Estate Planning: A Proper Transfer

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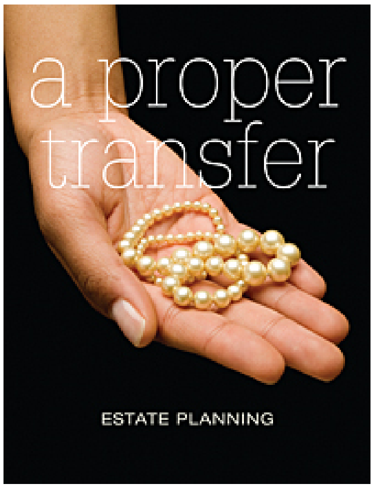

When your client dies, there are nine ways his or her assets can be passed on to heirs.

When an individual dies, every piece of property owned by that deceased individual must be transferred to a new owner. Both real property and personal property (tangible and intangible) can pass to the decedent's heirs in a number of ways. Property can take on many forms, such as shares of a closely held business (i.e., corporation, limited liability company, partnership), real estate, bank accounts, stocks, bonds, mutual funds, life insurance, annuities, qualified retirement plans (401(k)s, profit sharing, SEP, defined benefit), IRAs, Roth IRAs, 403(b) plans, 457(b) plans, non-qualified deferred compensation plans, notes and loans receivable, stock options, collectibles, jewelry, cash, etc.

Being able to discuss the post-death transfer of all types of property with your clients can give you an edge as a trusted professional advisor. Many clients are under the mistaken impression that all their property will pass under the terms of their wills. Nothing could be further from the truth. Each and every piece of property owned by a client at death must be inventoried, valued, and distributed according to the property transfer laws of descent and distribution.

Nine ways property can be legally transferred at death:

1) Intestate: Property owned in a sole name (individually) is considered probate property and will pass according to statutory state intestacy law when there is no will. The final distribution must be approved by the Probate Court.

2) Will: Property owned in a sole name (individually) is considered probate property and will pass to heirs according to specific directions in a legally executed will. The final distribution must be approved by the Probate Court.

3) Living Trust: The trust may be revocable or irrevocable. A revocable living trust automatically becomes irrevocable upon the death of the grantor. Property owned in the legal name of the trustee passes to trust beneficiaries according to the terms of the trust. The remaining beneficiaries of the trust may be individuals or another trust. Property owned by a living trust will not be subject to probate.

4) Testamentary Trust: Property owned in a sole name (individually) first passes through the will, and then into the trust by specific language in the will. The remaining beneficiaries of the trust may be individuals or another trust. The property passing through the will is probate property and the final distribution to the testamentary trust must be approved by the Probate Court.

5) Contract in Lifetime: A classic example of a contract in lifetime is a buy-sell business transfer agreement. At the death of a business owner, the shares of the business are purchased from the estate by a third party (i.e., corporation or surviving shareholder). This transaction will not be subject to probate.

Another good example is a contingent-owner designation of a third-party-owned life insurance policy. Upon the death of the policy owner while the insured is still alive, the ownership of the policy will automatically transfer to the contingent owner and will not be subject to probate.

6) Beneficiary Designations: Life insurance, annuities, qualified retirement plans, IRAs, non-qualified deferred compensation benefits, and transfer on death (TOD) designations of non-qualified investment accounts all pass to the designated beneficiary and will not be subject to probate. The designated beneficiary may be an individual or a trust.

7) Joint Tenancy with Right of Survivorship (JTWROS): This undivided interest in property passes automatically by operation of law to the surviving joint owner and will not be subject to probate.

8) Tenancy in Common: This undivided interest in property owned in a sole name (individually) with other tenant-in-common owners passes according to specific directions in the will of the deceased or by the intestacy laws of the state if there is no will. The tenant-in-common interest is probate property and final distribution must be approved by the Probate Court.

9) Qualified Disclaimer: If the recipient of any type of property executes a qualified disclaimer within nine months of the death of the owner of probate property, the property in question will instead pass to the remaining beneficiaries of a probate estate. For life insurance, annuities, qualified retirement plans and IRAs, the property in question will pass to the contingent beneficiary when the designated primary beneficiary disclaims. Sometimes a “double disclaimer” needs to take place in order for the disclaimed property to be transferred to the desired heir.

Each and every asset owned by a deceased individual must pass through one of the property transfer methods described here. Financial professionals should record and update an accurate asset inventory for their clients that lists current value, asset title, and whether the asset will pass through the probate court process or not.

State estate taxes and IRD income taxes

Also, certain states have state estate taxes that must be paid. Generally, states that “de-coupled” from the federal estate tax system so they could continue to levy death taxes on their deceased residents have progressive state death taxes ranging from about 5 percent up to 16 percent, depending on the size of the taxable estate. There is currently a federal estate tax deduction for any state death taxes actually paid. If the “sunset” of the current federal estate tax law takes place as scheduled on December 31, this federal estate tax deduction will automatically revert to a federal estate tax credit as it existed prior to 2005.

States that remained “coupled” to the federal estate tax system currently have no state death taxes at all since the phase-out of the “pick-up” state death tax credit in 2005. However, if the “sunset” of the current federal estate tax law takes place as scheduled on December 31, these “coupled” states will automatically be “re-coupled” to the federal estate tax system and will receive an amount of federal revenue sharing in the form of the so-called “pick-up” estate tax according to the Credit for State Death Tax Table of IRC Section 2011. Thus, “coupled” states like Florida, Texas, and California will once again “pick-up” a share of estate taxes as they did prior to 2005. Financial professionals should advise their clients whether or not state death taxes may be part of their planning picture again depending on whether their state is a “de-coupled” state or a “coupled” state.

Finally, financial professionals should advise their clients whether or not there will be any post-death income taxes on certain financial assets. This post-death income is known as “income in respect of decedent” (IRD). Two major types of financial assets affected by this post-death IRD tax are qualified retirement plans (i.e., IRA and 401(k)s) and the deferred gain amount in excess of the cost basis for non-qualified deferred annuities. Plan beneficiaries of these assets will report the receipt of these post-death taxable amounts as ordinary income on their own federal and state personal income tax returns. There are certain options available under the Internal Revenue Code and Regulations to spread out the IRD post-death taxation over a number of years after the account owner’s death if desired. Generally, these rules allow up to five years as a post-death distribution option or, conversely, a post-death distribution option over the life expectancy of the beneficiary. Smaller accounts may opt for the five-year plan whereas larger accounts may find the life expectancy method more suitable to their needs. Clients should consult their financial professionals and tax advisors to explore these post-death “inherited” IRA or “inherited” non-qualified annuity distribution options.