's daughter on Mrs. Widow's death, "by right of survivorship," completely outside Mrs. Widow's Will. In other words, because of the way the 2 bank accounts are titled, when Mrs. Widow dies, the daughter will automatically become the owner of all of the funds in those accounts upon presentment of a death certificate for Mrs. Widow.

If the daughter shares the funds in these accounts with her siblings, or uses some of the funds to make the gifts to the grandchildren, she will be making a *taxable gift* to the extent the amount given to each person exceeds $14,000 (the 2014 annual gift tax exclusion amount). When a "right of survivorship" feature is included on an account, it does much more than give another person *access* to the account–it makes that other person the exclusive *owner* of all of the funds in the account upon the depositor's death. **Everyone needs to understand this!**

Second, the IRA rollover is also going to be distributed completely outside Mrs. Widow's Will pursuant to the beneficiary designation form on file with the IRA custodian. Although it may seem like a good idea for Mrs. Widow to name her "Estate" as the beneficiary of her IRA (so that the IRA will be distributed according to her estate plan in her Will), it's not. An *Estate* is not a "designated beneficiary" under applicable income tax rules. Thus, if an IRA owner names her *Estate* as the beneficiary of her IRA, her beneficiaries will be stuck with the worst possible income tax rule after her death.

Now let's look at the simple gifts that Mrs. Widow wants to make to her grandchildren. Remember that the bank accounts will pass outside the Will unless the titles are changed. If Mrs. Widow's home is left to her daughter as a specific gift in her Will, then the only other assets passing under her Will that can be used to make the gifts to the grandchildren are the household furnishings and the car. Even if the car is sold, there won't be enough cash in Mrs. Widow's Estate to make the gifts to the grandchildren. And, don't forget, the Executor is going to need some cash in the Estate to pay Mrs. Widow's debts, funeral expenses, final income taxes, Estate income taxes and administration expenses during the post-death period. The Executor might also need to pay property taxes and maintenance on the home until it is distributed to the daughter. Thus, unless the title to the two bank accounts is changed to make them *probate* assets (i.e., assets passing under the Will), the gifts to the grandchildren cannot be included in the Will and the Executor is going to be cash-poor.

What about using the IRA rollover to make the gifts to the grandchildren and the church? Let's start with the gift to the church. A pre-tax asset, meaning, an asset that was "funded" with amounts on which no income taxes were paid (such as the IRA), is the perfect asset to leave to the church (or other charity) at death. A charity does not pay income taxes on pre-tax assets that it receives. In contrast, human beings who inherit IRAs must withdraw "minimum required distributions" each year and pay income taxes on those withdrawn amounts. In addition, for persons who have a taxable estate, there is an unlimited charitable deduction for federal estate tax purposes for gifts made to charity at death. Thus, pre-tax assets, such as IRAs, are the best assets to leave to charity at death--such gifts avoid both income taxes and estate taxes. However, most people do not plan to leave their entire IRA to charity at death. Usually, charity is just one of multiple beneficiaries of an IRA. That causes some issues.

In a Will, it is easy to make specific bequests of cash and other assets to various beneficiaries, and it is also easy to say that 10% of the decedent's "remaining assets" passing under the Will (after all of the specific bequests, debts, taxes and expenses have been paid) should be distributed to the church. However, it is *not* easy to do something like that with an IRA. Most IRA beneficiary designation forms are based on the idea that percentages of the IRA, as a whole, will be distributed to beneficiaries in the same class. If Mrs. Widow wants to use her IRA rollover to make the gifts to her grandchildren and her church, with the balance passing to her children, then a highly customized "Schedule A" attachment to the IRA beneficiary designation form will need to be prepared. In addition, some IRA custodians may not accept such an attachment to their standard beneficiary designation form.

On top of the difficulty of dividing an IRA among various beneficiaries like you would divide assets passing under a Will, there are additional issues. First, what if one or more of Mrs. Widow's grandchildren are minors (under age 18)? A minor cannot legally own anything and, therefore, a minor should never be named as a direct beneficiary on a

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beneficiary designation form. In a Will, it is customary to include "Contingent Trusts" that apply whenever a minor (or other young person) is entitled to anything under the Will. There is plenty of room in a Will to create Contingent Trusts and to provide the terms of trust. There is no room in a beneficiary designation form to create a trust and provide its terms. It may be possible in the Schedule A attachment to make the grandchildren's gifts "subject to" the Contingent Trust provisions in Mrs. Widow's Will. If not, a custodial provision under UTMA would need to be added.

Also, it is likely that the most that can be provided with respect to the gift to the church from the IRA is that the church will receive 10% of the value of the IRA at the time of Mrs. Widow's death. It is not likely that an IRA custodian will accept a "formula gift" which provides that the church is to receive an amount from the IRA equal to10% of the value of Mrs. Widow's estate as a whole at the time of her death. In addition, if Mrs. Widow lives long enough, very little may remain in her IRA at death to leave to the church. Further, the amount remaining in the IRA at death may not be sufficient even to make the cash gifts to the grandchildren. Thus, the Schedule A attachment to the IRA beneficiary designation form has to cover these possibilities as well. And whenever charity is one of multiple beneficiaries of an IRA, there is another income tax "issue" that must be addressed (too complex to discuss here).

Bottom line: it is very difficult to do "contingency planning" with non-probate assets like beneficiary designation assets and multi-party accounts. Even a simple estate plan like Mrs. Widow's estate plan may require a lot of effort to accomplish.

Contact us:

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

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