Estate Planning Insights

A Quarterly Publication of

Karen S. Gerstner & Associates, P.C.

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

Vol. 18, No. 3 **July 15, 2021**

PAY ATTENTION TO HOW ASSETS ARE TRANSFERRED AT DEATH

Methods for Transferring Assets at Death. There are four methods for transferring assets at death: (1) by Will (or intestacy), (2) by beneficiary designation, (3) by revocable trust, and (4) by a "non probate multi-party arrangement." The question is, "what" transfers the particular asset FROM the deceased person (decedent) TO the new owner or owners (beneficiary/beneficiaries) on the decedent's death? If you want to skip the introductory part, go to "Analysis of Grandma's Estate Plan" on Page 2.

<ins>Will</ins>. Assets that are transferred by Will (or intestacy) are considered "probate assets." *Intestacy* means the person died without having a valid Will and, therefore, state statutes provide who the beneficiaries of the probate assets are. None of our clients are in that situation, *so we will not discuss intestacy*. Thus, a transfer by Will is the only *probate* transfer method among the four transfer methods. Despite what some people say, there is no compelling reason to "avoid probate" in Texas. Texas has about the simplest probate process of all fifty states. In addition, there are actually some *advantages* to transferring assets by probate. Likewise, there are some serious disadvantages to transferring assets using the second and fourth methods listed above. Further, if the decedent owns an interest in real property at death, the Will is usually going to need to be probated.

<ins>Beneficiary Designation</ins>. Four types of assets are transferred by beneficiary designation: (a) life insurance (whether personally owned or provided by an employer or former employer), (b) employee benefit plans (such as 401(k) plans, profit-sharing plans, and stock bonus plans), (c) IRAs of all types, including pre-tax IRAs, IRA rollovers and Roth IRAs, and (d) annuities sold by insurance companies. We refer to these assets as "beneficiary designation assets" because of how they are transferred at death. If the decedent names his "estate" as the beneficiary, then the asset will become a probate asset, but in all other cases, this is a non probate transfer method. In the case of a beneficiary designation asset, the "listed owner" (who might really only own ½ of the beneficiary designation asset due to community property law) completes a beneficiary designation "form" and submits it to the "sponsor" or "custodian" of the asset. The sponsor or custodian would be the insurance company in the case of a life insurance policy or annuity, the plan administrator in the case of an employee benefit plan and the IRA custodian in the case of an IRA. When the listed owner dies, the sponsor or custodian distributes the beneficiary designation asset to the beneficiary or beneficiaries named in the beneficiary designation form. In some cases, the named beneficiary could be the listed owner's revocable trust. That does not mean the asset was a trust asset as of the decedent's date of death–it's not. It just means the revocable trust is the recipient of the beneficiary designation asset. It is still the *beneficiary designation form* that transfers the asset *from* the decedent *to* the recipient.

<ins>Revocable Trust</ins>. More and more Texas residents are using a revocable trust, also referred to as a living trust, as their primary estate planning "vehicle." (The term *vehicle* works well when talking about the methods for transporting assets at death.) A revocable trust is the vehicle of choice for people who live in the states that have a "horrible" probate process. As noted, however, the probate process in Texas is very simple compared to the probate process in most other states. So avoiding probate in Texas is usually not the primary reason why Texas residents use a revocable trust. One reason why some Texas residents use a revocable trust as their

primary estate planning vehicle is because they own real property in another state. By creating a revocable trust and putting the non Texas real property into the trust, they can avoid ancillary probate (i.e., a second probate process) on their death in the state where the real property is located. There are other reasons to use a revocable trust which are beyond the scope of this newsletter. Note that all the same planning that can be included in a Will can be included in a revocable trust. If a primary goal is to "avoid probate" in Texas, a revocable trust–rather than using the fourth transfer method listed above (and discussed next)–is the right way to do that. However, the assets must actually be titled in the name of the trust prior to death to avoid probate.

Non Probate Multi-Party Arrangement. The fourth transfer method is very problematic for many reasons. Examples that come within the fourth transfer method are accounts and assets titled in two or more persons names as "Joint Tenants with Right of Survivorship" (JTWROS or JT TEN), accounts that have a "Pay on Death" (POD) arrangement, and accounts and real property that have a "Transfer on Death" (TOD) arrangement. These arrangements are used with bank accounts, brokerage accounts, investment assets and real property. The fourth transfer method is similar to the second transfer method listed above, but there is a significant difference between the two methods, which is why we never combine transfer methods two and four into one method. With respect to transfer method number 2–beneficiary designations–there is no alternate transfer method available for the assets subject to this method. The only transfer method for a *beneficiary designation asset* (i.e., life insurance, employee benefit plans, IRAs and annuities) is the beneficiary designation "form" (whether paper or electronic). In contrast, with respect to *other* assets and accounts (here we mean assets and accounts that are NOT life insurance, employee benefit plans, IRAs and annuities), the owner has a choice of transfer methods. These other assets and accounts can be transferred by Will or by revocable trust–they are not required to be set up with a non probate multi-party arrangement. In fact, many of the problems we see in the estate planning and probate field are due to extensive use of these arrangements. We also find that people in the financial services industry "push" their customers to use these arrangements.

