# Estate Planning Insights

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## TOD: Transfer On Death *or* Trample One's Disposition?

**Increasing Use of TOD and Increasing Problems Due to Use of TOD.** We are going to discuss the increasing use of "Transfer on Death" ("TOD") arrangements for "after-tax" or "regular" accounts (see below*). All of the discussion in this newsletter is equally applicable to "Pay on Death" ("POD") arrangements. Both TOD and POD are arrangements that can be used on bank, brokerage and other accounts to provide for a "non-probate transfer" of the account directly to named beneficiaries at death. The #1 "selling point" for TOD arrangements is that they "avoid probate." Before one assumes that this is always a good thing, *please read this entire newsletter.*

**Some Preliminary Matters.** Someone famous once said, for every complex problem there is a simple solution–and that solution is usually wrong. **There are no simple solutions to complex problems!** There might be simple solutions to simple problems. However, a person must know and understand enough about a particular problem to determine whether the problem is simple or complex before that person can select an appropriate solution.

When we hear people repeatedly say they want to "avoid probate," we can't help thinking that they do not have enough knowledge to understand both the pros and cons of avoiding probate. There are actually numerous advantages of going through probate that you do not get when you avoid probate. Sometimes the "simple solution" to avoiding probate causes more problems than it solves. One is reminded of that old adage: out of the frying pan and into the fire.

<u>The Post-Death Process</u>. We have previously discussed, in numerous newsletters, the various parts of the "post-death process." Probate is only one part of the post-death process. Even if one avoids probate, one does not avoid the other parts of the post-death process.

<u>Over-Simplifying the Problem</u>. A whole lot happens, legally, when someone dies. *Much more is going on than the transfer of assets from the decedent to the new owners.* It is best to have <u>someone</u> "in charge" of handling all of the post-death matters that must be handled when a person dies. Thus, it is overly simplistic (some would say, it is evidence of "ignorance" regarding the post-death matters) to focus solely on the transfer of assets to beneficiaries at death. That is one of the many problems with the use of TOD. It is an overly simplistic "response" to a complex situation.

<u>Beneficiary Designation Assets</u>. *This newsletter does NOT apply to the four types of "beneficiary designation assets." It is vitally important to understand the difference between "true" *beneficiary designation assets*, on the one hand, and all other assets and accounts, on the other hand.

There are four types of "true" *beneficiary designation assets*: (i) life insurance (whether individually owned or provided by an employer), (ii) employee benefit plans of all types (such as 401(k) plans and profit-sharing plans), (iii) IRAs of all types, and (iv) annuities. Not everyone owns all four types of beneficiary designation assets, but nearly everyone owns at least one type of beneficiary designation asset.

No other accounts or assets are "true" beneficiary designation assets. Again, one must understand this important distinction. This newsletter is going to focus solely on accounts and assets that are NOT true beneficiary designation assets.

<u>Avoiding Probate</u>. As we have previously written, if you "avoid probate" with respect to one or more of your "after-tax" or "regular" accounts (again, we are NOT including any *beneficiary designation assets* in this discussion), it means that, with respect to those assets,

*you avoid everything provided for in your Will.* Why bother even having a Will then? TOD arrangements may be appropriate for a person who does not have a Will on a theory that TOD is "better than nothing." But if you have taken the time and spent the money to craft an estate plan that does what you want it to do, why allow accounts and assets to be distributed outside that estate plan?

You could say that a TOD arrangement is "the poor man's Will." TOD arrangements are a substitute for having a Will. They generally should not be used by people who have a Will.

About Probate. People who recommend and/or use TOD on their after-tax accounts believe they have found a simple solution to a horrible problem. First, the "probate problem" is grossly exaggerated. Second, the "simple solution" causes new problems that are avoided by going through probate or otherwise having assets pass pursuant to one's primary "estate planning vehicle" (an alternative vehicle to a Will is a trust).

Probate is "state specific." In general, there are 30 "bad" probate states and 20 "easy" probate states. Texas is among the "easy" probate states and, in fact, most people believe that *Texas has the simplest probate process of all 50 states*. So, is it really necessary to "avoid probate" if you live in Texas and all of your real property is in Texas?

