Estate Planning Insights

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WARNING! DANGER! NONPROBATE ACCOUNTS!

With apologies to the robot on the mid-sixties TV show, Lost in Space *(who would issue warnings of impending danger to members of the Space Family Robinson just in time to avoid a disaster), this newsletter will discuss a recurring problem that is getting worse: the overuse of nonprobate accounts. Unfortunately, many people working in financial institutions who are charged with opening new accounts for clients have insufficient training in the broader aspects of estate planning. They may be following the "company line" when opening new accounts, but this is not always best for clients. In fact, the overuse of nonprobate accounts can totally decimate a client's estate plan.*

Opening Disclaimer. In this newsletter, we are *not* discussing individual retirement accounts (IRAs) held at financial institutions. While IRAs of all types are *nonprobate assets*, the issue with respect to IRAs (and other assets that are distributed pursuant to a beneficiary designation form at death) is entirely different than the issue discussed in this newsletter. With IRAs and other assets that are transferred at death by a *beneficiary designation form* (i.e., "beneficiary designation assets"), the risk for the client in terms of achieving his overall estate planning goals is completing the beneficiary designation forms in an appropriate manner. With true *beneficiary designation assets*, a client has no other option–a beneficiary designation form is the sole legal document of transfer and must be completed by the client. Thus, when we are referring to *nonprobate accounts* in this newsletter, we are not referring to IRAs and other beneficiary designation assets. (We have previously addressed the proper completion of beneficiary designation forms for beneficiary designation assets and will do so again at a later date.)

Further, this newsletter will *not* discuss in much detail the idea of creating a revocable trust (or, "Living Trust") to avoid probate. A Living Trust is an excellent estate planning vehicle for many clients. If a client really does wish to avoid the probate process at death (especially for out of state real property and minerals), all he need do is create a Living Trust and then *fully fund it* before he dies (i.e., change the title on every asset he owns, including all of his accounts, into the name of his trust prior to his death). As a reminder, merely creating a Living Trust is not sufficient to avoid probate. The trust must be *fully funded* before death. (To simplify the discussion, and because it makes no difference in regard to the point being made in this newsletter, we will treat a Will and a Living Trust the same and hereafter refer to both documents as a "Will" *unless a distinction is necessary*.)

Focus of Newsletter. This newsletter will focus solely on "regular" accounts, which means non-IRA accounts and other "after-tax" accounts. Examples would include bank accounts, brokerage accounts, certificates of deposit and investment accounts. The information in this newsletter applies to accounts that hold cash as well as accounts that hold other assets, such as stocks, bonds, and mutual funds. Further, the problem discussed in this newsletter also occurs when assets not held in accounts, such as real estate, are titled improperly.

What Are Nonprobate Accounts? Every account is either a *probate* account or a *nonprobate* account, based on the precise way the account is "titled" or "registered" when it is opened. A deceased person's interest in a *probate* account is distributed according to the terms of his Will. In contrast, a *nonprobate* account passes outside a person's Will at death. In other words, *nonprobate accounts* are transferred outside the probate process and, therefore, "avoid probate."

While avoiding probate may *seem* like a good idea, it is not a good idea if the person who owns the account is doing any tax planning and/or trust planning and/or contingency planning and/or charitable planning in his Will. (This tax and other planning that a client does in his Will is referred to as "estate planning"). In other words, nonprobate accounts override a person's estate plan in her Will. If a client's *only* estate planning goal is to avoid probate, then nonprobate accounts will meet that goal. If a client has *other* estate planning goals, however (some of which may be even more important than avoiding probate), nonprobate accounts should be avoided as much as possible.

Nonprobate accounts include the following:

1. Survivorship Accounts. An account titled in the names of two or more people that includes a "right of survivorship" provision (such wording may appear only in the fine print of the account agreement) is a nonprobate account. The account agreement creating a survivorship account would include wording such as "Joint Tenants with Right of Survivorship" ("JTWROS"), "Community Property with Right of Survivorship" ("CPWROS"), "Multi-Party Account with Right of Survivorship", "Joint Tenants" or "JT TEN". While the "listed account owners" (i.e., the persons whose names are in the account title–known as "joint tenants") are living, they own the assets in the account in proportion to their contributions. While all of the joint tenants are living, each of them has access to the entire account. On the death of one joint tenant, the amount in the account passes automatically, *by right of survivorship*, to the surviving joint tenant(s). This transfer occurs outside the probate process. Thus, this type of account is a substitute for a Will (and overrides what the Will of the deceased joint tenant provides). When a person opens an account of this type, he needs to be aware that he is "willing" the funds in the account to the joint tenant(s) when he dies (and not just giving the joint tenant(s) access while he's alive).