Analysis of Grandma's Estate Plan. Grandma already has a Will and other estate planning documents that were prepared by another lawyer. Grandma wants to make some additional cash gifts in her Will. Grandma has three children, Daughter, Son 1 and Son 2. Grandma has eight grandchildren, some of whom are still minors (under age 18). Grandma owns the following assets:

Home (no mortgage)	$600,000
IRA rollover (inherited from Grandpa)	$1,800,000
Brokerage account	$2,000,000
Bank Accounts	$350,000
Car	$50,000
Household furnishings	$100,000
Total	4,900,000

Grandma's existing Will provides as follows:

House to Daughter, outright
Specific cash gift of $50,000 to each grandchild
Car to Son 2
Household furnishings in equal shares to children
Remaining assets in equal shares to children, outright, with a predeceasing child's share passing to his/her children (i.e., a "per stirpes" provision)

Grandma tells you this:

1. She has named her three children as the equal beneficiaries of her IRA rollover in the beneficiary designation form submitted to the IRA custodian.

2. She has named her three children as the equal TOD beneficiaries of her brokerage account.

3. She has included her daughter on all of her bank accounts (to help her with bill paying and other financial matters) and all of the accounts include a right of survivorship.

4. Daughter and her husband "fight a lot" and may be headed for a divorce.

5. Son 1 is an OB/GYN doctor.

6. Son 2 owns a fireworks manufacturing business that is struggling financially.

The first thing to notice is that there will not be sufficient "probate assets" (i.e., assets passing pursuant to Grandma's Will) when Grandma dies to enable the Executor of Grandma's estate to pay the $50,000 cash gifts to the eight grandchildren. Remember, only the probate assets will be subject to (i.e., part of) the estate plan in the Will. In addition, there will not be sufficient probate assets to pay Grandma's (i) funeral expenses, (ii) debts, and (iii) final income taxes, and (iv) maintenance charges and expenses of the home until the home is transferred to Daughter, and (v) estate administration expenses, such as legal fees and accounting fees (we will refer to these five items as the "post-death charges"). A total of $400,000 in "available probate assets" is needed in the probate estate to make the cash gifts to the grandchildren and *some* amount (perhaps $50,000?) is needed in the probate estate to pay the post-death charges. That totals $450,000. There is basically no cash (or any other liquid assets) in the probate estate. This is an example of an "ineffective" estate plan caused, in part, by not considering *how* assets are transferred at death.

If Grandma wants to keep the cash gifts to her grandchildren in her Will, she will need to remove the TOD arrangement from her brokerage account and let that account become a probate asset. If she does that, there will be sufficient assets to pay the cash gifts to the grandchildren, as well as to pay the post-death charges, and to make additional cash gifts if Grandma wishes. The children will end up with what's left of the brokerage account after those amounts are paid.

Here are some additional issues and considerations:

1. No cash gifts should be made directly to minor grandchildren. Minors cannot legally manage cash or other assets. To avoid the gifts to the minor grandchildren ending up in a court-supervised guardianship, Grandma's Will needs to include either a trust for each minor grandchild or a provision directing the distribution of a minor grandchild's cash gift to a custodian for that minor grandchild pursuant to the Uniform Transfers to Minors Act (UTMA).

2. In view of each child's situation, Grandma should consider creating in her Will separate lifetime, divorce and creditor-protected trusts, called "Descendant's Trusts" (one for each child), to hold the assets distributable to each child. Even Grandma's IRA rollover can be distributed to the three Descendant's Trusts (in equal shares) pursuant to the beneficiary designation. If the Descendant's Trusts are drafted as "qualified see-through trusts" pursuant to the "minimum distribution rules" (i.e., the federal tax rules applicable to distributions from retirement plans), and each of those trusts receives an inherited IRA, the distribution period for each trust's inherited IRA will be the same as the distribution period that would have applied if the IRA had been distributed directly (outright) to the children: the 10 year rule. However, the Descendant's Trust structure will protect each child's inherited IRA from (i) a child's spouse suing for a divorce and (ii) other potential creditors suing on tort and/or contract claims.

3. When Grandma dies, Daughter is going to end up owning the Home (pursuant to Grandma's Will) and all of the cash in the Bank Accounts (pursuant to the non probate multi-party arrangement–i.e., the right of survivorship–on those accounts). Thus, Daughter will receive $950,000 more than Son 1 and Son 2. Is that really what Grandma wants? Or does Grandma simply want Daughter to end up with the Home *as part of Daughter's share of Grandma's estate*?

