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Beneficiary Designations for Qualified Assets

Many people believe that their estate planning is "complete" once they have a will and perhaps a revocable trust. But one of the most crucial elements of estate planning is reviewing beneficiary designations on certain assets to ensure they are consistent with your overall plan.

There are two main categories of assets that can pass by beneficiary designation: qualified assets and non-qualified assets. Qualified assets are those that meet certain criteria and therefore "qualify" for tax-deferred benefits, such as 401(k) plans and Individual Retirement Accounts (IRAs). Non-qualified assets do not have tax-deferred benefits and may include things like transfer on death ("TOD") and payable-on-death ("POD") accounts, and life insurance.

We have previously written about non-qualified assets and concerns about using designated beneficiaries on those accounts (see box on next page), so this article will focus primarily on beneficiary designations for qualified assets.

There is no general rule or "one size fits all" language for completing a beneficiary designation form for a qualified asset. The appropriate designation will depend on the participant's goals with regard to such assets after his or her death. There are, however, several general principles that you should keep in mind:

Karen M. Hart, CPA, MST Has Joined LeBlanc & Young

We are pleased to announce that Karen Hart has joined our practice as Fiduciary Services Administrator. Given her history as one of Portland's top fiduciary accountants, Karen brings immediate and obvious professional skills to our fiduciary tax practice. She will also assist with our trusts and estates practice by reviewing and finalizing tax returns and fiduciary accountings, and supervising the work of our trust and estate paralegals.

Karen graduated in 1986 from the University of Maine with a degree in Business Administration and a concentration in Finance. She received her CPA certificate in 1999 and earned her Master of Science degree in Taxation from Thomas College in 2002. Prior to joining LeBlanc & Young, Karen worked for over 25 years in public accounting where she focused on assisting clients with income, gift and estate tax planning, as well as trust and estate compliance.

Karen is a member of the American Institute of Certified Public Accountants. She is also a member of the Board of Trustees of Mercy Hospital, and is a Board member and past President of the Maine Estate Planning Council.

- It is almost always not a good idea to name your “Estate” as beneficiary of a qualified plan asset.
- Designating a trust as the beneficiary of a qualified plan asset can result in unintended adverse consequences and must be done carefully and with the help of an advisor.
- Many firm administrators provide pre-printed beneficiary designation forms, often with a “check-the-box” option. You should be very careful in completing such forms, as the options provided may yield surprising and unintended outcomes.
- A surviving spouse, unlike other beneficiaries, has the right to roll over to his or her own IRA any eligible qualified plan account left to him or her by a deceased spouse. As a result, the surviving spouse will then own the account as the participant and may designate his or her own beneficiaries for purposes of the IRS minimum distribution rules.
- A non-spouse beneficiary, on the other hand, may only roll over his or her benefits to an inherited IRA which is established for the purpose of receiving the distribution. The non-spouse beneficiary may be able to name new beneficiaries, depending on the terms of the plan, but the minimum distributions will not change, having been established after the death of the original participant. ◊

We have seen an increasing number of situations where a decedent had designated beneficiaries of a bank or investment account, apparently to “avoid probate,” and in some cases (according to family members) to avoid the claims of his or her creditors after death. Although beneficiary designations are necessary for IRAs, retirement accounts and life insurance, they are not necessary and are often undesirable for other accounts. Under current Maine law a person can designate a bank or investment account as a “transfer on death” (TOD) or “pay on death” (POD) account and thereby avoid probate because such accounts will not be governed by the provisions of his or her will. However, TOD and POD accounts do not affect creditors’ claims (contrary to what many seem to believe); and probate avoidance is generally not a significant consideration in the estate plans of Mainers because of the simplicity of estate administration under the Maine Probate Code. We have concerns about the increasing use of TOD and POD accounts. First and foremost, the beneficiary designations are often not consistent with the estate plan embodied in a person’s will and revocable trust. Since planning for minimization of Maine estate taxes is involved in most of the documents we prepare, we are concerned about the potentially adverse estate tax consequences of an ill-considered beneficiary designation signed without our knowledge or advice. Secondly, if a majority of a person’s liquid assets pass at death in accordance with TOD or POD designations, that decedent’s estate may have insufficient funds available to pay debts, taxes and other expenses, thereby requiring the Personal Representative to go through a lengthy and complicated process to get those assets back into the estate. Further, it can force a disproportionate level of expense on the assets that pass through the estate and result in some beneficiaries receiving little or nothing while others receive proportionately more than the decedent intended. Given these concerns, we strongly recommend that you confer with us before signing any TOD or POD designation, so that you can make sure a designation makes sense with respect to any given account and that the designation is consistent with your overall estate plan.