2. POD and TOD Arrangements. It is now possible to designate one or more beneficiaries to receive amounts in accounts *directly* on the death of the account owner, outside the probate process. Thus, an account owner may complete the paperwork to designate one or more "Pay on Death" ("POD") or "Transfer on Death" ("TOD") beneficiaries of his accounts. While the account owner is living, the POD or TOD beneficiary does *not* have access to the funds or assets in the account. On the death of the account owner, the amount in the account is paid directly to the designated beneficiary or beneficiaries, outside the probate process. These POD and TOD arrangements are also Will substitutes.

3. Totten Trust Account. The "Totten trust" account is an arrangement used with a bank account in which a depositor designates himself "as Trustee" for the benefit of a named beneficiary in a case where there is no actual trust. On the death of the Trustee, the funds in the account are then paid to the named beneficiary directly, free of the probate process. This arrangement is another substitute for a Will.

4. Combinations of the Above. It is possible to create an account that has both a survivorship feature *and* a POD beneficiary.

Sometimes these nonprobate account arrangements are referred to as "the poor man's Will." They are usually OK for persons of *very modest means* to use, but should not be used extensively by persons doing estate planning.

Nonprobate Accounts Thwart the Client's Estate Planning Goals. Apparently, many people who open new accounts at financial institutions believe that all clients have *only one* estate planning goal: to avoid probate on their death. Based on our almost thirty (30) years of working with clients, we can report that, while avoiding probate *might* be in the top ten estate planning goals some clients have, it's almost never in the top five. Thus, many financial institutions are *working against their own clients* when it comes to titling new accounts. Some new accounts people even tell our clients that what *we* are recommending is wrong. First, they warn clients that if they don't use one of these nonprobate accounts, their accounts will be "frozen" at death (more on this below). Second, they state that the right of survivorship form of account *must* be used to allow a person beside the depositor to have access to the depositor's account (this is not true–see below). Third, they intimate that the only reason attorneys are opposed to nonprobate accounts is because attorneys "make a lot of money" probating Wills. This is spurious because attorneys can create Living Trusts for clients who want to avoid probate and still accomplish *all* of their clients' estate planning goals. The problem is that many new accounts people "know enough to be dangerous" (and they are). Further, many financial institutions have no interest in training the people who open new accounts so that they will understand the legal and other effects of various forms of account titling. Yet, the form of title does affect their customers' estate plans. We previously discussed this same issue in a newsletter titled, "Should your Bank Teller be your Estate Planner?" However, we need to make the point again: the way accounts are titled has a legal effect, which might not be what you want. To protect our clients, we are sounding this much stronger warning against the indiscriminate and rampant use of nonprobate accounts. We apologize for being repetitive, but conventional wisdom says that a person must read or hear something *at least seven times* before it "sinks in."

Some Estate Planning Goals. So, what are some of the estate planning goals clients have that are thwarted by nonprobate accounts?

1. To avoid, reduce or defer "death taxes" as much as possible. Avoiding the payment of "avoidable" death taxes is a top goal of most clients (by death taxes, we mean the federal estate tax and the Texas inheritance tax [and other state inheritance taxes applicable when Texans die owning real property or minerals in other states]). This goal is accomplished through the creation of special tax-advantaged trusts in the person's Will (such as a Bypass Trust, a Marital Trust, a "GST Trust," or a charitable trust). Since the combined death tax rate often exceeds 50%, this is a major goal of estate planning.

2. To provide financial security for their spouse after their death. Most clients who are married want to make sure their surviving spouse has sufficient funds for her health, support and maintenance for the rest of her life. Trusts created in the Will are often used to make sure of this. In some cases, a professional Trustee is appointed to manage and administer the trust.

3. To provide asset management for beneficiaries who are not able to handle large amounts wisely. If any assets will be passing on the client's death to a beneficiary who is not able to handle the assets wisely (e.g., a minor or other young person, a mentally incapacitated person, a person with a substance abuse problem, a person who is a spendthrift), an appropriate trust can be created in the client's Will to receive the inherited assets. Again, in some cases, a professional Trustee is appointed.

4. To leave a final legacy to charity. Many clients desire to make a final gift to their favorite charity upon their death and, thus, will include specific charitable gifts in their Will or will leave a share of their residuary estate to charity. Some wealthier clients even create a charitable trust or foundation in their Will.

5. To prevent a deceased person's assets from passing to the new spouse of his/her surviving spouse. Most clients want to take care of their spouse when they die (see #2 above); however, many clients do not wish to take care of their spouse's new spouse (i.e., the person their spouse marries after they die). They recognize that if they don't put assets into trust for their spouse and he/she remarries after they die, their assets can end up with the new husband or wife of their spouse (and, ultimately, with that person's children, to the exclusion of their own children). This result can be prevented by creating an appropriate trust for their spouse in their Will.

