Estate Planning Insights

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COMPANY LAW – PART TWO

What is Company Law? In our last newsletter, Company Law–Part One, we introduced the topic of "Company Law." We defined "Company Law" as the rules, policies and procedures of companies, along with the terms of contracts you have signed with those companies. The theme of this series of newsletters on Company Law is that Company Law can–and often does–override otherwise applicable law. In addition, Company Law can cause "difficulties" for your "fiduciaries" (such as your agent in your Power of Attorney, Executor under your Will, and successor Trustee of your Revocable Living Trust) upon your death or disability. Further, Company Law can cause problems for your beneficiaries after your death. Before we talk about the specific example that we will cover in this newsletter, *how* is it that Company Law can override otherwise applicable state (& US) law?

First, each agreement that you sign with a company to open an account of any type or to arrange for particular services (such as email services) is a legal contract. Although you live in Texas, a legal contract that you sign with a particular company can override Texas law by making the law of another state applicable for all purposes of the contract. That is not unusual. In addition, legal contracts can override the law of *every* state and provide the "law" that the particular company wishes to use, as long as the terms of the contract are clear and the "Company Law" being used does not violate public policy.

Second, there are other legal documents, such as beneficiary designation forms promulgated by companies that serve as custodians of IRAs, that may prevent your IRA from being distributed as you desire when you die. Each company that sponsors IRAs has its own beneficiary designation form and can impose its own "rules" in regard to that form. For example, many IRA custodians do not allow IRA owners to direct a "per stirpes distribution" of their IRAs upon their deaths. As you may recall, in general, a *per stirpes distribution* means that, if one of your children predeceases you (or dies at the same time as you), the share of your IRA that would have been distributed to that child (if he or she had survived) will instead be distributed to that child's children, in equal shares, and *not* to your other child/children. The companies that do not allow a *per stirpes distribution* of your IRA require a predeceasing child's share to be distributed to your other child/children. In addition, even some companies that allow IRA owners to use a *per stirpes distribution* require all of their customers to abide by that company's particular definition of "per stirpes."

Third, there are yet other documents, such as qualified plan documents, that contain provisions that are binding on you if you are a participant in that qualified plan or a beneficiary of a participant in that qualified plan. Many provisions in qualified plan documents are mandated by federal law and, in particular, the Employee Retirement Income Security Act of 1974 ("ERISA"). However, as long as qualified plan documents comply with ERISA, the company sponsoring the qualified plan can add other provisions that produce a different result from the result that would be produced under otherwise applicable state and/or federal law. We will see how that works in the example in this newsletter.

Testamentary Intent. In the field of estate planning and probate law, which is also referred to as "wealth transfer law" and "trust and estate law," a fundamental goal is *to carry out the testamentary intent of the decedent*. Your *testamentary intent* refers to your desire regarding the persons who should receive your assets when you die. (Note that the term "person" can include a trust.) It is not necessarily a primary goal of companies that hold your assets to carry out your testamentary intent when you die. If it were, those companies would quit thwarting your testamentary intent in your Will by telling you to set up your accounts with them in a manner that "avoids probate." As we have explained *many* times before, titling accounts as JTWROS or to include a POD or TOD arrangement means that those accounts will not be part of your estate plan in your Will. In addition, in the case of qualified plans governed by ERISA, it is clearly *not* a goal of ERISA to make sure that your qualified plans are distributed pursuant to your actual (or presumed) intent when you die. ERISA has other goals and purposes, as stated in the statute itself and by federal courts in numerous cases, which are as follows: (i) to reduce the administrative burden on qualified plan administrators, (ii) to achieve national uniformity in the administration of qualified plans, and (iii) to make sure that the participant's qualified plan is available to provide retirement benefits to the participant himself when he retires and to the participant's surviving spouse on the participant's death. Various provisions are used to uphold ERISA's goals, such as the "plan documents rule." Pursuant to the *plan documents rule*, the participant's qualified plan MUST be distributed to the person named on the beneficiary designation form, even if that person is the participant's ex-spouse and even if that ex-spouse waived all her rights to the participant's qualified plan as part of the divorce. This is true even if otherwise applicable state law revokes all gifts to a former spouse after a divorce. State law is *preempted* (overridden) by federal law (ERISA) in that case.

Qualified Plan Example. So, let's look at another example of how "Company Law" can thwart a client's testamentary intent. This is an actual case.

"Dad" was age 89 when he died in May 2014. "Mom" survived Dad, but died in August 2014 at age 91. Son, age 57, the only child of Mom and Dad, survived both parents.

