TESTAMENTARY SUBSTITUTES

OPERATION OF LAW TRANSFERS

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There are three types of post-mortem transfer techniques: **Operation of Law Transfers**, **Testamentary Transfers** and **Statutory Transfers**. All three have different distribution requirements timeframes upon which distribution actually occurs. As a general rule, when expediency is the primary objective, Operation of Law Transfers are favored. Where Surrogate's Court oversight is required (such as Testamentary Transfers) or demanded (Statutory Transfers) the timeframe of actual distribution may increase drastically.

Certain transfers, such as by operation of law, do not require direct court oversight, while others, such as Testamentary transfers (I.e. property transferred by the Probate of Wills) require direct oversight. However, where there is a dispute over any property of a decedent, no matter what type of transfer is involved, the Surrogate's Court has original jurisdiction over the matter. This includes claims of wrongful death and creditor disputes, as well as disputes among family members.

Remember that an "Estate" is, essentially, the property of a deceased person: We do not know who receives these assets outside of what is contained in a Will or, in the absence of a Will, the distributive pattern of Estate Administration. This is the allure of utilizing Operation of Law transfers: The property has a designated beneficiary, thereby not being a deceased person's property after death, and thereby passing outside of Probate.

Because these assets transfer outside of a Last Will and Testament, they are often referred to as **Testamentary Substitutes.**

The primary document to enable the transfer of Operation of Law assets is an original **Death Certificate**.

A **Beneficiary Designation Form** will be required for Retirement Plans and Life Insurance Policy transfers, and a TOD account will need to be set up by the account owner. Both must be completed prior to the owner's passing.

Though some estate planning practitioners prefer to merely advise clients on how to name their beneficiaries on these forms, it is a better practice for the practitioner to both prepare life insurance and retirement plan beneficiary designation forms for the client, then follow up with the respective institutions a few months later to ensure the proper beneficiaries are actually recorded. Setting up TOD accounts is not the practitioner's duty, as it requires greater financial institution oversight.

For many married clients assets being transferred by operation of law may represent the bulk of the couple's estate: A couple with a jointly owned house and bank account serving as the main source of paying expenses, some assets in retirement accounts and a modest life insurance policy may have only a fraction of his or her assets pass under their Will. Due to this reality, an attorney who merely prepares a Will for his clients should be very clear that he is not preparing a comprehensive estate plan.

1. Life Estates

A Life Estate is typically a retained interest in real property, and it is usually both initially owned and created by the Grantor [the "Life Tenant"]. The Life Tenant is entitled to possession, use and enjoyment of the real estate during his or her life, and upon his or her passing the real property transfers to the remaindermen. The remaindermen need not go through Probate to enable this transfer, and can instead merely do a Deed Change with the municipality. An original Death Certificate will be required.

The creation of the Life Estate may take place in a number of ways, and may be more labor-intensive than the actual transfer of the real property at the passing of the Life Tenant. The simplest and most cost-effective way to create a Life Estate is to have the Grantor / owner of the property execute a new Deed that creates the Life Estate to the real estate during his or her lifetime. Under these circumstances the only outside involvement is the filing of the new Deed with the relevant municipality. If, however, the Life Estate is created pursuant to a Will the creation of the life estate will be a bit more labor-intensive, as it requires Probating the Will prior to this process.

While still suitable for the sake of transferring assets outside of Probate, Life Estates have some negative consequences in the Elder Law world: The fractional interest of the real estate owned by the life tenant may have a Medicaid Lien attached to it by the Department of Social Services if the life tenant utilizes Medicaid Institutional Care (I.e. nursing home care). Though this topic is beyond the scope of this program, it is imperative to consult with an Elder Law attorney prior to creating a Life Estate when Medicaid Planning is being contemplated.

2. Transfer on Death / In Trust For / Payable On Death

Transfer on Death accounts ["TOD""] are governed by EPTL Section 13-4. Legislation was originally passed in 2006, and some minor modifications have taken place since then. Some financial institutions will also use the terms In Trust For ["ITF"] or Payable on Death ["POD"], though the nature of the accounts are effectively the same: During life the account holder has sole, revocable access to the account, and upon death the transferee can collect any remaining funds or securities outside of Probate by merely providing a Death Certificate to the financial institution.

Prior to the passage of ETPL 13-4 New York permitted the use of Totten Trust accounts which had the same end-effect. While Totten Trust accounts do still exist, most new accounts are now set up as TOD accounts.

TOD accounts have become popular for several reasons: Assets pass without Court fees and the wait times associated with Probate or Administration, the beneficiary of the account need only go to the financial institution (and may receive the assets on the same day), and the owner may increase or decrease the amount of the account at a moment's notice. In addition, they may be useful for paying for burial costs (provided the beneficiary of the account uses the funds according to the original owner's instructions).

TOD accounts are not the best option where a beneficiary is a spendthrift: Funds vest in the beneficiary's name upon retrieval of the account. However, some financial institutions will allow a TOD account to vest to a Revocable Trust at death. Whether this is a good practice (I.e. just name the account after the Trust to begin with) should be determined on a case-by-case basis.

3. Joint Property

Unlike Tenants in Common Property[1] (which passes as a Testamentary transfer unless owned by a Trust), joint property does pass by operation of law. Joint property may include real property, investment accounts, and the like. All that is required to claim the property is a death certificate and that the other named party to the property outlives the decedent.[2] Ownership of joint property vests in the survivor even if title is not formally changed to the survivor as sole owner, such as when a spouse who own real estate as Tenants by the Entirety[3] with another spouse who predeceases but does not change the Deed to reflect her new individual ownership.

Due to the ease of the transfer and access to joint property, it has a valuable place in estate planning. However, when taking estate tax considerations into account, a practitioner should attempt to minimize the amount of joint property owned between spouses and / or parents.

Analysis of Account Designations

Type of Account	Current Effect	Future Effect
True Joint Account	Both parties have full access	Survivor gets all
Tenants in Common	Both have present interest in ½	Survivor has future interest in ½
TOD / Totten Trusts	Account owner owns all; survivor not entitled to anything now	Survivor gets all
"Account of Convenience"	Account owner owns all; survivor not entitled to anything now	Assets go through Probate or Administration

Of greater concern is the concept of a "Convenience Account." These accounts are set up so that a second individual may access the funds, typically a child as a joint owner of an account for an aging parent. While this does allow a more-healthy individual to help another person access the funds, upon death the joint owner does not receive the funds. This is typically because the joint

[1] EPTL §6-2.2

[2] However, in the case of bank and investment accounts, see New York Banking Law §675, which allows a party to rebut the transfer to the survivor if the account merely state "Joint Tenant," in which case the account is considered an "account of convenience," in which case the property becomes a Testamentary asset. In order to ensure the property passes to the joint owner the term "Joint Tenant with Right of Survivorship" should be used.