6. To protect a child's or grandchild's inheritance from loss due to a divorce or other lawsuit. The use of "lifetime, protective trusts" for children, grandchildren and other beneficiaries has become very common since 1986 (due to moderately wealthy clients deciding to affirmatively use their exemption from the generation-skipping transfer tax). Because of the 50% divorce rate and the prevalence of lawsuits, this kind of trust is now very popular. Further, in several recent bankruptcy cases, state creditor protection laws applicable to IRAs inherited by children have been nullified. Thus, many clients wish to create a "bullet-proof" receptacle for each child's inheritance that protects the inherited assets from loss due to a divorce or other lawsuit while still allowing distributions to be made to the child and his children for their health, support, maintenance and education (and for even broader purposes if the trust has an independent Trustee). This "have your cake and eat it, too, trust" is created in the client's Will.

7. To create a "Special Needs Trust" for a disabled child. In the case of a disabled child, parents (and sometimes grandparents) create a "Special Needs Trust" in their Will, designed to provide supplemental funds that can be used to enhance the life of the disabled beneficiary while not disqualifying the beneficiary from receiving government benefits to which he/she is entitled.

8. Estate planning for large IRAs or qualified plans. For estate tax reasons, some people need to allocate pre-tax retirement plans (e.g., 401(k) plans, profit-sharing plans, 403(b) plans, IRAs) to trusts to avoid future estate taxes, but this must be done very carefully to avoid accelerating the income taxes. Also, sometimes these retirement assets are allocated to a Marital Trust for a second spouse, so that the amount remaining on the spouse's death can be distributed to the children of the original retirement plan owner. Further, special trusts can be used for IRAs passing to children to provide divorce and creditor protection for those assets (see #6). In all these situations, technical provisions must be included in the client's Will so that a trust that is the recipient of a qualified plan or IRA will be treated as a "qualified see-through trust" under the U.S. Treasury Regulations.

9. To retain family assets in the family. A client who wishes to insure that certain family assets will remain in the family as long as possible may include special provisions to that effect in his Will.

10. To cover various contingencies. When clients create an estate plan, they usually address at least the most foreseeable contingencies. The most common

contingency has to do with an intended beneficiary predeceasing the client or predeceasing another beneficiary whose interest comes first. Another contingency that should be addressed is the possibility that a beneficiary might not be able to handle his share of the inheritance (perhaps due to being disabled or too young). Because a client will not always be able to change his estate plan later (perhaps due to developing some form of age-related mental incapacity), and because very few clients want to pay an attorney to continually update their Will, foreseeable contingencies are addressed in advance in the client's Will. Thus, the client will provide for alternate beneficiaries if one or more primary beneficiaries predecease her or die at the same time. Further, appropriate trusts can be provided for any beneficiaries who might need them. This is a major problem with using nonprobate accounts as a Will substitute–the inability to address contingencies in advance (e.g., deaths out of order and a beneficiary needing a trust).

11. To allow the post-death process to be efficient. When a person dies, the Executor appointed in his Will is in charge of the post-death process. Serving as an Executor of a decedent's estate is a difficult job that becomes much more difficult if all of the decedent's accounts are nonprobate accounts because all of the funds in those accounts will pass outside the Will directly to the surviving joint tenants or named POD/TOD beneficiaries. The Executor does not have access to or control over these nonprobate accounts (and if the Executor is one of the nonprobate beneficiaries, he will be using personally owned money on behalf of the decedent's estate). Thus, the Executor may not have sufficient cash or other assets to pay the decedent's funeral expenses, expenses of last illness, final income taxes, and debts and to pay all post-death liabilities, such as estate taxes, estate income taxes and administration expenses. If the decedent owned a home that has to be maintained until sold, the Executor will not have funds for property taxes, insurance, utilities, repairs and maintenance of the home. The Executor may even have to sue the beneficiaries of the nonprobate accounts to obtain funds to do his job. What a mess!

12. To appoint guardians for minor or disabled children. A parent of a minor or disabled child can appoint guardians for that child and create trusts for that child in her Will. A minor or disabled child should *never* be named as the beneficiary of a nonprobate account.

13. To give a beneficiary more income tax options. Certain trusts created in a Will provide the beneficiary with multiple options with respect to taxation of the income earned by the inherited assets held in the trust.

14. To avoid probate. For some people, avoiding probate is an important goal, although the probate process in Texas is fairly simple and straightforward. If a client truly wishes to "avoid probate," the solution is *to create and fully fund a Living Trust* and not to title all of the client's accounts as nonprobate accounts.

The Danger of Nonprobate Accounts. As already noted, the *only* estate planning goal accomplished by nonprobate accounts is the goal of avoiding probate. All other estate planning goals and desires are thwarted by nonprobate accounts. It's a wonder that such accounts are even allowed!

