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Trusts and Estates

Proceed With Caution When Will Substitutes Are Involved

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"Will substitutes," as the name suggests, allow individuals to accomplish, in part, what they could otherwise address through a will—the identification of the recipient of a decedent's property at death. Unlike the case of assets passing under a will, the assets disposed of by a will substitute do not become part of the decedent's probate estate and, by definition, do not pass under the terms of a decedent's will (or in the absence of a will, under the intestacy laws). Will substitutes can include revocable living trusts, joint tenancies, multiple-party bank accounts, payable-on-death accounts, transfer-on-death accounts, Totten trusts, life insurance policies, annuity contracts, retirement plans and IRAs, and each will substitute disposes of assets by its own separate method. Given that assets may pass at death in any number of ways, whether under a will or under one or more will substitutes, clients should proceed with caution to make sure that their estate-planning documents properly dovetail so that all of their assets pass to the right beneficiaries and in the right way.

A revocable living trust is the most akin to a will because it provides the grantor with a mechanism to include finely tuned dispositive and administrative provisions according to his or her wishes. A revocable living trust only helps to avoid probate (or reduce the assets passing under the probate process) to the extent that the trust was funded during the decedent's lifetime (this may be advisable in certain jurisdictions, such as Florida, where the probate process can be particularly expensive and burdensome). Generally, a revocable living trust is drafted in conjunction with a "pour-over" will so that any assets that were not transferred to the trust during lifetime would ultimately be "poured" into the trust after death and administered and disposed of in accordance with the provisions of the living trust. Most often a will and revocable trust are drafted to be well coordinated, so each time a change is made to either the will or the revocable trust, the other document will typically need to be thoroughly examined to make sure that they remain consistent.

Real estate that is titled in joint names with rights of survivorship is a common form of will substitute. Most real estate owned by a husband and wife is in this form of ownership (in Pennsylvania and other states, this may be referred to as "tenants by the entireties"). When one of the owners of a joint tenancy account dies, the surviving owner or owners automatically inherit the rights to the property by operation of law, so that the property will not ordinarily be disposed of under the will of a joint owner who dies. Sometimes it may be advisable for the decedent to avoid this automatic transfer on death and, instead, enable the decedent to dispose of his or her portion of the property by will. A common reason to do this is to enable the decedent to leave his or her portion in trust rather than outright to the survivor (for creditor protection reasons, tax shelter reasons or otherwise). In order for the decedent to avoid this automatic transfer to the survivor at death, he or she would have had to own (or to transfer the property into) a tenancy in common ownership structure during his or her lifetime. In that case, the decedent's portion of the property (one-half if the tenants owned it equally) would pass under his or her will.

Banks and other financial institutions offer many will-substitute options, such as joint or multiple party accounts, payable (transfer) on death accounts, and Totten trust accounts (named after a New York case that first approved this form). While these accounts can avoid probate, they don't necessarily avoid problems, as described below.

A joint or multiple party account is an account where two or more people are named as the account holders, and any of them can deposit or withdraw from the account. As is the case with real estate, a joint account with rights of survivorship would pass to the surviving account owner(s) automatically by operation of law (rather than pass under the terms of the will of the first owner to die). Placing assets in joint accounts solely for convenience purposes can lead to problems. First, adding an account owner to an account may be deemed to be a taxable gift for gift tax purposes. Another issue is that, in the case of unmarried account owners, if the owner who is listed on the account for convenience purposes only dies, the estate will need to prove that he or she did not contribute any assets to the account in order to avoid a potential estate or inheritance tax. Another concern with these types of accounts is the possibility of a co-owner draining the account without the approval of the other owner. Rather than having a joint account for convenience purposes, the safer practice is to give someone power of attorney over the account. The power of attorney agency relationship imposes fiduciary obligations on the agent, which would provide more protection against improper usage of the funds than could a typical joint account arrangement.

Under the laws of many states, individuals may designate a beneficiary to receive any balance remaining of bank and investment accounts or individual stock certificates or savings bonds upon their deaths. These designation accounts include payable-on-death accounts, transfer-on-death accounts or Totten trust accounts. While the simplistic approach to these forms of will substitutes can be appealing, oftentimes issues arise in the estate because of these designations. A common pitfall with these accounts is that other intended beneficiaries may be disinherited, and, even worse, bear the burden of the inheritance and/or estate taxes imposed on such assets passing outside of the probate estate. For example, a child may be named as the original beneficiary but after-born children are not, or, sometimes only one beneficiary is allowed to be named for each account. This unexpected inequality of distribution can lead to unpleasant and expensive conflict during the estate administration process. Another common pitfall with these types of will substitutes occurs when the estate plan involves a trust. In that situation, using these titling arrangements to name beneficiaries on death would typically cause the assets to pass outside of the trust structure, which can be inconsistent with the overall plan.

Perhaps the most common types of will substitutes are beneficiary designations for life insurance policies, annuity contracts, retirement plans and IRAs. In fact, these will substitutes are generally unavoidable because beneficiary designations are required by contract for these forms of assets. In order to avoid unintended consequences, it is essential to make sure that these designations are properly coordinated with the overall estate plan. This will avoid unintended inequality in distribution, can eliminate the need to modify these designations every time a change is made to the estate plan and also can provide a cohesive, well-integrated, estate plan. For example, if the estate plan involves one or more trusts that are to be established under a will or revocable trust after the decedent's death, the beneficiary designations can name those trusts as the primary or contingent beneficiaries (for retirement plans or IRAs, the spouse is often named as the primary beneficiary to take advantage of the rollover option, and it is generally not advisable to name the decedent's estate as a beneficiary in order to preserve optimal income tax deferral features of such assets). Naming a trust will accomplish several purposes. It will keep the planning consistent by having all of the assets consolidated to flow through the overall dispositive scheme contained in the trust provisions. Also, if later there are any changes made to the terms of the trust by a codicil to the will or amendment to the revocable trust, no changes need to be made to the beneficiary designations since the trust (not the beneficiary designation) contains the operative dispositive provisions.

Whenever a will substitute is involved in the mix, care should be taken to make sure that it is properly coordinated with the overall estate plan. Although simple on its face, having a will substitute that is inconsistent with a will or other related etate-planning documents will often create more complications than it avoids.

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