[3] EPTL §6-2.2(b); "Tenants by the Entirety only applies to Real Property owned by spouses, and allows a spouse's homestead to be sheltered from his or her spouse co-owner's financial depravities.

owner did not have the chance to sign the account's signature card, which has long been a litigated matter. If access to funds is the primary motivator for creating a Convenience Account, it is preferable instead to execute a Power of Attorney for the client and set up an individually-owned bank account or TOD account.

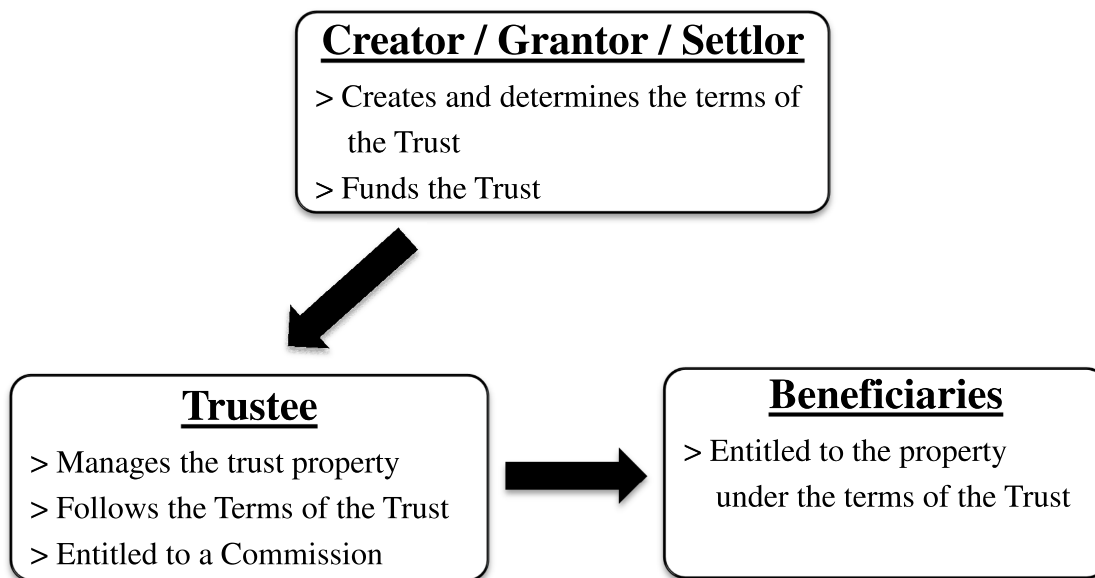
4. Trusts

Transfers in trust pass by operation of law. The caveat is that the mere existence of a trust is not sufficient to transfer assets – an unfunded trust is akin to a bank account with no money in it. Merely naming the property to be owned by the trust in the trust document is also insufficient.[4]

A trust must be funded in order to transfer any assets. The owner of the property must be the trust, such as a bank account being owned by ***"The Doris Day Revocable Trust,"*** or the Deed to a house naming ***"John Rockefeller, Trustee of the John Rockefeller Revocable Trust."***

There are numerous, powerful benefits to utilizing trusts. Some of these benefits may be available using either **Inter Vivos Trusts** (those created during life using a separate instrument, sometimes referred to as "Stand Alone Trusts") or **Testamentary Trusts** (trusts created after death, typically by a section in a Will).[5] However, certain powers and benefits only apply to inter vivos trusts.

A. Parties to a Trust



[4] This concept, known as "Incorporation by Reference," used to be permitted under New York state law. However, currently New York does not recognize Incorporation by Reference, either for property or for one estate planning document (such as a Pour-Over Will) instructing a party to respect the terms of another document (such as a Trust).

[5] A Will containing a testamentary trust should name both an Executor and a Trustee within the Will; these individuals do not have to be the same person or entity.

There are three primary parties to any Trust: The Settlor (also known as the Grantor or Creator), the Trustee and the Beneficiary. Each party may include more than one individual, such as two grandparents who create and fund a trust (the Settlors) who name their three children to administer to the property in the trust (the Co-Trustees) for the benefit of the Settlor's grandchildren (the Beneficiaries).

Settlor (or **Grantor,** or **Creator)**[6]**:** The Settlor creates the trust, typically with the assistance of an attorney, executes the trust, and funds the trust. The Settlor of a trust can never change – once a trust is created by a party no other party can create it, though other people may be permitted to contribute to the trust.

Trustee: The Trustee is the fiduciary of the trust: He manages and invests the trust property, follows the terms of the trust, represents the interests of the trust (such as protecting the beneficiaries assets in the trust from creditors), and distributes trust funds to the beneficiaries. Trustees are entitled to a commission of approximately one percent (1%) of principal, income and distributions,[7] but are not required to accept them. Upon the resignation, death or incapacity of a Trustee a Successor Trustee takes the initial Trustee's position and responsibilities. This allows for continuity of administration of trust assets. Because the creator of a testamentary trust is deceased at the moment the trust is created, it should be obvious that the testator should not name himself the trustee of his own testamentary trust.

Beneficiary: There are frequently several levels of Beneficiaries. There is typically an initial beneficiary(s), followed by one or more remainder beneficiaries once the initial beneficiary no longer receives trust funds. A beneficiary may compel the Trustee to account for trust funds and expenses, but there is still a question as to whether a Trustee has an obligation to inform a beneficiary of her right to receive trust funds prior to the time they are entitled to distributions. Again, the creator of the testamentary trust is deceased, and should not name himself the beneficiary of the trust.[8]

B. Benefits of Using Inter Vivos Trusts

The general rule for estate planning practitioners is that use of inter vivos trusts is almost always the preferred way to distribute estate property. The only rational reason not to have an inter vivos trust implemented is when the client does not want to pay the added legal fees for the additional document(s). Probate is not required if all of the Settlor's potential testamentary assets are held in an inter vivos trust, but a Will should always be created in addition to a trust for any assets that are not titled correctly. Therefore, it is best to view an inter vivos trust as the complement to a Will, and not as a supplement.

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[6] These three terms are used interchangeably, though it is preferable to use the term "Settlor" in the trust document; the term "Grantor" is most frequently used to describe trust income tax treatment (see below); the term "Creator" is rarely used in legal documents, but is the best term to describe the position to the client. Therefore, it is best to show the client all three terms together at once.

[7] SCPA § 2307 serves as the default rate available to Trustees, however the Settlor may permit higher or lower commission levels in the trust instrument.