Planning with Portability

As noted in prior newsletters, a new concept called "portability" was incorporated into federal transfer tax law in 2010 as a temporary measure and became a permanent feature in 2013. In a nutshell, portability allows a surviving spouse to inherit the **unused balance** of the deceased spouse's federal exclusion amount for gift and estate tax purposes (the "DSUE amount") and add it to his or her own federal exclusion amount. Thus, if hypothetical client, George, were to die in 2014 and leave his entire $4 million estate to his wife, Martha, his entire $5.34 million federal exclusion amount would be "unused" (because the estate will have passed to Martha tax-free under the marital deduction) and this DSUE amount would be added to Martha's own federal exclusion amount, thereby increasing her federal exemption level to $10.68 million for gift and estate tax purposes. In order to utilize this portability feature, the personal representative of the first decedent's estate must make a timely election on a federal estate tax return and report on that return the DSUE amount passing to the surviving spouse. That DSUE amount can then be utilized by the surviving spouse (in addition to his or her own federal exclusion amount which will increase each year due to inflation adjustments) to shelter lifetime gifts and/or deathtime transfers from federal gift and estate taxes. If, however, the surviving spouse later remarries and then survives his or her second spouse, only the DSUE amount (if any) of the last deceased spouse will be available and any unused portion of the first deceased spouse's DSUE amount will be lost.

The addition of portability to federal transfer tax law should enable many clients to simplify, and in some cases significantly improve, their estate plans. This is particularly true in cases involving large retirement account and IRA balances, where naming one's spouse as the primary beneficiary (rather than a trust) is often the preferred course of action. Portability can also be used in combination with tailored trust provisions to achieve positive long-term results given the specific circumstances of a particular client situation. In other words, portability has become an important new planning tool which can eliminate the need for some of the trusts traditionally used in the past, but can also enhance the benefits of other trust arrangements more tailored to particular client needs. In determining how best to utilize portability in differing situations, several factors may have to be considered. These might include, but not be limited to, the following:

1. Portability does not apply to the Maine estate tax. The current exemption in Maine is $2 million per decedent, and this is a "use it or lose it" exemption. As a result, for many married couples with a combined estate worth more than $2 million, it will continue to be important when planning to eliminate or minimize the Maine estate tax that each spouse own a substantial **separate** estate which can be left to a trust for the benefit of surviving spouse that will not be included in the surviving spouse's estate for Maine estate tax purposes.

2. Portability does not apply to the federal generation skipping transfer tax either, so couples who want to maximize their utilization of both available GST exemptions will have to utilize appropriately drafted trusts in order to do so.

3. In the pre-portability days, when the federal estate tax exemption amount was significantly lower than it is now, many married couples traditionally utilized a trust at the first death equal to that lesser federal exemption amount to benefit the surviving spouse and possibly other family members. As a result, the assets passing to such a trust, no matter how much they might appreciate in value over the remaining lifetime of the surviving spouse, would be

excluded from his or her estate for federal estate tax purposes. This could result in significant estate tax savings for the family, but at a cost on the income tax side of things, since the adjustment of cost basis to date of death value is not available with respect to assets excluded from a decedent's taxable estate. Now, with portability available as a planning tool, clients and their advisors can assess the pros and cons of estate tax savings versus income tax savings (avoidance of capital gains) in light of the particular client situation, and can plan accordingly to achieve the best overall result consistent with the client's long-term objectives.

4. In situations where a surviving spouse remarries and then outlives his or her second spouse, there is a risk with portability that the DSUE amount of the first deceased spouse will not be fully utilized unless the surviving spouse is able and willing to make sufficient gifts prior to the second spouse's death.

We believe portability has been an excellent taxpayer-friendly addition to the federal transfer tax system. It can certainly simplify many traditional estate planning arrangements; but it can also improve the effectiveness of several others if used wisely. ◊

Thoughts on Gifting

Many of our clients have found that making gifts from time to time to family members, as part of a more comprehensive estate plan, can be a very tax-efficient and personally satisfying way to transfer their wealth to younger generations. However, there are many factors that should be considered before a viable client-specific plan can be developed. A starting point would be a basic understanding of how gifts are treated for tax purposes

The federal government imposes a tax on certain transfers made during life (gift tax) or at death (estate tax); and it assesses an additional tax on certain transfers made to or for the benefit of persons two or more generations below that of the transferor (generation-skipping transfer tax). There are common elements in these three tax regimes, including an unlimited marital and charitable deduction (there is no transfer tax imposed on transfers to your spouse or qualifying charities). Transfers which do not qualify for a marital deduction or charitable deduction may be subject to a federal transfer tax, but only when the aggregate amount of such transfers exceeds an applicable exemption (currently $5,340,000).