Let's look at some examples of the problems caused by nonprobate accounts.

Example #1: Use of Nonprobate Account costs $435,000 in Otherwise Avoidable Estate Taxes. A married couple has an estate valued at $2,000,000, all community property. Recognizing that the estate tax exemption amount will be only $1,000,000 for persons who die after December 31, 2010 (unless changed by Congress), the couple decides to create a Bypass Trust in their Wills, to become effective on the first spouse's death. The idea would be to place the first spouse's estate, being half the total estate (i.e., $1,000,000), into the Bypass Trust upon the first spouse's death so that the first spouse's exemption from the estate tax won't be *wasted*. The surviving spouse could serve as sole Trustee of the Bypass Trust and could be either the sole beneficiary or the primary beneficiary of the Bypass Trust (children and grandchildren can be secondary beneficiaries while the surviving spouse is living, if desired). On the death of the surviving spouse, the Bypass Trust assets would pass free of federal estate taxes to the couple's children because the assets that were placed in the trust would be covered by the first spouse's $1,000,000 estate tax exemption. The $1,000,000 owned by the surviving spouse (i.e., the other half of the community property estate) would also pass free of federal estate taxes to the couple's children on her death because it does not exceed the $1,000,000 estate tax exemption amount. Thus, by using a Bypass Trust, the couple can take care of the surviving spouse (and children) and then pass on $2,000,000 (or more) to their children, free of estate tax (all of the assets in the Bypass Trust pass free of estate tax to the children on the second spouse's death, even if the trust has grown above its original $1,000,000 value).

Suppose, however, that the couple's entire estate is held in a joint brokerage account titled in both spouses' names as "Joint Tenants with Right of Survivorship." The couple is in a horrible car accident. The husband is killed instantly and the wife is seriously injured. The wife's agent under her financial power of attorney goes to the brokerage firm to obtain funds for the wife's care and support. The wife's agent presents a death certificate for the husband and the brokerage firm promptly re-titles the brokerage account into the wife's name, as the surviving joint tenant. The wife dies nine months later. Because the wife owns the entire $2,000,000 brokerage account at the time of her death, estate taxes in the amount of $435,000 have to be paid to the Internal Revenue Service (the wife is only one person and she is transferring a $2,000,000 estate at the time of her death and her estate is only entitled to one $1,000,000 exemption, making everything above $1,000,000 taxable). This is a case where the cost of *avoiding probate* (by titling the account as JTWROS) is $435,000, the amount of estate tax that could have been avoided had the couple had a joint account *without* a right of survivorship.

<u>Example #2: Use of Nonprobate Account Distorts Widow's Estate Plan</u>. A widow has three (3) children, two sons and a daughter. Her Will leaves her entire estate, valued at $900,000, to her three children, in equal shares. The widow is getting up in years and wants her daughter, who lives close by, to help her with her financial matters. The widow and her daughter go to every bank, savings & loan association, credit union and brokerage firm where the widow has accounts and "add" the daughter's name to each account (in many cases, the old account will be closed and a new account opened). Each financial institution titles the widow's accounts in the joint names of the widow and her daughter as "Joint Tenants With Right of Survivorship" (JTWROS).

Sometime later, the widow dies. Upon the widow's death, her entire $900,000 estate (i.e., the assets held in her various accounts) belongs entirely to her daughter as the sole beneficiary. This is the legal result of titling each account in both names with the JTWROS designation. The daughter, as the surviving joint tenant on all of the accounts, becomes the owner of all of the accounts on her mother's death. The widow's sons do not receive anything, although that was not the widow's intent. If the widow's daughter decides to keep the entire $900,000, her brothers will have no legal recourse to force her to share her $900,000 inheritance with them because, in this case, there is no ambiguity in the JTWROS wording on the accounts. Thus, the widow's estate plan in her Will is thwarted because of her nonprobate accounts.

Suppose the daughter decides to give $300,000 to each brother. In that case, the IRS correctly takes the position that the daughter is *making a taxable gift* in the total amount of approximately $600,000 ($300,000 to each brother less the $13,000 amount she can give each brother, tax-free, for that year). Thus, if the daughter gives each brother $300,000, she has made a taxable gift that must be reported to the IRS on a timely filed U.S. Gift Tax Return (Form 709). These gifts use up most of the daughter's own $1,000,000 exemption from the estate and gift tax, which the daughter may not wish to do. Failing to report these taxable gifts, however, is not an option because that would be tax fraud.