Dad had worked for BP for many years and was still a participant in BP's 401(k) plan (the "BP Plan") at the time of his death. (Years before he died, I had advised Dad to roll over his BP Plan to an IRA rollover, for various reasons, but he never did.) Dad's interest in the BP Plan was worth over $2 million at the time of his death (and worth even more when Mom died later). On the beneficiary designation form that Dad had submitted to the BP Plan Administrator prior to his death, Dad named Mom as the primary beneficiary of his BP Plan. ERISA, as amended by the Retirement Equity Act of 1984, actually requires a qualified plan participant to name his spouse as the primary beneficiary of his qualified plan (although plan participants and spouses can submit appropriate forms to the plan administrator to override this requirement, if desired). Dad named Son as the contingent, or secondary, beneficiary, of his interest in the BP Plan.

When Dad died, Mom was too ill to take any action with respect to the BP Plan. Mom died before completing the claim forms for Dad's BP Plan. Obviously, then, Mom died before accepting the BP Plan and before completing and submitting a beneficiary designation form for the BP Plan.

Both Dad's and Mom's Wills were probated shortly after Mom died and Son was appointed as the Independent Executor of both Estates. Based on otherwise applicable state and federal law, as soon as Son was appointed as the Executor of Mom's Estate, he executed a "Disclaimer" (i.e., a renunciation) on behalf of Mom, declining to accept Dad's gift to Mom of Dad's interest in the BP Plan. Under both applicable Texas law and federal tax law, an Executor is authorized to execute a disclaimer on behalf of the decedent he represents.

While disclaimers originated pursuant to English common law centuries ago, today, all 50 states and the District of Columbia, have laws authorizing the making of disclaimers. A person who wants to make a disclaimer should comply with both applicable state law and applicable federal tax law and should usually make a "Qualified Disclaimer," if possible. The Texas Estates Code provides the Texas rules for making disclaimers. In addition, disclaimers are *specifically* authorized in at least 4 different sections of the federal Tax Code: the estate tax, gift tax, GST tax, and the income tax rules applicable to distributions from qualified retirement plans and IRAs (known as the "minimum distribution rules").

To make a "Qualified Disclaimer" for state and federal tax law purposes, here are the requirements:

1. The disclaimer must be in writing;
2. The disclaimer must be *executed* (signed in the presence of a notary public, who must complete the notarial acknowledgment) by the *disclaimant* (the person making the disclaimer) within 9 months of the date of the gift (which, in the case of a gift made upon death, means within 9 months of the decedent's death), BEFORE the *disclaimant* has "accepted" the gift or even any benefits from the gift (such as the income earned by the asset being disclaimed);
3. The disclaimed asset (the gift that is being renounced) must be distributed to the alternate beneficiary pursuant to the original instrument that made the original gift (i.e., the disclaimant cannot take any action to transfer the gifted asset–it's like a "hot potato" and the disclaimant can't touch it at all or direct where it goes);

4. Copies of the executed Disclaimer must be presented to the "record title holder" of the asset being disclaimed (such as the Plan Administrator in the case of a qualified retirement plan) and to the Executor of the decedent's estate; and
5. The original Disclaimer must be filed in the probate records with the particular probate court where the decedent's Will was probated.

In essence, a Disclaimer allows a person to refuse to accept a gift, resulting in the gifted asset then being distributed to the "next" beneficiary pursuant to the original document that made the gift, which could be the decedent's Will or a beneficiary designation form (as applicable). If the disclaimer is a *Qualified Disclaimer* under applicable state and federal law, there are no adverse tax consequences for the person making the disclaimer (i.e., the disclaimant is *not* treated as making a gift of the disclaimed asset to the actual, ultimate recipient of that asset). The disclaimant is simply treated as if he or she had predeceased the person making the gift, never having received that gift in the first place.

Per an old case, the historical basis for a disclaimer is the premise that, "No man should be forced to accept a gift against his will." A disclaimer is a legal right that every person has under both state and federal law, *including the minimum distribution rules* (i.e., the federal income tax laws applicable to distributions from qualified plans and IRAs after the participant's death).