[8] Though the testator / settlor may allow their trustee to reimburse or supply the executor of his estate the expenses needed to pay for estate expenses used for the benefit of the testator, such as burial costs.

Much like Wills, the **Rule Against Perpetuities** does apply to both inter vivos and testamentary trusts, but some states, such as Delaware and Alaska, allow for much longer ROP periods than 21 years, or abolish the rule entirely. [9] Only inter vivos trusts may have their "situs" changed in order to take advantage of these and other valuable benefits. The ROP to a Will is applicable as to the date of death, whereas the ROP for an inter vivos trust commences upon the execution of the trust.

1. Avoidance of Probate / Continuity of Asset Management

Trust assets pass by operation of law, thus are not Testamentary transfers, and thus do not pass through Probate. This is desirable for several reasons. Probate has filing fees that are not required for transfers in trust. These court fees are reasonable, but the paperwork required to Probate Testamentary assets is lengthy and may add substantial attorney fees to administration expenses. Probate also takes more time to accomplish than trust administration, due to the fact that multiple court requirements must be fulfilled. When a person passes away her assets are required to be frozen until Letters Testamentary have been issued. However, if a successor trustee is named in the instrument and agrees to serve, inter vivos trusts allow these assets to be administered, traded or transferred.[10]

Probate is a public affair – even lineal descendants who are being disowned by the Testator are entitled to notice of Probate, whereas the *administration of Trusts is a private affair.*[11] Administration and distribution of trust assets is much faster than going through Probate. Lastly, Inter Vivos Trusts (those created during the Settlor's life) require no court supervision, whereas Testamentary Trusts (those created by a Will at the death of the Testator) may require court oversight and supervision, thereby drastically increasing expenses.

Negatives aspects of trusts are (1) trusts are typically more expensive to create than Wills, and (2) a great deal of time may be required to fund the trust by renaming the Settlor's assets. In addition, the mere existence of a trust does not obviate the need to have a Will in place as well, since it is inevitable that some assets will not be owned by the trust.[12]

If the Settlor / Testator does not perceive a conflict between family members he or she may choose to have a **Pour-Over Will.** This Will has standard Will provisions (naming an Executor, preferred Guardian of minor children, etc.), but also includes the entire content of his or her trust, which states how the estate is to be distributed. The property not owned by the Trust does go through Probate, but the beneficial testamentary pattern is maintained. This can be done by simply "copying and pasting" the trust into the Will.[13] Therefore, even though the Pour-Over

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[9] Delaware has abolished ROP entirely, excluding real estate, thereby enticing billions of out of state dollars to be held in trust and managed within the state. In addition, this allows wealthy individuals to create "Dynasty Trusts" that have the potential to provide trusts distributions and protections for several generation of their family.

[10] Active management of trust assets may not be desirable if the estate wishes to take advantage of six month alternate valuation rules.

[11] Despite this secrecy, an interested party may still petition the Court for information regarding the Trust if he knows to ask, and would probably do so if he or she was disowned by the Decedent.

[12] For example, few clients will change the title to their automobiles to being owned by their trust.

Will shall be a longer document than the trust itself, it may have less significance for transferring estate property.[14]

2. Avoidance of Ancillary Probate

Certain property, such as cash in a bank account or securities in a brokerage account, are considered fungible for estate administration purposes – the fact that the financial institution is in a state other than the decedent's domicile has no relevance in determining the proper venue to Probate the assets. However, real property and the personal property located in that real property is different. Real property is unique: It cannot be transferred, so a decedent's estate owning real property in two or more states shall need a Will in each of those states and shall face Probate (or Intestacy) in each of those states.

The process of having to hold a Probate proceeding in a non-domiciliary state is known as **Ancillary Probate**. From a financial perspective this process has no benefit, as attorneys in two different states will need to do nearly identical work in order to settle the decedent's estate. Ancillary Probate can be avoided by having the out-of-state real property owned by a trust. Because property owned by a trust does not need to be Probated the real property in the second state avoids Probate entirely.

3. Types of Inter Vivos Trusts

The number of trusts that can be created during the Settlor's life and the terms that can be applied to them are only as limited as human imagination and certain laws will allow. One important rule does remain constant: <u>Any and all trusts become irrevocable upon the death of the Settlor, even Revocable Trusts.</u> What follows is a brief explanation of frequently utilized inter vivos trusts.

a. Revocable Trusts: Settlor's Alter Ego / Seamless Transition

Frequently the Settlor will serve as the initial Trustee and Beneficiary of his or her Trust: Trust property is administered by the Settlor for the benefit of the Settlor. Upon the Settlor's incapacity his or her choice of Successor Trustee can continue to use trust assets for the Settlor's benefit. Upon the Settlor's death the next Beneficiary begins receiving trust assets (typically a spouse, child, more distant family member, friend, or a charity). <u>*This is currently the most frequently utilized Trust*</u>: The trust acts as the Settlor's alter-ego by creating wealth, administering these assets and taking distributions, while also permitting near-seamless transition of administrative power and funds to other parties. In this vein, because the trust property is included under several Grantor Trust IRC sections any income generated by the trust is taxable at the Grantor's favorable income tax rate. However, a revocable trust is included as property included under IRC §2038, so property held in revocable trusts are always included in the Settlor's gross estate for estate tax purposes.

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[14] If the Settlor / Testator does perceive a dispute amongst descendants receiving differing amounts of estate assets he or she will NOT want a Pour-Over (because the terms of the trust are public); and may choose to have the unequal portion transferred by a Trust (thereby maintaining enhanced privacy) with the remaining amount transferred by a non Pour-Over Will (which is transferred publicly).

b. Irrevocable Trusts

All trusts, including revocable inter vivos trusts, become irrevocable upon the death of the Settlor.[15] Apart from **Decanting** under EPTL Section 10-6.6, irrevocable trusts cannot be changed.[16] In addition, unless Grantor Trust Rules apply, the trust will need its own tax identification number and will need to pay taxes on any investment gains, even if this income is not distributed to the beneficiaries.

➔ *Keep in mind that successfully transferring property does not automatically mean the transfer avoids estate taxation – the terms of the trust must comport with IRC sections 2033 – 2044 in order to avoid inclusion in the gross estate for estate tax purposes.*

Some irrevocable trusts are created to transfer wealth to family members in order to avoid estate taxes or prepare for Medicaid Planning. Some may have simple terms that merely require the Settlor to transfer funds into the trust. Other trusts, such as **GRATs** (grantor retained annuity trusts)**, GRUTs** (grantor retained unitrusts)**, QPRTs** (qualified personal residence trusts)[17] and **QDOTs** (qualified domestic trusts) attempt to avoid estate tax by transferring property several years in advance and using IRS mandated formulas and percentage rate[18] in order to escape estate taxation. **CLATs** (charitable lead annuity trusts) and **CLUTs** (charitable lead unitrusts) use these same formulas and rates to leave an income interest to charities with a remainder interest to family members (giving the Settlor both an income and estate tax deduction): **CRATs** (charitable remainder annuity trusts) and **CRUTs** (charitable remainder unitrusts), give the family member(s) a lifetime income interest, and leave the charity a remainder interest (thereby providing the Settlor with an estate tax deduction).