NOTE: If you really want to avoid probate when you die, the correct way to do that is to create a revocable trust and fully fund it before you die (i.e., retitle *all* of your assets that can be titled in the name of your trust into the name of your trust before you die). A fully funded revocable trust will avoid probate the right way–without causing the type of problems caused by the use of TOD arrangements–and will also insure there is an official "person in charge" (i.e., the Trustee) who has the same duties and powers as the Executor under a Will and can handle all of the post-death matters free from court control and supervision.

As previously noted, in addition to probate, there are other matters that must be handled when someone dies, such as paying the decedent's (i) funeral expenses, (ii) debts, (iii) final income taxes, and (iv) asset maintenance charges, such as mortgage payments, liability insurance premiums, property taxes, etc. In addition, the "person in charge" must handle some very complicated federal tax matters. Note that we are not just talking about federal estate tax matters. Under current law, very few estates are large enough to require the filing of a federal estate tax return. However, every Executor needs to prepare a spreadsheet listing *all* assets in which the decedent owned an interest at death. Further, the Executor must value each asset at its "fair market value" as of the date of death, in accordance with IRS regulations. The "Estate Asset Spreadsheet" serves as proof of the Executor's "due diligence" for *both* federal estate tax purposes *and* income tax basis purposes. So, even though few estates have estate tax matters, ALL estates have income tax matters.

Remember that each "capital asset" in which the decedent owned an interest at death achieves an adjustment to its "tax basis" (aka "cost basis") at death and the Executor (or the person who the IRS treats as the Executor) must make sure this new basis information is properly recorded and provided to the beneficiaries who receive those assets. If the fair market value of an asset is higher at death than its original cost basis, that results in a "step up" in basis at death. The Executor must handle these post-death tax matters (among other tax matters, such as filing the decedent's final income tax return, paying the decedent's final income taxes, filing any income tax returns required to be filed by the decedent's estate, etc.) during the post-death period. If the decedent's Will is not probated (perhaps because all of the decedent's assets are passing directly to named beneficiaries pursuant to a TOD arrangement), these matters must still be handled and, in fact, the IRS imposes liability on certain persons, including beneficiaries, if these matters are not handled. It is much easier to have an Executor under a probated Will handle all of the post-death tax matters than to leave these things to the beneficiaries to handle.

In our experience, people mistakenly blame probate for the various federal tax matters that must be handled when someone dies. Also, in our experience, Executors find the probate part of the post-death process to be simple and easy, but find the tax part of the post-death process to be complicated. Again, do not blame probate for the fact that the federal tax laws require various tax matters to be handled when someone dies. Probate and post-death tax matters are two completely different things!

**Real Cases in which Use of TOD Caused A Problem.** We are now ready to discuss some real cases in which the use of a TOD arrangement caused a problem.

Case #1: The Testator (a man who makes a Will) had a Will in which he left his assets to his three children, in equal shares, but also provided that, if any child happened to predecease him (i.e., die before him), that predeceasing child's share should be distributed to that predeceasing child's children, in equal shares. Basically, that is what is meant by a "per stirpes" distribution.

The Testator had a sizeable investment account with a brokerage firm. Shortly before his death, his account executive at the brokerage firm advised him to place a TOD designation on his brokerage account "to avoid probate." Thus, the Testator completed and submitted the brokerage firm's TOD paperwork, indicating that his brokerage account should be distributed to his three children, in equal shares, pursuant to the TOD arrangement. About one month before the Testator died, his son died. The Testator did not update his TOD designation. Thus, when the Testator died, survived by his two daughters, the brokerage account became payable 50% to each daughter. The son's three children were not entitled to any share of the brokerage account because the son predeceased (i.e., did not survive) the Testator.

The two daughters both want the son's children to receive the son's 1/3 share of the TOD account. If the daughters simply give the son's children a portion of their respective shares of the brokerage account, the daughters will be making "taxable gifts" because the amount each of them will be giving to each child of the son exceeds the annual exclusion from the federal gift tax (currently $15,000 per donor [gift-giver] per donee [gift recipient]). All taxable gifts must be reported in a timely filed federal gift tax return (Form 709). Taxable gifts use up portions of the donor's lifetime gift tax exemption and, at the same time, reduce the amount of the donor's estate tax exemption.

Note that if the Testator had NOT place the TOD arrangement on his brokerage account, so that the brokerage account would have been distributed pursuant to the Testator's probated Will, the son's 1/3 share of the brokerage account would have been distributable to the son's children, in equal shares, and the daughters would not have found themselves in a taxable gift situation.