If, instead of setting up the accounts with her daughter as JTWROS, the widow had structured her accounts as "convenience accounts" and merely added her daughter to the accounts as a convenience signer, the widow's goals could have been accomplished: her daughter could have helped her with her accounts during her life and, upon the widow's death, each of her children would have received $300,000 pursuant to her Will, a transfer free of estate taxes and with no adverse gift tax consequences for the daughter. As another alternative, if the widow had an already effective financial power of attorney ("POA") appointing her daughter as her financial agent, she could have added her daughter to each of her accounts as her agent under her POA. Unfortunately, many financial institutions do not offer a *convenience account* and many will not recognize even a legally valid power of attorney for this purpose (allowing the widow to still have access to her own account, with the daughter also having access to the account in her capacity as her mother's agent under a presently effective POA).

<u>Example #3: Use of Nonprobate Accounts Distorts Widower's Estate Plan</u>. A widower has three sons, Abel, Baker and Cain, and a total estate with a value of $770,000. Each of his sons has one or more children. The widower's Will leaves his estate to his three sons, in equal shares, but also provides that if a son predeceases him, or dies within thirty (30) days of him, that son's share will pass to that son's children, in equal shares. The provision providing that a predeceasing son's share passes to his children in equal shares is referred to as a *per stirpes* distribution. The possibility that a child might predecease his parent is a very common contingency that people should provide for in their Wills. Usually, if the predeceasing child has children of his own, most people want the share intended for that deceased child to be distributed to that deceased child's children, rather than to their other children. Of course, this means "real" children and not step-children.

In addition, almost all Wills contain a "survivorship period" because even though a beneficiary may survive the Testator (the person making the gift to the beneficiary in his Will), if the beneficiary dies soon after the Testator, there is no point having the same assets go through two estates in such a short time. Using a survivorship period allows a short-lived beneficiary's estate to be "skipped" altogether.

Many nonprobate accounts cannot be structured to address the contingency of a beneficiary predeceasing the account owner (to avoid distortion of the estate plan). Further, the typical 30, 60 or 90 day survivorship period used in Wills seldom applies to a nonprobate account.

The widower in our example owns a house worth $170,000, with no mortgage. He does not like to invest in the stock market and, thus, the remainder of his estate consists of six (6) $100,000 certificates of deposit (CDs). He has named each of his sons as the POD beneficiary of two (2) of the six (6) CDs.

The widower and his son Abel are in a plane crash and both die immediately upon impact. The two (2) CDs that would have been paid directly to Abel if he had survived his father fail as POD dispositions (because a POD beneficiary must survive the depositor to receive the funds in the account). That $200,000 in CDs is now part of the widower's estate passing under his Will. Thus, the total value of the assets passing under the Will is $370,000 (the house and the two (2) CDs on which Abel was listed as the POD beneficiary). Baker and Cain each receive their $200,000 CDs directly from the bank upon presentment of a death certificate for their father. Some time later, the house is sold and the Executor is ready to distribute the probate assets pursuant to the widower's Will. Let's assume that the debts, final income taxes, and funeral, administration and other expenses paid by the Executor total $10,000. Of the $360,000 net probate estate, 1/3 is distributed to Baker, 1/3 is distributed to Cain, and 1/3 is distributed to Abel's two children, Sally and Sam, in equal shares (this is due to the *per stirpes* provision in the Will). Thus, Baker and Cain each receive a total of $320,000 ($200,000 in CDs payable to them as the POD beneficiary and $120,000 in cash from the Executor), while Abel's children together receive a total of only $120,000 (or, $60,000 each). If *all* of the assets had been distributed under the widower's Will, the result would have been three equal shares, with Sally and Sam splitting their deceased father's share. Thus, the widower's intended estate plan is thwarted due to the use of nonprobate accounts, which override the provisions in his Will.

Again, true "contingency planning" cannot be done with nonprobate accounts. Further, POD beneficiaries have to receive equal shares, which is not always what the client wants.

<u>Example #4: Use of Nonprobate Accounts Results in No Final Gift to Charity</u>. A woman who never married has no close relatives other than her great-nephew. She lives in a retirement home and has a modest estate of $300,000, consisting mostly of bank accounts. In her Will, the woman leaves half of her estate to her great-nephew and the other half to her favorite charity. The woman is growing feeble and needs help from her great-nephew. She and her great-nephew go to her banks and place her great-nephew on all of her accounts so that the great-nephew will have access to her accounts and can help her write checks, make deposits and pay bills. The woman does not realize or understand that each of the new accounts is set up in both names as a "Multi-Party Account with Right of Survivorship." The woman dies. Her entire estate passes directly to her great-nephew outside her Will. The woman was able to "avoid probate" completely! On the other hand, her favorite charity never received the final gift she wanted to give them.

Probate Accounts. What are some types of *probate* accounts that can be used by persons who want their estate plan in their Will to be effective? Here are some "labels" or "titles" that can be used on accounts that will not override the estate plan in the Will. In other words, using one of these account types will result in the decedent's interest in the account at death being distributed according to his Will.