4. Funding Inter Vivos Trusts

Unlike testamentary trusts, which are funded through the Probate process, inter vivos trusts must be funded prior to the Settlor's death. An unfunded inter vivos trust is ineffective in transferring assets by the terms of the trust, which leads to the assets having to pass by the Settlor's Will (Probate), Intestacy or a form of operation of law transfer. It is absolutely essential that the attorney oversees the process of naming assets correctly to fund the Settlor's trust.

Example: An investment or bank account should be named ***The Margaret Smith Revocable Trust.*** In order to avoid Ancillary Probate, the Deed to an out of state residence should be titled to ***The Jeremy Roberts Revocable Trust, Jeremy Roberts as Trustee***

Most financial institutions and insurance companies will require two aspects of the trust before they will allow the account to be owned by the trust: (1) The page with the Article naming the

[15] However, as shall be discussed later, a trust may be altered if it meets the requirements of New York's "Decanting" statute, EPTL §10-6.6(b).
[16] Unanimous beneficiary approval may be nearly impossible to attain, especially where minors are involved.
[17] IRC §2702
[18] IRC §7520; these interest rates are revised monthly.

trust, and (2) the signature page of the trust.[19] A less experienced estate planning practitioner should initially ask for the assistance of a financial planner and bank manager in correctly setting up a client's trust accounts; setting up these accounts typically does not cost the client any administrative funds. When retitling real estate to a trust as the owner a practitioner should work with a Title Insurance company to file the Deed; this will often lead to costs associated with changing the Deed with the municipality and fees owed to the Title Company for preparation, but these costs are often well worth the expense.

5. Using Inter Vivos Trusts to Transfer Operation of Law Assets

Certain operation of law assets, life insurance and retirement accounts in particular (as described further below), can name a trust as the beneficiary of the asset. This provides two important safeguards for the beneficiary. First, a trust beneficiary who may not have financial discipline can have life insurance or retirement plan proceeds distributed at intervals instead of all at one time. Second, as explained below, a beneficiary with creditor issues will not receive the asset, but rather have them held in trust until a settlement can be made with the creditor.

C. Creditor Protection / Naming the Correct Trustee

One substantial benefit of using trusts is the power to protect trust assets from creditors. A Settlor cannot protect his own property from creditors by placing it in a trust for his own benefit. In addition, state law permits a person's creditors to attach certain transfers which are made in anticipation of a lawsuit.[20] However, a trust, whether it is an Inter Vivos or Testamentary Trust, does allow for creditor protection of Trust assets for almost anyone other than a Settlor (though a spouse or a beneficiary may not have complete protection). The rationale for allowing this protection is that the property held in trust is owned by the Settlor or his estate, so he and his successor fiduciaries may dispense with the funds as they see fit. In New York it is assumed that the Settlor desires this protection for his beneficiaries, even if the trust is silent as to this protection.

For example, a family member who has defaulted on his debts is the beneficiary of a trust. Under the trust instrument the trustee is permitted to withhold trust distributions if he believes it would be prudent to do so. When the beneficiary's creditors demand payment the trustee can continue to withhold distributing trust funds to the beneficiary until the creditors negotiate for a lower settlement amount (perhaps forty percent of what is owed, though the actual amount will vary depending on the circumstances).

This strategy will typically not succeed if the beneficiary also happens to be the trust's sole trustee or if the trustee is "beholden" to the beneficiary, such as a spouse, employee or child of the beneficiary. Some exceptions may be made if the distributions are based on an **Ascertainable Standard** for the <u>trustee/beneficiary's</u> **health, education, maintenance or**

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[19] For this reason it is a good practice to include an Article explicitly naming the trust, and having the following trust requirements on the same page: (1) the Settlor and Trustee's signatures, (2) the signature of two witnesses, and (3) notarization of the Settlor and Trustee's signatures.

[20] For example, if a parent involved in a driving accident believes he will have to compensate the victim, then tries to transfer the bulk of his property in an irrevocable trust for the benefit of his children, the victim

support [sometimes referred to by the acronym **"HEMS**"],[21] but there are several intricacies that should be understood before naming a beneficiary as the sole trustee of his or her own trust. To avoid these problems it is advisable to include trust language permitting a trustee or trust protector to appoint a disinterested co-trustee.

D. Estate Tax Credit Shelter Trusts (for Married Couples)

Another advantage of both testamentary and inter vivos trusts is their ability to shelter estate assets from estate taxes. A **Credit Shelter Trust**, also known as an "A/B Trust," is typically not its own document, but a provision in a trust or Will that holds aside the estate tax credit amount upon the death of a married decedent. This credit shelter amount may be referenced as either the federal exemption amount, the New York state exemption amount, or specifying neither, allowing the then-serving trustee to make the determination. The practitioner should typically avoid refering to the exemption as a **Pecuniary Formula** (a specific dollar amount) which would make it rigid and inefficient due to changes in future legislation, but should instead use a **Fractional Formula** (defines the parameters of the numerator and denominator of the bequest) to determine the credit shelter amount.

Qualified Terminal Interest Property ["QTIP"] Trusts[22] may be suitable when only one spouse has substantial assets and does not want the other spouse to have unfettered access to the principal of his or her credit shelter amount. At a minimum a QTIP must leave an income interest to the less wealthy spouse while permitting the wealthy spouse to name the residuary beneficiary and utilize the less wealthy spouse's estate tax exemption. A QTIP is typically used when the wealthy spouse is remarried but has children from a prior marriage, or when the wealthy spouse does not feel the surviving spouse will be responsible for managing a CST's principal. In order for a QTIP Trust to be effective in utilizing the non-wealthy (surviving) spouse's estate tax exemption amount the trust must meet the following requirements: (1) the property must pass from the decedent, (2) the surviving spouse must have a "qualified income interest for life" in the property, and (3) the decedent's Executor or Trustee must make a valid election to treat the property as a QTIP, at which time the election becomes irrevocable.

