Property: Is Your Title in the Donut or the Donut Hole

Illowa Partnership for Philanthropic Planning

Davenport, Iowa
May 13, 2010

James A. Nepple
Nepple Law, PLC
Offices in Davenport, Muscatine & Rock Island
www.nepplelaw.com
jim@nepplelaw.com

I. Introduction

II. Title to Property – Your Estate

a. Your Will – The Donut Hole

i. Title in Your Name

These properties include cash, checking, savings, money market, certificates of deposits, stocks, bonds, government obligations, promissory notes, closely-held stock, general partnership interests, limited partnership interests, limited liability company interests, vehicles, personal property, and real estate.

ii. Title as Tenancy in Common

This form of ownership for real or personal property is held by several persons where you as the tenant have the right to determine who will receive your share by the dispositive provisions of your Will.

iii. Title with the Beneficiary Designation being the Estate

If your life insurance, annuities, retirement plans or IRAs have your estate as the beneficiary, then the dispositive provisions of your Will determines who receives the property.

b. Your Other Titles to Property – The Donut

i. Life Insurance Policies and Annuity Products with Named Beneficiaries other than your Estate

Each of these is a contract that you as the owner have with the insurance company. That contract says that on your death, the insurer agrees to pay the death benefits to the person you designated. Consequently, the provisions of your Will or trust do not determine to whom the proceeds will be paid.

ii. Retirement Plans and IRAs with Named Beneficiaries other than your Estate

The common examples of these assets are:

- Individual Retirement Accounts (IRAs)
- Roth IRAs
- Pension Plans
- Profit Sharing Plans
- 401(k) Plans
- 403(b) Plans

Each of these is a contract that you as the owner have with the pension plan administrator. That contract says that on your death, the administrator agrees to pay the death benefits to the person you designated. Consequently, the provisions of your Will or trust do not determine to whom the proceeds will be paid.

iii. Title as Joint Tenants with Rights of Survivorship

Joint tenancy assets pass to the other joint tenant or tenants immediately at your death. Consider:

- The possibility that you are with the other joint tenant in a common disaster. If you die first (even by a few seconds) your joint tenancy assets pass under the Will of the other person and not under your Will. That may be fine for many people; but often the primary owner prefers to control the disposition of his or her property in this situation.
- The possibility that the other joint tenant files bankruptcy or is involved in a divorce. Your jointly owned assets may be in jeopardy.

Bank accounts with two names are almost always joint tenancy accounts unless you have specified differently when you set up the account. If you want to have another person sign for you in the event of an emergency, you can designate that other person as an accommodation signer.

However, most people have not made this arrangement with their bank. In that case, the other person on the account becomes the owner immediately on your death.

iv. **Title as Tenancy by the Entirety for Illinois Homestead Property of Husband and Wives**

This limited form of property ownership passes to the surviving spouse upon the death of the first spouse. While in this form of property ownership, the property is not subject to any separate claims by either spouse.

v. **Bank Accounts Titled as Payable on Death (POD) to Named Beneficiaries**

These designations are often made on various bank accounts and certificates of deposit. The property passes immediately on your death to the person or persons that you have designated.

vi. **Brokerage Accounts , Stocks, Bonds, and Other Investments Titled as Transfers on Death (TOD) to Named Beneficiaries**

Transfers on death designations are often made for securities held individually or in accounts with brokers. The property passes immediately on your death to the person that you have designated.

vii. **Irrevocable Trusts**

1. **Life Insurance Trusts**

   This type of trust owns an insurance policy on the insured for the benefit of his or her spouse and children or owns a survivorship policy on the insured and his or her spouse for the benefit of the children or lower generation beneficiaries. Funds to pay the premiums are gifts to the trust and the beneficiary designations cannot be changed.

2. **QTIP Trusts**

Qualified Terminable Interest Property Trusts can be established during lifetime to provide income to the spouse for life with the remainder to designated beneficiaries. The beneficiaries are generally fixed and the spouse agrees to report the trust property in his or her estate.

viii. **Revocable Funded Trusts**

1. **Substitute it for the Will – Transfers from the Donut Hole to the Donut**

Establishing and funding the trust is like probating your own estate while you are living rather than having someone do this for your estate after you pass away.

2. **Titles to Property in Part (a) above are Transferred to the Trust**

Property transfers to the trust are by bills of sale for personal property, deeds in trust for real estate, letters of instructions for your investments, and beneficiary designations for life insurance and retirement plans. In Iowa, vehicles can be transferred by completing an affidavit and providing a death certificate without a transfer to a trust.