Some lifetime transfers are not treated as gifts for federal transfer tax purposes, and others are treated as gifts but do not have to be reported. The first category consists of tuition payments made directly to a school, and medical expenses paid directly to a provider, for the benefit of another person. The second category includes so-called "annual exclusion gifts." These are present-interest gifts made to individuals (or to certain trusts) which have a value less than the annual exclusion amount in the year of the gift. Gifts not covered by the annual exclusion amount are called "taxable gifts" and are offset by the transferor's lifetime gift tax exemption on a cumulative basis over the years. Once your entire lifetime exemption has been so utilized, all taxable gifts thereafter will result in a gift tax. More details on these various concepts are set forth below.

Annual Exclusion and Gift Splitting

The gift tax annual exclusion is $14,000 per recipient per year and is being adjusted from time to time for inflation. The annual exclusion allows you to transfer property worth up to $14,000 per year per recipient and not have to report those gifts to the IRS. To qualify for the annual exclusion, the gift must be of a so-called "present interest" where the recipient has immediate control over the gifted property. If your spouse signs an appropriate consent, you can also use your spouse's annual exclusion and therefore give up to $28,000 per recipient without making a taxable gift; however, this **does** require your filing a gift tax return with the IRS, because that is the form on which your spouse would be confirming his or her consent.

2015 Federal Exemptions

The federal exclusion amount for gift and estate tax purposes will increase by $90,000 from $5.34 million per taxpayer ($10.68 million per couple) in 2014 to $5.43 million per taxpayer ($10.86 million per couple) in 2015. The annual exclusion amount for present interest gifts will remain at the $14,000 level in 2015.

Lifetime Exemption and Tax Rate

As noted above, present interest gifts over the annual exclusion (and gifts of future interests) are "taxable gifts," which will reduce your transfer tax exemption (currently $5,340,000). Each taxpayer's gift tax exemption is "used up" on a cumulative basis over his or her lifetime to shelter "taxable gifts" from any gift tax liability. Once the exemption has been fully utilized, all further taxable gifts will generate a gift tax at a flat rate of 40%. One last point about the gift tax exemption: whenever a taxpayer makes a "taxable gift" and uses up some of his lifetime gift tax exemption, he is also in effect reducing his estate tax exemption by the same amount. In other words, if Father makes a $100,000 gift to his daughter in 2014, the first $14,000 will be sheltered under the annual exclusion and the remainder will reduce **both** his gift tax exemption and his estate tax exemption by $86,000. As the exemption increases with indexing, clients may be able to make taxable gifts that top off earlier gifts that fully utilized previous exemptions.

Gifting to Reduce Estate Tax

Many clients with federally taxable estates (estates over $5,340,000 for an individual or $10,680,000 for a couple) leverage the annual exclusion by making annual $14,000 gifts to children and grandchildren, transferring assets to future generations without <u>any</u> transfer tax exposure and reducing their estates (perhaps to levels below the exemption amount) without paying any transfer tax. For those clients who have estates above the Maine estate tax exemption amount (currently $2 million) but below the federal exemption amount, lifetime gifts (even those above the annual exclusion, which will use some of the client's federal transfer tax exemption) can often be used to reduce, and possibly eliminate, the Maine estate tax. For example, consider an individual with an estate of $4,000,000 (which is below the federal exemption but above the Maine exemption). Absent lifetime gifts, his estate will be subject to a Maine estate tax of approximately $160,000. Had this individual made lifetime gifts of $2 million, thereby reducing his estate from $4 million to $2 million, he would have eliminated that Maine estate tax liability. There is, however, one potential wrinkle – for Maine estate tax purposes, Maine ignores taxable gifts made in the year before death. In order to work to reduce or eliminate the Maine estate tax, you have to survive for a year after making the gift.

Another benefit of making lifetime gifts is to shift the future appreciation on the gifted assets into the hands of the recipient family members, so the appreciation is not taxed as a transfer from the donor (later gift or taxable in the estate). For example, if cash is transferred to a recipient child by a parent, and the cash is then invested and appreciates in value, the increase in the value is out of the donor's estate.