For <u>married persons</u>, possible "titles" or "labels" or types of accounts to use include:

1. "Community Property" (but *not* "CPWROS"),
2. "Tenants in Common" ("TIC"),
3. "Joint Tenants <u>Without</u> Right of Survivorship,"
4. "Multi-Party Account <u>Without</u> Right of Survivorship,"
5. An Individual account titled in just one spouse's name (*without* a POD or TOD arrangement), and
6. A "plain vanilla" (old fashioned) joint account (*without* a survivorship feature).

It is fine for a married person to have an individual account. Placing community funds or other community assets in an account titled solely in one spouse's name will not convert community property to separate property (except in very rare cases, not applicable here). When community property is titled in the name of just one spouse, that property is treated as *sole management* community property (i.e., assets controlled or managed by that one spouse). Nevertheless, sole management community property is still *community property*, owned 50% by each spouse.

For single persons, possible "titles" or "labels" or types of accounts to use include:

1. An Individual account (*without* a POD or TOD arrangement). If the owner of an individual account loses her mental capacity and can no longer handle her financial matters, then the owner's agent under her Statutory Durable (financial) Power of Attorney can take control of her account. The primary purpose of a financial power of attorney is for the "principal" (the person executing the Power of Attorney, which is an agency contract) to appoint a trustworthy person, in advance, as her agent, so that if the principal loses her mental capacity, her financial affairs can be managed by her agent without a legal guardianship having to be established in the probate court.

If a single individual wants someone else to have access to her accounts during her life, these arrangements may be used:

2. "Joint Tenants Without Right of Survivorship,"
3. "Multi-Party Account Without Right of Survivorship,"
4. A "convenience account" with someone listed as a "co-signer" on the account for the convenience of the account owner, and
5. An account with the joint names of the account owner and the owner's agent under a presently effective Statutory Durable Power of Attorney (but *without* a right of survivorship feature or a POD or TOD arrangement).

Survivorship Accounts: The Access Argument. As noted above, it is *not legally necessary* to create a joint account with a survivorship feature (i.e., a "right of survivorship") in order to provide another person with access to one's accounts during life. There are other account arrangements or documents that would allow another person access to the depositor's account during her life that don't override the depositor's estate plan in her Will. Unfortunately, many financial institutions will not allow these other types of accounts or arrangements. If that is the case, one solution would be to create a *small* joint account with a right of survivorship, to allow the joint tenant access to the account during the account owner's life and to provide immediate funds to those who depend on the account owner for support for a few weeks after his death. The same account could be used to pay immediate expenses that cannot wait the 2-3 weeks it takes to obtain the appointment of the Executor for the deceased account owner's estate. We recommend that this one (and only) nonprobate account not have more than $50,000 in it. As noted, as soon as the Executor named in the deceased account owner's Will is duly appointed and qualifies, he can present his Letters Testamentary to the financial institution and take control of all of the decedent's (probate) accounts. This can usually be accomplished within a few weeks of death. A second thing that can be done if a financial institution does not offer any joint accounts other than those having a right of survivorship is for the parties to the joint account to write a "Section 440 letter" (a letter authorized by Section 440 of the Texas Probate Code) to the financial institution, advising it that the parties do not intend for the account to have a survivorship feature.

Real and Imagined Issues with Probate Accounts. As noted above, financial institutions warn clients that if they title their accounts as *probate* accounts, their accounts will be "frozen" upon their death. It is true that the interest of a deceased person in a *probate* account will be "in limbo" after his death until such time as the Executor of his estate is able to present Letters Testamentary to the financial institution. This could take 2-3 weeks. If family members will need access to the decedent's funds during this time (because they have no funds of their own and/or no credit cards they can use to pay the immediate expenses, such as funeral expenses), it is OK to have *one* relatively small nonprobate account (with $50,000 or less in it) that will be immediately available to the decedent's surviving family members. If the decedent limits his nonprobate accounts to one small checking account, for the most part, the integrity of his estate plan will still be preserved. It is when *all* (or nearly all) of his accounts are structured as nonprobate accounts that the estate plan is decimated.

Except for the short-term, post-death cash needs of the survivors (which can be taken care of by having one small nonprobate account), it is not necessarily "bad" that the decedent's interest in his probate accounts is temporarily "frozen" on death. Serious, costly mistakes are made when family members act too quickly after a loved one has died. In some cases, these ill-advised and uninformed actions can ultimately cause hundreds of thousands of dollars in unnecessary estate taxes to be paid. Thus, this short-term "hold" on the accounts should allow the named Executor (and family members) enough time to obtain good legal counsel regarding what should be done with the decedent's accounts (and other assets).