E. Supplemental Needs Trusts

Of the many irrevocable trusts that are available in addition to those already mentioned, perhaps the most frequently utilized one is the **Supplemental Needs Trust ["SNT"]**[23]. It is crucial that an estate planning attorney understand how to use SNTs, even if they are not drafting the documents themselves, and may want to partner with an elder or disability law attorney to ensure the SNT is effective.

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[21] See Jennings v. Smith, 161 F.2d 74 (2d Cir. 1947) and Leopold v. US, 510 F.2d 617 (9th Cir. 1975) regarding guidelines for determining guidelines for an "ascertainable standard"; however, also see Estate of Flood, 262 A.D. 2d 643 (1999) regarding permitting a creditor the right to attach all property subject to a trustee/beneficiary's power to withdraw.

[22] IRC §2056(b)(7)

[23] EPTL §7-1.12

SNTs are irrevocable discretionary spendthrift trusts that terminate at the death of a named beneficiary who has a severe and chronic or persistent disability (even if the recipient is over the age of 65). SNTs are meant to supplement (not supplant) government benefits which the individual is eligible, such as Medicaid, Supplemental Security Income and Social Security Disability Income.[24] Funds transferred to these trusts are meant to be used for a disabled beneficiary for any purpose that is not being paid for by a government program. Vacations, wide screen televisions and clothing are all permissible expenses. However, the beneficiary cannot be the trustee, and can never receive trust funds in the form of cash or a check.

SNTs can be created inter vivos or testamentary, but it is often best to avoid testamentary SNTs to minimize future Surrogate's Court supervision and associated legal fees. The trust document must clearly state that the beneficiary cannot have power to assign, encumber, direct, distribute or authorize distribution from trust. The be submitted to the Department of Social Services to assure the trust conforms with state requirements, and must name a remainder beneficiary.

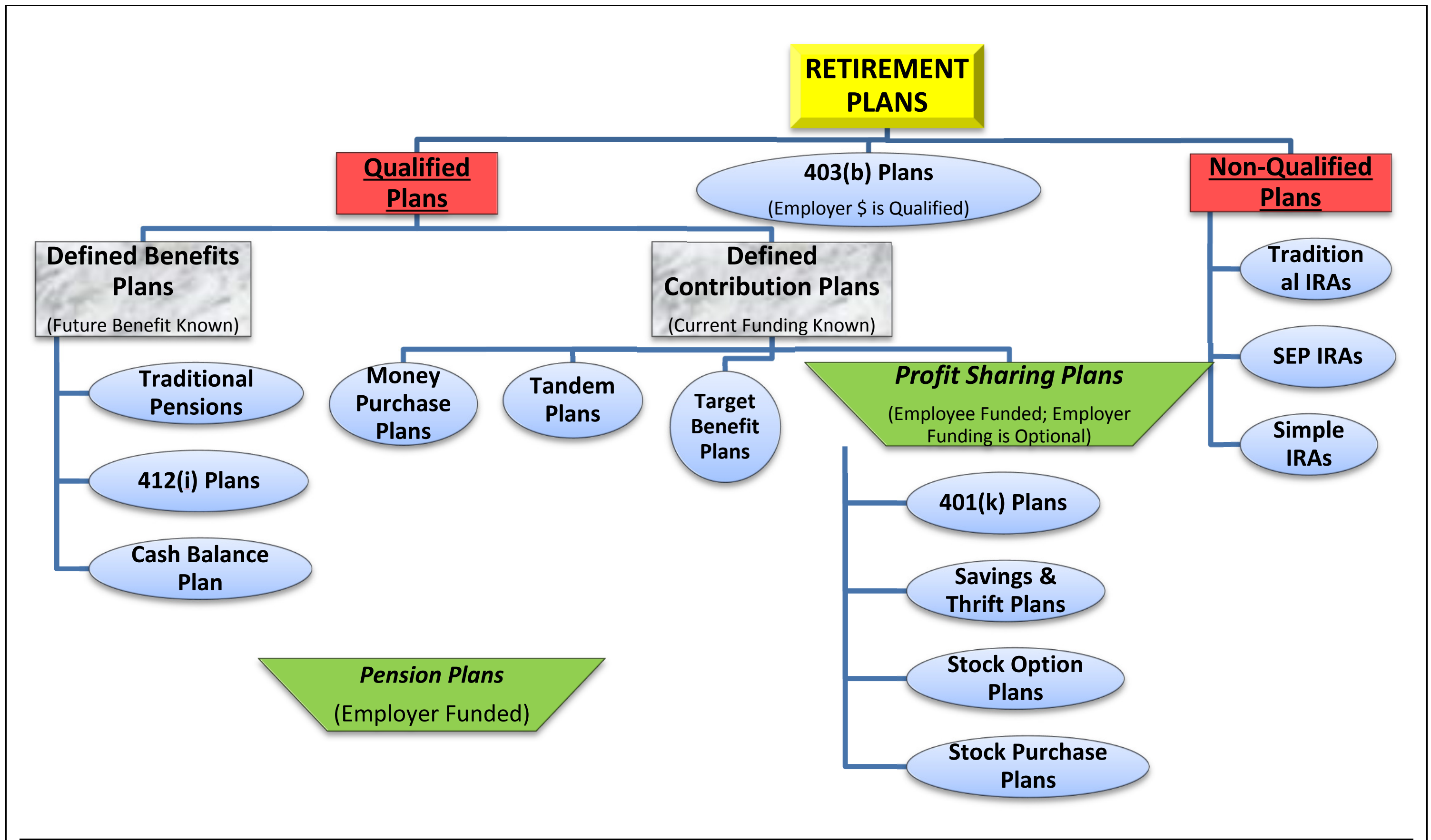
"Third Party SNTs," meaning those created and funded by a settlor other than the beneficiary, and must be established by a parent, grandparent, legal guardian, or court, even if the funds being used are for an individual who also has full mental capacity. Because the trust corpus is from a third party the remainder trust principal is directed to a named remainder beneficiary at the death of the disabled individual. "First Party SNTs" are created with the beneficiary's money (typically from an unforeseen inheritance or lawsuit), and must contain a payback provision for Medicaid.

5. Retirement Plans

Retirement plans, such as IRC §401(k)s and §403(b)s Plans or Individual Retirement Accounts ["IRAs"] also pass by operation of law. As will be discussed later, it almost always makes sense to name a spouse as primary beneficiary for a retirement plan due to favorable Required Minimum Distribution[25] ["RMD"] rates. Otherwise, consideration should be made to determine whether to fund the participant's Credit Shelter Trust with the principal from the plans. When neither of these scenarios apply it may make sense to have the beneficiary of the plan be a See-Through Trust for the benefit of the plan participant's children in order to provide creditor protection associated with Trusts while simultaneously ensuring favorable RMD rates.