III. Revocable Funded Trusts

a. **Right to Revoke, Terminate, or Amend**

The person who creates the trust retains the right to amend, revoke or terminate the trust just as one has the ability to change or revoke a Will. It is easier to change the living trust since you avoid the formalities of witnesses required in changing a Will.

b. **Trustees**

The person who sets up the trust can act as his or her own trustee during their lifetime or until they become incapacitated. The trust agreement provides for the successor trustee, who is a person or bank trust department named by the person setting up the trust.

Using a revocable trust permits the use of a nonresident person as successor trustee. Thus, a son, daughter or an “in-law” that may reside in another state can be brought in to assist in managing the affairs without any concern that a probate court will not recognize such person or would require a bond be posted by such person, if the estate was handled through the use of a Will.

c. Avoids Probate

When the assets of the person setting up the trust are in the trust at the time of death, the successor trustee named in the trust agreement immediately takes over, winds up the decedent’s affairs and distributes the assets in accordance with the trust terms. The trust agreement contains all of the provisions, which are normally in a Will. Another way to understand the use of a trust is to simply state that the trust, if funded, “leapfrogs” the entire probate process. The trust, by its terms, transfers the assets from the deceased person to the beneficiaries designated in the trust agreement without the probate process. This results in a considerable reduction in the time for administration and expense.

d. Avoids Conservatorship

Having the assets in a revocable trust can also avoid conservatorship proceedings. Thus, if a person is injured or has a stroke and the assets are in a revocable trust, the successor trustee named in the trust agreement takes over and handles all affairs until the person recovers or if death follows, winds up the affairs at death without going through the extensive and costly proceedings of conservatorship. There is no need to declare the person setting up the trust incompetent or for powers of attorney or temporary joint checking accounts.

e. Confidentiality

Using a revocable trust ensures that all of the information regarding the transfer of the assets remains confidential. The trust agreement, unlike a Will, does not need to be recorded in any public office.

f. Need for Pourover Will

A Will should also be signed by you, which provides that any assets which you may own and did not transfer to the trust during your lifetime will be transferred by your Executor under your Will to the trust. It is for this reason the Will has been called a "Pourover Will."

IV. Taxes

a. Federal Estate Tax

i. 2010

During 2010, there is no federal estate tax. If there is no surviving spouse and the estate exceeds $1.3 million, a tax report will be due listing the estate assets that will receive a step-up in basis and those that will have carryover basis. If there is a surviving spouse and the estate exceeds $4.3 million, then a similar tax report will be due. The Treasury Department has not yet released any such tax report.

ii. 2011

During 2011, federal estate tax will be due for estates exceeding $1 million, and the marginal tax rate will be 55%. If there is a surviving spouse, the marital deduction is available so no federal estate tax will be due in the first spouse's estate.

b. Iowa Inheritance Tax

The State of Iowa imposes an inheritance tax, not an estate tax. The inheritance tax rate range from 5% to 15% for bequests of property to persons other than direct descendants (including step-children) and direct ascendants.

c. Illinois Estate Tax

The State of Illinois imposes an estate tax with tax rates from approximately 6.2% to 16% for estates in excess of $2 million. If there is a surviving spouse, the marital deduction is available so no estate tax will be due in the first spouse's estate.

d. Tax Apportionment Clauses

For individuals passing away in 2011 when the federal estate tax exemption will be $1 million, planning for liquidity needs to pay the transfer taxes is required and determining which assets will pay these taxes is critical. The Wisconsin Supreme Court ruled on May 4, 2010 that "payable on death accounts" are not subject to the estate tax liabilities where the Will or trust does not specify who is responsible. Iowa by statute and Illinois by case law generally follow this Wisconsin case. Thus specific bequests to charities or a percentage of the residuary passing to charities under a Will or trust may not be funded if the estate assets are used to pay transfer taxes.

V. Conclusion

The focus has been on the title to properties and coordinating the various forms of ownership of property. The focus has not been on charitable planning. Typically charitable planning is a specific bequest of a certain dollar amount or a percentage of the residue of an estate in a Will or revocable trust. But what if the titles to the properties are not in the probate estate or trust estate? What if the cost of administration or transfer taxes exceeds the value of the property in the probate estate or trust estate? Then, there are no funds to pay these charitable amounts. Charitable planning needs to also consider naming the charity as the beneficiary or one of the beneficiaries on a POD account, a TOD account, a life insurance policy, a retirement plan, or an IRA. Having a charity as a beneficiary of a retirement plan or IRA not only reduces transfer taxes but, it avoids the income taxes payable on these funds. All this becomes much more important when beginning in 2011 the federal estate exemption will be $1 million dollars.