With respect to married couples, upon learning of the death of one spouse, the financial institution will freeze the *entire* account, and not just the deceased spouse's community property ½ interest in the account. This appears to be over-reaching on the part of the financial institution. On what legal basis does the financial institution "freeze" the interest in the account of a living account owner who has not done anything wrong? First, accounts titled jointly in both spouses' names come within the community property presumption. This means that each spouse owns a community ½ interest in the account. Second, Texas law specifically provides the following with respect to joint accounts holding "funds on deposit" that do *not* have a survivorship feature: "A financial institution that pays a sum from a joint account to a surviving party to that account pursuant to a written agreement under Section 439(a) of this code [which includes Multi-Party Accounts <u>Without</u> the Right of Survivorship], is not liable to an heir, devisee, or beneficiary of the decedent's estate." *See* Texas Probate Code Section 445. Thus, in view of the community property presumption under Texas law for funds in a married couple's joint accounts, plus the provisions of Section 445 of the Probate Code, a surviving spouse *should* be able to access her half of the joint account immediately after the other spouse's death. In fact, she is legally authorized to access the *entire* account after the death of her spouse. This routinely does not happen, however (since the entire account is frozen). So, my advice to married couples is this: when the first spouse dies, you do not have to "rush out" and inform all of the financial institutions that your spouse has died. If you are named on any joint accounts, you may continue to use those joint accounts after your spouse's death, as long as you do not do anything with the deceased spouse's half of the account that violates his interest in the account or negates his estate plan. In many cases, of course, the surviving spouse *is* the first named Executor in the deceased spouse's Will. Thus, within a matter of weeks, she will gain control over the deceased spouse's interest in the account as the duly appointed Executor of the Estate and, at that time, her own interest in the account will also be "unfrozen." Whether it's legally correct or not, couples should anticipate the freezing of the entire joint probate account on the death of the first spouse. Thus, couples may wish to set up one joint checking account (with $50,000 or less in it), having a right of survivorship feature, to provide immediate funds to the surviving spouse.

Single individuals who have loved ones who may need immediate funds for their support or to pay pressing bills right after they die can also set up one small nonprobate account for this purpose (with $50,000 or less in it).

Use of Disclaimers. Sometimes, *but not always*, surviving family members who are <u>sufficiently knowledgeable</u> and <u>able to act immediately</u> can avoid the problems caused by nonprobate accounts and uphold the decedent's intended estate plan through the use of disclaimers. A "disclaimer" is a post-death technique that must be completed within 9 months of the decedent's death. In a disclaimer (a legal document), a person who is entitled to a gift at death via a nonprobate account or arrangement renounces the gift coming to him so that the gifted asset will instead be distributed according to the deceased person's Will. If a disclaimer is done correctly, there are no adverse tax consequences for the person making the disclaimer. If a disclaimer is not done correctly, then the person who transfers all or any part of the gifted asset to someone else is treated as making a taxable gift (see example 2 above). Disclaimers are used most often by a surviving spouse to whom assets are passing by right of survivorship (or other nonprobate arrangement) where the surviving spouse wants the deceased spouse's interest in the account to pass into a Bypass Trust created in the deceased spouse's Will instead of to the surviving spouse directly. As noted, fully funding a Bypass Trust on the first spouse's death can save hundreds of thousands of dollars in estate taxes. One requirement for a valid disclaimer, however, is that the person making the disclaimer must do so prior to accepting any benefits from the asset or account to be disclaimed and prior to the asset/account being re-titled into her name. Thus, once the assets are put into the name of the surviving spouse (as happened in example 1 above), it is too late to make a qualified disclaimer. Further, once the beneficiary of a nonprobate account has started using the funds in the account, it is usually too late to make a disclaimer. Even when a qualified disclaimer is able to be made, the result is not as good as the result had the assets been held in probate accounts and not nonprobate accounts. For example, a *power of appointment* given to a surviving spouse over a Bypass Trust cannot be exercised with respect to assets passing into the trust via a disclaimer. A power of appointment is a device that provides flexibility to a surviving spouse because it allows the surviving spouse to make changes to the ultimate distribution of the Bypass Trust on her death based on changes that occur after the first spouse's death. If the assets pass into the Bypass Trust "automatically" through the deceased spouse's Will, the surviving spouse may utilize this device, but if the assets arrive via a disclaimer, she can't.