Due to both the massive amount of wealth currently held in retirement plans and the impending retirement of a large percent of the US population, and considering the amount of wealth in New York, an estate planning attorney must quickly attain a level of comfort and understanding of the issues surrounding retirement plan. Retirement plans pass by operation of law, so a beneficiary designation form (not a Will) provides the means to successfully transfer the property.

[24] For an SNT to be valid the beneficiary must typically be receiving either SSI or SSDI.
[25] IRC §72(t)



A. Required Minimum Distributions [“RMDs”]: During Life

IRC §72(t) mandates that owners of certain retirement accounts begin taking distributions the year they turn 70½.[26] These distributions are known as **Required Minimum Distributions [“RMDs”].** Missing an RMD or underpaying what is owed leads to the IRS assessing a 50% penalty on the shortfall.[27] The amount of RMD due is determined using (1) the total IRA and Qualified Plan balances on December 31st of the prior year divided by (2) the percentage noted in the standard IRS “**Uniform Tables.**”

[26] Exceptions include qualified funds when the employee is still working at the business sponsoring the plan and Roth IRAs. However, non-spousal beneficiaries of a Roth must begin taking RMDs from the inherited Roth account.
[27] Use IRS **FORM 5329**, which asks the IRS for an exception for missed RMDs (due to bad health, bad advising, etc)

Age	Distribution Period	Age	Distribution Period
70	27.4*	93	9.6**
71	26.5	94	9.1
72	25.6	95	8.6
73	24.7	96	8.1
74	23.8	97	7.6
75	22.9	98	7.1
76	22.0	99	6.7
77	21.2	100	6.3
78	20.3	101	5.9
79	19.5	102	5.5
80	18.7	103	5.2
81	17.9	104	4.9
82	17.1	105	4.5
83	16.3	106	4.2
84	15.5	107	3.9
85	14.8	108	3.7
86	14.1	109	3.4
87	13.4	110	3.1
88	12.7	111	2.9
89	12.0	112	2.6
90	11.4	113	2.4
91	10.8	114	2.1
92	10.2	115+	1.9

RMDs are based on a person's life expectancy: The tables require a higher percentage of plan assets to be distributed to older recipients and lower amounts to younger recipients. A 70 year old has to withdraw 3.77% of her retirement funds (100 / 27.4*), and pay income taxes on this amount, whereas a 93 year old will have to withdraw 10.4% (100 / 9.6**) of her combined retirement account values. Some commonly used abbreviations to describe how the RMD process works include:

- **Applicable Distribution Period ["ADP"]**: the period during which benefits can be distributed
- **Required Begin Date ["RBD"]:** April 1st of the year following the year in which participant reaches age 70½
- **First Distributions Year ["FDY"]:** Typically the year owner reaches 70½ at which time the distribution can be made by December 31st of that year. However, this can be postponed to April 1st of the following year. The RBD is the following year (because a distribution is "required" by then). Waiting for the RBD will lead to two years worth of distributions and income taxes (one for FDY and one for the RBD year)

B. RMDs After Life

Estates and charities receive the worse RMD treatment, because an estate or charity does not have a life expectancy. Of course, since a charity is not required to pay federal income taxes this is not a terrible outcome. However, for the estate this will lead to the **5 Year Rule** for RMD purposes: The retirement account must be distributed in full by the fifth year after the death of the participant, leading to large income tax rates in the short term.

Spouses receive the most favorable RMD treatment: A surviving spouse may either (1) keep the funds in the deceased spouse's retirement account (and distribute RMDs based on the deceased spouse's life expectancy), or (2) transfer the account to his or her own retirement plan.

All other individuals must transfer the retirement account of a decedent to an "Inherited IRA." A non-spousal beneficiary must begin taking RMDs no matter what his age, but because he is typically younger than the participant RMD rates are relatively low. This allows for gradual distributions, thereby assessing lower income taxes in any given year, and longer tax deferral

periods. This is known as a **Stretch IRA**, since the beneficiary is stretching distributions based on his or her longer life expectancy.

Inherited IRAs: Aside from instances of fraud or the use of a QUADRO in divorce disputes, retirement plans generally cannot be transferred to another person or creditor during the account owner's life.[28] However, when a plan participant (the owner of the retirement plan) passes away the funds may either be transferred to his or her spouse's IRA, or be transferred to another person using an "Inherited IRA." These must be titled as ***"IRA f/b/o Tom Smith, John Smith, Dec'd"*** or ***"John Smith, IRA (deceased on May 21, 2007) f/b/o Tom Smith, Beneficiary."*** Be very cautious to work with the financial institution holding the account: Failure to fulfill Inherited IRA requirements (for example, rolling over the funds directly into a non-spousal beneficiary's IRA) causes immediate taxation of ALL the funds, an obvious income tax nightmare.

Eligible Designated Beneficiaries ["DB"]: A **Designated Beneficiary** is different than a "Beneficiary." Many entities (charities, corporations, estates, non-qualified trust) can be the latter, but only an individual or a qualifying trust can be a DB. Remember: If even ONE beneficiary is not a DB then NONE of the beneficiaries are DBs. Whether or not a beneficiary is "applicable" to be a DB is determined on Sept. 30 of year following the participant's date of death.

		Death BEFORE RBD	**Death AFTER RBD**
If NO Designated Beneficiary (on the Beneficiary Designation form)	**First Year**	• All Qualified Pland & IRA funds must be distributed by 12/31 of year of 5th anniversary of owner's death	• RMDs over the owner's remaining life expectancy without recalculation
	Subsequent Years		▪ RMD is calculated by reducing the owner's life expectancy by "1"
If a Legitimate "Individual" Designated Beneficiary	**First Year**	• RMDs made over the bene's life expectancy from the Single Life Expectancy Table IF the bene commences distributions by 12/31 of the year after the year of owner's death • RMD for designated bene uses bene's life expectancy for his age on his birthday in the year following the year of the owner's death	• RMDs may be made over the longer of: (1) the owner's remaining life expectancy, or (2) the bene's remaining life expectancy
	Subsequent Years	• RMD calculated by reducing bene's life expectancy by "1"	RMD calculated over bene's life expectancy from the Single Life Expectancy Table

[28] Funds in a Qualified Plan are generally fully protected against creditors absent fraud. Funds in a contributory IRA are protected up to $1,000,000 or more. It is a suggested practice that funds initially contributed to qualified plans be transferred to separate IRAs, thereby segregating them from contributory IRAs.