So, in the case of Dad, Mom and Son, here is what SHOULD have happened when Son made the Qualified Disclaimer on behalf of Mom under otherwise applicable Texas and US tax laws: Dad's BP Plan should have become payable to Son as the contingent (or, secondary) beneficiary named in the beneficiary designation form because Mom is treated as having predeceased Dad due to her Qualified Disclaimer. Pursuant to the Pension Protection Act of 2006, Son, as the beneficiary of Dad's interest in the BP Plan, SHOULD have been able to move Dad's interest in the BP Plan in a "trustee to trustee" (or, direct) transfer from the BP Plan to an inherited IRA established for Son at a financial institution of his choice. When a "direct" transfer is made from the decedent's qualified plan to the beneficiary's inherited IRA, no federal income taxes have to be withheld. Also, no income taxes are triggered by such a transfer.

Under the minimum distribution rules (the federal income tax rules applicable to distributions from qualified plans and IRAs), Son SHOULD have been able to take a minimum required distribution ("MRD") from his inherited IRA each year, based on Son's life expectancy, not recalculated. Therefore, Son SHOULD have been able to "stretch" his inherited IRA over many years. The federal income tax rules that otherwise would have applied would require Son to take his first MRD by December 31, 2015 (the end of the year after Dad's death). Son's MRD for the first distribution year would be calculated using the *divisor* from the IRS's Single Life Table for Son's age as of his birthday in 2015 (i.e., 58). Per that table, Son's divisor for 2015 would be 27. Therefore, assuming the BP Plan attained a value of $2,500,000 on December 31, 2014, Son's MRD for 2015 would have been $92,592.59 ($2,500,000 ÷ 27), which represents approximately a 3.7% withdrawal from Son's inherited IRA in that first year. (In each subsequent year, Son would have to subtract the number 1 from the prior year's divisor to calculate his MRD.) Note that the *divisors* from the Single Life Table for Dad and Mom for 2015 (the first distribution year) would be 5.5 and 4.9, respectively.

HOWEVER, we are forgetting about Company Law! So, to continue with our true story, after Son submitted a copy of Mom's Qualified Disclaimer to the BP Plan Administrator, he discovered that, in recent years, BP had amended the documents applicable to the BP Plan to include the following provision:

"A Participant's Beneficiary may not be changed following the Participant's death, including, but not limited to, by a disclaimer otherwise valid under applicable law."

WOW!!! The BP Plan provision just quoted overrides otherwise applicable state and federal law and disallows disclaimers. As a result, the BP Plan *had* to be distributed to Mom, now deceased, as Dad's primary beneficiary. In addition, since Mom never submitted a beneficiary designation form for the BP Plan, Mom was deemed to have died without naming a "designated beneficiary." It was never exactly clear in this case whether Mom was being treated as the (now deceased) *beneficiary* of Dad or whether Mom was being treated as the (now deceased) *participant* of what used to be Dad's BP Plan. Regardless, the minimum distribution rule applicable when either the beneficiary or participant of a qualified plan is either Dad's age or Mom's age and there is no designated beneficiary results in *a huge acceleration of distributions from the plan and a huge acceleration of income taxes.* Again, compare the life expectancy of Son in the first distribution year–27 years–with the life expectancies of Dad and Mom in that year–5.5 years and 4.9 years.

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Can companies that sponsor qualified plans include an "anti-disclaimer provision" in their plan documents? While we are not aware of any reported federal case directly on point, other federal court cases involving other qualified plan provisions (such as requiring the participant and his spouse to be married for at least one year before the spouse is entitled to REACT benefits) indicate that companies can include provisions in their qualified plan documents that override otherwise applicable state and federal law, as long as ERISA is not violated. Therefore, BP's anti-disclaimer provision would probably be upheld by a federal court if challenged.

Perhaps the better question is whether companies *should* include anti-disclaimer provisions in their plan documents. No doubt, such a provision makes it easier for the Plan Administrator to distribute the plan benefits on the death of the plan participant and that is certainly one of the stated primary goals of ERISA. Yet, the anti-disclaimer provision can clearly thwart the intent of plan participants–who doubts that Dad would have wanted Son to have his BP Plan in this case with a good tax result? In fact, we would be very surprised if the top executives at BP were aware of this change to the terms of the BP plan. Normally, it is wealthier clients (such as executives at oil companies) and their families who take advantage of disclaimers to "move assets" in a tax-free manner to other beneficiaries after the participant's death, such as beneficiaries in lower income tax brackets and trusts designed to avoid estate taxes.

Bottom Line: Be aware that Company Law may have a much greater impact on your estate plan than you ever considered and try to plan accordingly.

Holiday Schedule. Our firm will be closed November 26 & 27 for Thanksgiving, December 24 & 25 for Christmas, and January 1 for New Year's Day. Happy Holidays to all our clients and referral sources!

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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