FDIC Insurance Issues. Fairly recently, the FDIC insurance limit was increased from $100,000 per account to $250,000 per account This increase in insurance coverage should help avoid what previously was another reason why so many people were (inappropriately) using nonprobate accounts. When people want to have multiple accounts at the same financial institution, all covered by FDIC insurance, they have to use different types of accounts, meaning, accounts with different registrations. For example, a person could have (1) a joint account with another party *with a right of survivorship*, (2) an individual account with POD beneficiary A, (3) another individual account with POD beneficiary B, (4) a Totten trust account with themselves as Trustee for the benefit of beneficiary C, (5) another Totten trust account with themselves as Trustee for the benefit of beneficiary D, (6) a joint account with another party *without* a right of survivorship, (7) an individual account (with no POD beneficiary), and (8) a joint account with another party with a right of survivorship and with POD beneficiary E. When the FDIC insurance limit was only $100,000, having 8 differently titled accounts, as in the above example, would mean that the person could have $800,000 in one financial institution, with all of the funds being protected by FDIC insurance. Of course, most of the accounts above are nonprobate accounts that would pass outside the depositor's Will. As already indicated, having all of these nonprobate accounts thwarts the depositor's intended estate plan in his Will.

Now, with the higher FDIC insurance limit, it should be possible for people to have more funds at a single institution without overriding their estate plan by using multiple nonprobate accounts. For example, we are currently working with a single lady who wishes to divide her estate among multiple beneficiaries, in different percentages, some of whom are minors and must have a trust. Her estate planning desires cannot be accomplished using nonprobate accounts. We need to be able to spell out her customized estate plan in a document with sufficient room to name multiple beneficiaries who are receiving different percentages, to address what happens if one or more beneficiaries predecease her, and to create trusts to hold the shares passing to beneficiaries who are minors (or mentally incapacitated). This lady currently has approximately $500,000 at one financial institution, a bank which she really likes. Her current accounts name some (but not all) of her intended beneficiaries as POD beneficiaries but, as noted, some of them are minors (a minor should never be named as the beneficiary of anything). Further, all POD beneficiaries must receive the same percentage of the account, which is not what she wants. Therefore, to accomplish *all* of this client's estate planning goals, we are creating a Living Trust for her. We are not really concerned about "avoiding probate" (since the probate process in Texas is so simple), but we do have other good reasons for using the Living Trust approach. Now this lady can have two $250,000 accounts at her favorite bank, one titled in her individual name (without a POD beneficiary) and the other titled in the name of her Living Trust. The individual account will pour into her Living Trust on her death through probating her "pour-over" Will. The other account is already part of her trust. All of the $500,000 will then be distributed upon her death according to her customized estate plan in her Living Trust. In the meantime, her $500,000 at her favorite bank will be fully covered by FDIC insurance because it's divided between two differently titled accounts.

In some cases, people may just need to move funds to other institutions in order to obtain sufficient FDIC insurance and obtain their desired estate planning goals. One would hate to think that people would be willing to override their own estate plan (by creating numerous nonprobate accounts) just to keep all of their money in one place. We don't ever want to "let the tax tail wag the dog" and we sure don't ever want to "let the FDIC insurance tail wag the dog" either. If necessary to obtain sufficient FDIC insurance coverage, move money to other financial institutions. But don't improperly title your accounts as nonprobate accounts.

Summary. Be very wary of nonprobate accounts. Just because nonprobate accounts "avoid probate" doesn't mean they should be used indiscriminately. The probate process is very simple and straightforward in Texas if you have a good Will and, therefore, avoiding probate is not that important. In addition, just because nonprobate accounts are a substitute for a Will doesn't mean you should use them as a Will. Very few important estate planning goals can be accomplished with nonprobate accounts. In fact, the overuse of nonprobate accounts will thwart your estate planning goals. If your estate planning goals are important to you, then be sure all of your accounts are titled properly–in a manner that doesn't override your estate plan in your Will. It's OK to have one relatively small nonprobate account for immediate post-death needs (with no more than $50,000 in it), but more than that is counterproductive.

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Final Word on Nonprobate Accounts. Hopefully, this newsletter has given our clients and colleagues an in depth understanding of the recurring and escalating problem caused by the overuse of nonprobate accounts. Now, like the robot on *Lost in Space*, go forth and warn others regarding the dangers of nonprobate accounts!

Changes to the Estate Tax. As of this writing, Congress has not made any changes to the estate tax laws that are already "on the books." Further, it is unclear what will happen to the income tax laws in the future. If and when Congress does make changes, we will discuss those changes in a newsletter or "special alert" sent to everyone on our mailing list.

THANK YOU. We are very grateful to our clients for the trust and confidence they have placed in us this year by allowing us to do legal work for them. We are also very grateful to our colleagues and clients who have referred new clients to us. We couldn't survive without you. It is a privilege, honor and blessing to work with you and the clients you refer to us.

HAPPY HOLIDAYS! All of us wish you and yours Happy Holidays. Our office will be closed Wednesday through Friday, November 24-26, for Thanksgiving, Friday and Monday, December 24 and 27, for Christmas, and Monday, January 3, for the New Year's holiday.

Contact us:

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

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