Naming one or several DBs on the beneficiary designation form allows for the most favorable post-mortem Stretch RMD treatment using the beneficiary's longer life expectancy. Failing to name DBs, or naming multiple beneficiaries where even one is not a DB, will invoke the 5 year rule, forcing the beneficiaries to withdraw all funds from the retirement plan within five years, negating the opportunity to stretch distributions. The DB's actual name need not be stated as long as the DB(s) can be identified using a class or distinction, such as *"my children"* or *"my living lineal issue at the time of my death."*

If there are multiple DBs or only one qualifying trust, even if all of the beneficiaries are eligible DBs (I.e. identifiable individuals) RMD treatment is based on the DB with the shortest life expectancy – the oldest beneficiary. In this case the client may want to separate & retitle assets into separate IRAs; this can also be done post mortem by September 30th of year following the date of death to ensure all DB's get their own life expectancy for stretch RMDs. For all beneficiaries to use their own life expectancy, IRAs must be divided into separate Inherited IRAs by December 31st of the year following the participant's date of death.

Good RMD Beneficiaries	**Bad RMD Beneficiaries**
Spouse: Best RMD Treatment; can transfer to his/her own account and use his / her life expectancy	**Estate:** Has no life expectancy, so it is not a designated beneficiary; 5 year rule applies
Younger Individuals: Use original owner's life expectancy table as a starting point.	**Older Individuals:** Use their own life expectancy table.
"See-Through" Trusts: same as above	**Non-Conforming Trusts:** 5 year rule applies
Leaving ALL of an account to a Charity: No RMD benefit, but estate receives income and estate tax deduction	**Leaving some to a Charity, the rest to Designated Beneficiaries:** If even one beneficiary doesn't have a life expectancy then NO beneficiary has a life expectancy; 5 year rule applies

Common Mistakes: Post-mortem problems frequently occur when retirement plans have multiple DBs, or a non-DB such as a charity being a partial beneficiary with other DBs. This can be corrected in several ways, but all require that the fiduciary change the decedent's retirement account structure post-mortem. This is permissible until the "Beneficiary Finalization Date." Then, the fiduciary of the estate can "unlump" the beneficiaries by creating separate Inherited IRAs, one for each beneficiary, thereby (1) avoiding all beneficiaries receiving RMDs at the oldest beneficiary's RMD rate, and (2) giving the charitable beneficiary its own account so the DBs can avoid the 5 year rule.

Avoid paying estate taxes with IRA assets: An estate is a non-DB, which accelerates RMDs under the 5 year rule. To avoid this, customize the beneficiary designation forms to say (1) all

estate taxes and expenses and (2) all charitable bequests that may apply to a Trust beneficiary of an IRA, must be made by September 30th of the year following the participant's death.

If a minor is named as a direct beneficiary there must be a Guardianship Proceeding[29] since a minor cannot disclaim the assets. It is better to name a Trust as the IRA beneficiary: The IRA will pay RMDs based on the minor's life expectancy to the trust, which then holds the funds until the beneficiary becomes an adult and is entitled to distributions under the trust's terms.

When a DB takes over an Inherited IRA name a beneficiary for when the DB passes away; here the RMD is fixed at the life expectancy of the DB because he is the initial beneficiary. If an Inherited IRA is in the participant's spouse's name (which should almost never be your strategy) and she dies, the successor beneficiaries get the worst RMD treatment because the spouse's life expectancy becomes the measuring life for RMDs, even for the successor beneficiaries. Instead, if the estate tax exemption is fully utilized at the participant's death you should always roll the IRA over to a Spousal IRA. The result upon the death of the spouse is that her beneficiaries receive RMDs based on their life expectancies since the funds are technically in the spouse's IRA as if the participant had never lived.

C. RMDs when Naming Trusts as Beneficiaries

Qualified / "See Through" Trusts: With these trusts the beneficiary is treated as the beneficiary of the retirement account for purposes of determining whether there is a DB. *This is the most desirable outcome for a parent to child transfer*, especially if the child is still a minor, since RMDs will take place at the rate of the child beneficiary. In order for a See Through Trust to accomplish this end the following requirements must be met:

(1) The trust must be valid under state law,
(2) The trust must have identifiable beneficiaries; "classes," such as "my children," are okay, but the beneficiaries with the longest and shortest life expectancies must be identifiable at the time of the transfer,
(3) The trust must be irrevocable before or as of the participant's death,
(4) A copy of the Trust must be sent to the plan administrator or trustee by 10/31 of the year following participant's death, or the plan administrator or trustee must receive a list of all trust beneficiaries (including contingent and remainder beneficiaries) by September 30 of year following participant's death, and
(5) All primary trust beneficiaries must be individuals

Conduit Trusts: With a Conduit Trust all distributions paid to the trust are immediately distributed to the beneficiary and not accumulated for future distributions to the successor beneficiaries. This language must be written into the trust in order for it to be effective. In addition, make sure there are separate trusts for each beneficiary in order to take advantage of favorable stretch RMD distributions for the younger beneficiaries.

Accumulation Trusts: These trusts are good if the Settlor / plan participant wants to withhold principal and income from the initial trust beneficiaries, thus it is the opposite of a Conduit Trust.

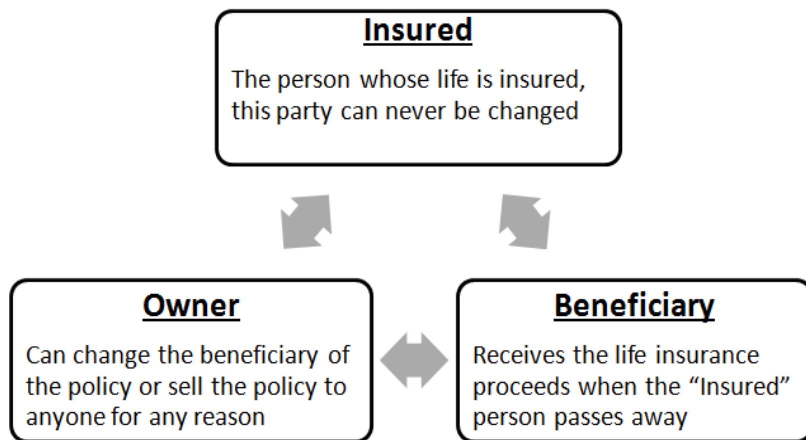
[29] SCPA Article 17

However, these trusts receive the worst RMD treatment as they must use the life expectancy of the oldest beneficiary, even if he or she is only a contingent beneficiary, and even if there is an extremely low probability that beneficiary will collect the funds.