4. If Daughter decides to share the bank accounts with her brothers, she will be making *taxable gifts* to them, reportable in a Form 709, U.S. Gift (and GST) Tax Return, because the amount she would need to give to each of her brothers to provide them with shares equal to her share exceeds the gift tax annual exclusion, which is currently $15,000 per recipient per year. Daughter could spread out the gifts over multiple years, if she wants, or she could include each brother's wife as a gift recipient, too.

5. What if Daughter decides to use the cash in the bank accounts to pay the post-death charges (see description above)? That would be a gift, too, because Daughter became the personal owner of the funds in the bank accounts when Grandma died. That's the legal effect of the *right of survivorship* on the accounts. Thus, Daughter would be using personally owned assets to benefit Grandma's estate, which is indirectly a gift to the other beneficiaries of the estate, i.e., to her brothers.

6. In this case, Grandma put a TOD arrangement on her brokerage account. As noted earlier, the TOD arrangement causes the brokerage account to be distributed completely outside Grandma's estate plan in her Will. The TOD arrangement prevents the cash

gifts to the grandchildren from being made. But the use of TOD raises other issues, too. Did Grandma include a "per stirpes" provision with the TOD arrangement? If Grandma included a *per stirpes* provision, that means that, if a child predeceases Grandma leaving one or more children who survive Grandma, that deceased child's share will be distributed to that deceased child's children. If Grandma did *not* include a per stirpes provision with the TOD arrangement and a child predeceases her, that deceased child's share will *not* be distributed to his/her children. Instead, the deceased child's share of the brokerage account will be distributed to Grandma's other two children. That is different from the distributions provided for in Grandma's Will. In our newsletter dated April 30, 2018, *TOD: Transfer on Death or Trample One's Disposition?*, we discussed TOD arrangements and various problems caused by them.

The "per stirpes issue" also applies in the case of beneficiary designations for beneficiary designation assets. The minor grandchild problem applies, too.

7. If Grandma really wants to "avoid probate" (a questionable goal in Texas), she could create a revocable trust and title the assets that would otherwise be probate assets in the name of her trust. Grandma would need to re-title all of her probate assets into the name of her trust *before* she dies if her goal is to avoid probate. The cost of creating and fully funding a revocable trust before death should be compared to the cost of creating a Will and probating the Will after death. As we have explained before, even if the probate process is avoided at death, there are still "post-death matters" that must be handled and, of course, post-death charges to pay. Thus, it is not true that if probate is avoided, nothing has to be done when someone dies. Also remember that the IRS does not care which transfer methods are used to transfer assets at death. All of the assets in which the decedent owned an interest at death that are being transferred by any method are included in the decedent's gross estate for federal estate tax purposes.

Bottom Line: Grandma's estate plan is a failure.

Pending Tax Bills. In our eight page January 31, 2021, newsletter, we discussed various pending tax bills. We also discussed some planning considerations in 2021. We will not repeat that discussion in this newsletter. We encourage clients who have previously created "gift trusts" for children and grandchildren to consider making additional "sizeable" gifts to those trusts this year. If the full remaining amount of the grantor's lifetime gift tax exemption is contributed to such trusts this year, future estate taxes will be avoided on the difference between the current $11.7 million lifetime gift tax exemption and the estate tax exemption amount applicable (under current law) in 2026 (and beyond), i.e., $5 million, adjusted for inflation.

Recent Court Case Regarding Gift of "Personal Property." The decedent's Will gave all of his "remaining household and personal property" to Named Beneficiary. Named Beneficiary took the position that this gift included the "intangible personal property," such as bank accounts and stock, in addition to the household furnishings. The other beneficiaries under the Will disagreed. The Court noted that the term "personal property" is well defined under Texas law. It includes both "tangible personal property" (such as household furnishings, personal effects and vehicles) and "intangible personal property" (such as bank accounts and stocks). Legally, *personal property* means all property other than real property. Thus, Named Beneficiary prevailed in the lawsuit. This case shows the need to use precise terms having established meanings in Wills, trusts and other legal documents.

Electronic Distribution of Newsletters. This is the first time we are distributing the firm's newsletter electronically. If you know someone who would like to receive our newsletters, have them contact Laura Walbridge in our office, laura@gerstnerlaw.com, to be added to the distribution list. All of the firm's newsletters will continue to be accessible on the firm's website, www.gerstnerlaw.com, and downloadable in pdf format.

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, or by email sent to:

Karen S. Gerstner* karen@gerstnerlaw.com

*Board Certified, Estate Planning & Probate Law, Texas Board of Legal Specialization
Fellow, American College of Trust and Estate Counsel (ACTEC)