Gifting Vehicles

There are many ways to make gifts, including transferring property outright, or in a trust, or to a Section 529 account, and/or to Uniform Transfer to Minors Act account (UTMA).

As noted above, if you are looking to take advantage of the annual exclusion, gifts must be present interest gifts, which means trusts receiving gifts must include special tax-sensitive provisions. There are a number of forms of irrevocable trusts used to accept gifts. One form of trust is a so-called "Crummey trust," named after the case of *Crummey* v. *Commissioner*, 397 F.2d 82 (9th Cir. 1968). The *Crummey* case provides that if a trust is funded, but the beneficiary is given the right for a reasonable period of time to withdraw the contribution to the trust, then the contribution will be treated as a present-interest gift because of the immediate right to withdraw it. In addition to Crummey Trusts, Section 2503(c) trusts provide another avenue to make present interest gifts to a trust. A 2503(c) trust is an irrevocable trust, which provides that a transfer in trust for a minor is a present interest gift if the trust property may be expended for the benefit of the minor beneficiary before his attaining the age of 21 years, and will pass to the minor beneficiary on his or her attaining the age of 21 years.

Parents and grandparents may also wish to consider the use of a 529 Plan account for the benefit of a minor child or grandchild. A 529 Plan account is particularly useful as a device to pay college costs. Contributions to a 529 Plan account are eligible for the $14,000 annual exclusion for gift tax purposes. A donor may front load the account by making a $70,000 contribution to a 529 Plan account, which uses the donor's annual exclusions for the year of the gift and the next four years. A 529 Plan account grows tax free, like an IRA account. If the funds are withdrawn to pay for educational expenses, the proceeds from the account are not subject to income tax on withdrawal either. If the proceeds are ultimately withdrawn for purposes other than paying for educational expenses, the proceeds are subject to income tax and, under some circumstances, an additional 10 percent penalty tax.

Parents and grandparents can also make gifts for the benefit of minors under the Maine version of the Uniform Transfers to Minors Act. If the documentation at the time of the original gift provides for the account to continue until the child reaches age 21, that will control. Absent that direction in the original documentation, an UTMA account can only run to age 18. Upon the termination of an UTMA account, the custodian is required under Maine law to provide an accounting (i.e., a record of income and expenses) to the child and to the Probate Court. Because a child at age 21 (or 18!) may not be as responsible as one might wish, UTMA accounts are undesirable if a significant amount of money or other assets will be contributed to the account.

Risks of Gifting

Lifetime gifts, however, are not always appropriate (or the most tax efficient mechanism) to pass wealth to future generations. For example, the recipient of a gift succeeds to the transferor's cost basis in the gifted property. Any capital gain realized on the later sale of that property will generate an income tax liability. Conversely, assets **inherited** from a decedent receive a basis adjustment at death. The new cost basis is the fair market value of the property as of the decedent's date of death. As a result, the sale of inherited property shortly after a decedent's death should generate little if any capital gain. This significant difference in the treatment of basis for property received by inheritance rather than by gift is an important factor to be weighed in determining whether or not to make gifts, particularly by persons whose estates are not likely to be subject to the federal estate tax. By way of example, if Father owns General Electric stock valued at $100,000, which he bought for $10,000, and he gives the stock to his son during his lifetime; son will recognize a gain of $90,000 upon its sale. The federal and Maine tax on that gain will be approximately $21,150. If, on the other hand, Father bequeathed his stock to his son in his Will, his son would benefit from a stepped-up basis to $100,000 (fair market value on Father's date of death). Should his son immediately sell the stock, he would incur no tax. Had Father's estate been over the Maine exemption, but below the federal exemption, a lifetime gift of the General Electric stock would have saved his estate $8,000 in Maine estate tax, but would have caused (when son decided to sell) a capital gain of nearly three times as much.

Clients should also be mindful of their own needs when contemplating possible gifts. Specifically, most of us want to ensure that we have retained sufficient assets to provide for our own financial needs. This can become a difficult issue if long-term care is needed, where gifts can have a severe negative impact on one's eligibility for long-term care financial assistance.

Conclusion

Gifting remains an important component in many estate plans, but how it fits into a plan is very fact-specific and, as noted above, it is not the solution for everyone. Careful consideration to a number of factors should be given before embarking on a gifting program. ◊

Elevator Alert

Our elevator is scheduled for some major upgrades during the first two weeks of January and will be out of operation while that work is being done. This means we will be unable to schedule client meetings from January 2 through January 16. We are very sorry about any inconvenience this might cause.

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