Suggestions for Naming Children as Primary or Contingent Beneficiaries to a Retirement Plan
1. Split up IRA accounts so each child is a contingent beneficiary of his or her own account for RMD purposes (this can be done instead of using See-Through Trusts, and can be done after life)
2. Younger beneficiaries are able to "stretch" RMDs for longer periods of time due to their increased life expectancy, allowing for a longer period of tax deferral.
3. If children need funds now and the retirement plan does not have a Trust as the beneficiary RMD rules won't matter – they need the money now, so they will take it (and a hefty income tax).
4. If the account Owner's estate will be subject to **IRD** consider (1) converting the plan to a Roth IRA, and/or (2) having desired charitable legacies paid for out of the retirement plan to minimize short term and future income taxes.
5. Name a "See-Through Trust" as the beneficiary of the plan.

6. **Life Insurance**

Life insurance plays an important part in several people's estate plans: It provides a replacement source of income for a surviving spouse and children, it allows income tax free growth of investments, it allows businesses to cover costs for deceased partners or key employees, and it can be an effective investment for decreasing estate taxes.



There are three parties to any life insurance policy. The **Insured** is the measuring life that determines when the policy pays out (upon his or her death). The **Owner** is the party who may assign or trade the policy and may choose the beneficiary. The **Beneficiary** receives the proceeds of the policy upon the death of the Insured.

A. Parties to a Life Insurance Policy

There are three parties to a life insurance policy: The **Insured** is the measuring life for the policy paying out upon death, the **Owner** can trade the policy and name or change the beneficiary of the policy, and the **Beneficiary** receives policy proceeds upon the insured's death. Each has a different power and purpose relating to tax matters.

B. Benefits of Using Trusts as Beneficiaries

Naming the correct beneficiary on a life insurance policy is very important, particularly after a divorce or where minor children are involved.

Life insurance policies rarely pay out to minor beneficiaries - the beneficiary is typically a spouse or adult family member. However, two problems arise if a minor beneficiary does become the owner of policy proceeds: (1) The minor cannot claim any of the funds until the age of majority, thereby necessitating an SCPA Article 17 Guardianship (with all of the associated legal fees), and (2) when the beneficiary does reach the age of majority the policy pays out in full, leaving the young adult a financial windfall that he or she may not be old enough to appreciate. Alternatively, a child (or spouse) with spendthrift or substance abuse issues may not be well served by receiving the entire proceeds outright.

By having the insured policy owner create a revocable trust as beneficiary, with the trust itself naming the child or troubled spouse as beneficiary and naming the distributive terms, the Settlor can both determine how these life insurance proceeds may be used by the child during minority, and future payout options for any remaining proceeds upon the age of majority. In some circumstances the practitioner should strongly urge the client to name a trust as the life insurance beneficiary, such as when there are minor children but no surviving spouse or trustworthy alternate adult caretakers (this avoids a Guardianship Proceeding), where the life insurance proceeds are substantial (allowing for the beneficiary to receive proceeds gradually until they are responsible or adequately protected), or where the beneficiary has displayed self-destructive behavior (thereby protecting the beneficiary from himself).

C. Using "ILITS" to Avoid Estate Taxes

Several clients have the misconception that life insurance proceeds always escape estate taxes; this is far from the truth. Life insurance proceeds almost always avoid <u>income</u> taxation to the beneficiary (there are some notable nuanced exceptions, such as when an owner / insured withdraws funds in a heavily front-loaded policy, for beneficiaries who are organizations, policies owned by certain qualified retirement plans, etc.), but life insurance is more often than not included in the insured's gross estate for estate tax purposes if that insured is the owner of the policy. Remember that IRC §2033 includes any property in which the decedent had an ownership interest, IRC §2035 includes the proceeds of existing policies in the former insured/owner's gross estate if it was transferred to a new owner less than three years prior to death,[30] and IRC §2042 includes the death benefit in the estate of the insured/owner if he maintained any incidents of ownership.

The issue typically revolves around "Who owns the policy?" The most frequent way to avoid estate taxation on life insurance proceeds is to not have the insured own the policy either personally or through a revocable trust. An **Irrevocable Life Insurance Trust ["ILIT"]** names an irrevocable trust as both the owner and the beneficiary of a life insurance policy and almost always does not name the insured as the trustee. ILITs are one of the preferred methods of

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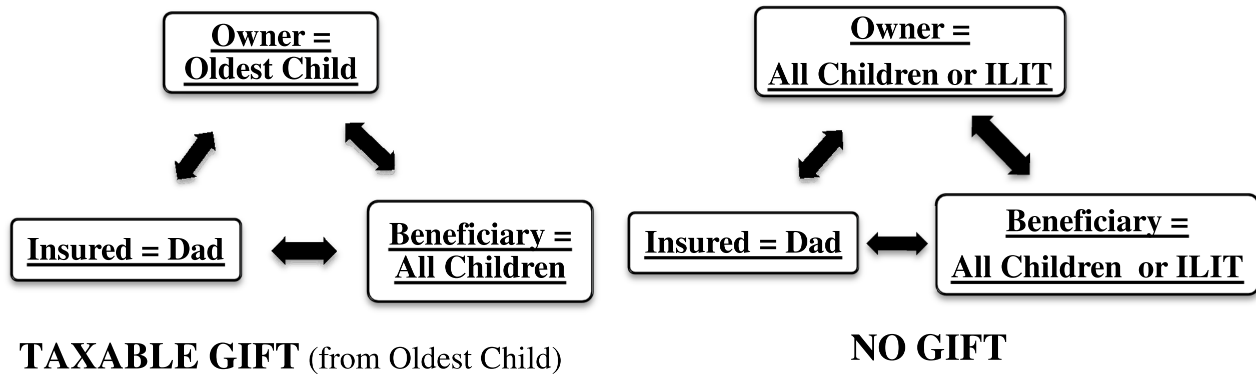
[30] The caveat to this code section relates to newly issued policies: If a life insurance policy is issued within the three year period

transferring wealth free of estate taxes, since they (1) avoid income taxes for the beneficiary, (2) are not included in the gross estate of the insured, thereby avoiding estate taxes, and (3) the Settlor of the trust can dictate the terms of the trust, provided those terms comport with IRC §§ 2033 – 2042.

D. The "Goodman Rule"

Estate planning is fraught with nuances and traps for the unwary practitioner. Naming the owner and beneficiary of a life insurance policy seems to be an innocent proposition, but like so many aspects of estate planning can lead to unintended outcomes. The **Goodman Rule** states that if the Insured, Owner and Beneficiary are three different people, the Owner (upon the death of the Insured) is treated as though he has made a gift of the proceeds.[31]



As a general rule, to avoid this (and several other) unpleasant outcome in respect to life insurance and taxation, it is advisable to name the Owner and Beneficiary as the same person, persons or trust.

[31] Estate of Goodman vs. Commissioner, 156 F 2d 218 (Second Circuit, 1946)