<u>Case #2</u>: The Testator had a Will that made an "equalizing gift" to his daughter upon his death due to a large gift the Testator had made during life to his son. The intended source of funds for that equalizing gift was the Testator's sizeable investment account. Other than the sizeable investment account, the Testator's only other assets were relatively small bank accounts and tangible personal property (i.e., household furnishings, personal effects and vehicles). The Testator's financial advisor at the investment firm advised the Testator to place a TOD arrangement on his investment account "to avoid probate." The Testator followed his financial advisor's advice and placed the TOD arrangement in favor of his two children on his brokerage account. When the Testator died, there were insufficient assets in his probate estate (i.e., the assets passing pursuant to his Will) to make the equalization gift to the daughter. In that case, the son did not want to share any of his share of the inherited investments with his sister. So, at least the son did not have a gift tax issue. Arguably, however, the Testator's intent was completely thwarted by the use of the TOD arrangement on his investment account.

<u>Case #3</u>: The Testatrix (a woman who makes a Will) had three children whose ages ranged from 14 to 21 at the time of her death. She was a widow who had inherited a sizeable brokerage account from her late husband. Her financial advisor recommended she use TOD on her brokerage account "to avoid probate" and she did. Fortunately, when she died, all three of her children survived her (unlike in Case #1). However, two of her three children were still minors (under age 18) when she died. Thus, the shares of her brokerage account distributable to her minor children ended up in a court-supervised legal guardianship. A significant portion of those assets ended up being "wasted" due to the payment of court costs, legal fees, guardian fees and expenses, bond premium, etc. Further, when each younger child reached age eighteen, the guardianship terminated and all of the assets were distributed directly to him. In fact, as it turned out, all three children spent 100% of their inheritance prior to reaching age 25. If, on the other hand, the Testatrix had allowed her brokerage account to be distributed pursuant to her Will (i.e., to go through probate), a trust would have been created for each of her three children. Her Will appointed her 45 year old sister, a CPA, as Trustee of each child's trust. Each trust was set up to last until each child reached age 30, with the sister, as Trustee, making distributions for their benefit prior to that time. No doubt, the Will provision was far superior to the TOD arrangement.

<u>Case #4</u>: When she died, the Testatrix owed income taxes for the prior year, medical bills accumulated during the six months prior to her death, and amounts charged on her credit cards. Pursuant to the advice of her financial advisor, she placed TOD arrangements on *all* of her accounts. When she died, her Will was not probated because she did not own a home or any other probate assets. The child who would have been the Executor under the Will if the Will had been probated took on the responsibility of paying her mother's debts

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and taxes. That child used her share of the TOD accounts to make those payments. Then she tried to recover the other children's shares from them. One of the other children had already spent his entire TOD inherited assets on a very expensive boat and could not contribute. The other child still had her TOD inherited assets, but simply chose not to contribute toward her mother's debts and taxes. So, one child bore the entire cost of those items. Technically, if the Will had been probated and the "responsible child" appointed as Executor, she would have had the legal right to sue her siblings to recover, out of their shares of the TOD assets, their respective amounts of the mother's debts and taxes. Of course, even if the responsible child had become Executor of her mother's estate, she may not have wanted to sue her siblings. The better result would have been if the mother had not used the TOD arrangement on her accounts. In that case, the Executor would have had sufficient funds to pay the mother's debts and taxes, plus estate "expenses" (i.e., accounting fees relating to the mother's final income tax return), out of the estate assets (i.e., the accounts) and would have simply remitted the *net* amount to the three children, in equal shares, pursuant to the terms of the Will.

**Closing Comment.** In the cases above, if a *lawyer* had recommended the client use a TOD arrangement, the lawyer could have been sued for legal malpractice. Lawyers owe fiduciary duties to their clients, which means they are held to the highest standard of behavior and must act solely in their clients' best interests. Lawyers who specialize in estate planning and probate law have to have comprehensive knowledge of all applicable law. If a client asks a lawyer about using TOD, the lawyer will do her best to explain the risks of using TOD and will generally discourage the use of TOD. While other professionals are knowledgeable in their particular areas of expertise, they should not be providing *legal advice* to their clients.

**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:

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