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Foulston Siefkin Estate Planning: PROBATE AVOIDANCE DEVICES

Counseling clients on the proper use of probate avoidance devices in the estate planning process is one of the major areas of emphasis of Foulston Siefkin's Estate Planning and Probate Practice Group. The estate planning law summary below is an overview of probate avoidance devices. It was authored by Tim O'Sullivan of the firm's Estate Planning and Probate Practice Group for the Kansas Bar Association (KBA) and incorporated in a pamphlet on the subject which is disseminated by the KBA. This pamphlet is one of the most frequently requested law pamphlets by practicing attorneys for distribution to their clients as well as by members of the general public. The strategies discussed therein are not designed to be an exhaustive discussion of all probate avoidance strategies or even any one strategy. Moreover, the conclusions reached may be subject to exceptions for which space did not permit a discussion, often are Kansas law specific, and are subject to varying and changing federal and state laws which may alter or diminish their efficacy. This summary should not be considered legal advice and no strategy addressed therein should be implemented or otherwise relied upon without the advice and assistance of an attorney who is both knowledgeable of probate avoidance devices in the estate planning process and who practices law in the state where the viewer is domiciled.

Introduction

Probate avoidance devices are becoming increasingly popular. Their benefit, as indicated by their name, is that they avoid probate. These devices are often employed with little thought given to the potential drawbacks which can be occasioned in choosing one probate avoidance device over another. This article will provide a brief introduction on what property goes through probate, followed by a discussion of the considerations involved with the three types of probate avoidance devices.

When Probate Is Necessary

If an individual dies owning titled property which is not held in joint tenancy and which does not have a valid beneficiary designation, probate normally will be required. Titled property is property having a written instrument establishing its ownership. For example, deeds specify the ownership of real estate. Likewise, stock is a titled asset because the owner is specified on a stock certificate. Other examples of titled property include bank accounts, bonds, mutual funds, and motor vehicles, all of which have written evidence of ownership.

Probate is normally required for titled property following the owner's death because a formal procedure is necessary to determine the name of the person or entity who or which succeeds to its ownership. Without probate, the property would remain titled in the decedent's name, and no one would have the legal authority necessary to manage, sell, mortgage, or otherwise encumber the property.

Third parties who hold the titled records on probate property of the decedent normally will not agree to transfer it absent a probate procedure. For example, let's assume a decedent's bank account is to pass to the decedent's son under the terms of the decedent's Will. Nonetheless, a bank normally would not turn the balance of the account over to the son except pursuant to a probate proceeding. Otherwise, the probate court might find that the Will is invalid or that a later Will of the decedent revoked the Will shown to the bank. In that event, the probate court could find that the bank account passed to someone other than the decedent's son. If the bank had previously paid the balance of the account to the decedent's son, the bank could be held liable to restore the bank account balance with its own funds and pay it over to the person the probate court determined inherited the account. Because there is no record title for certain types of personal property, such as clothing, furniture, jewelry, and livestock, probate would generally not be required for non-titled property as long as family members agreed on its distribution following the owner's death.

A decedent who dies with probate property can die either with or without a Will. The person or entity named in the Will to administer the decedent's property is called an Executor. When a person dies without a Will, referred to as "intestate," property titled in the decedent's name passes to the decedent's "heirs at law." Kansas intestacy laws determine the decedent's "heirs at law" and the amount of the decedent's estate that each heir receives. A representative, called an Administrator, is appointed by the probate court to administer the estate of a person dying without a Will.

Probate of a Will is necessary not only to provide for successor ownership of the decedent's probate property, but also to establish: (i) the validity of the Will; (ii) the portion of the decedent's property that must pay administrative expenses and claims; (iii) that the Executor named under the Will is a fit and proper party to administer the estate; and (iv) that the decedent's property is distributed to the parties named in the Will in the shares and manner specified in the Will.

Persons who do not desire for probate property to pass under intestacy laws, or who wish to vary the shares or manner in which their heirs would otherwise take under intestacy laws, should execute a Will. When a decedent dies with a Will, referred to as "testate," the provisions of the decedent's duly probated Will determine the amounts and manner the property titled in the decedent's name will be distributed to beneficiaries. Other benefits of having a Will as opposed to dying intestate include being able to: (i) name the Executor to administer the estate; (ii) ease the burden and costs of administration of the estate by waiving court approval of certain actions taken by the Executor (such as the sale of real property); (iii) waive the posting of bond by the Executor; (iv) name a guardian and conservator for minor children;
(v) create trusts for beneficiaries if desired; and (vi) provide for estate and income tax planning.
Probate Avoidance Devices

Probate avoidance devices allow an individual to legally pass title to property without the necessity of a probate procedure. This creates certain benefits. First, they save the time and expense of a probate proceeding. Second, unlike probate records which are open to the public and disclose the nature and beneficiaries of the decedent's estate, most probate avoidance devices are not a matter of public record. Third, probate avoidance devices involve a far less cumbersome procedure to transfer title following death than probate.

There are three types of probate avoidance devices. They are joint tenancies with rights of survivorship, beneficiary designations, and Revocable Trusts.

1. Joint Tenancies With Rights of Survivorship

An individual may avoid probate by titling property with another person(s) as "joint tenants with rights of survivorship." If such ownership is not clearly indicated between co-owners, the property will not be titled in joint tenancy and each co-owner's interest will pass through probate upon a co-owner's death.

Under joint tenancy law, upon a joint tenant's death the property interest of the deceased joint tenant immediately passes to the surviving joint tenant(s). To establish ownership, the surviving joint tenant(s) simply need to file a death certificate of the deceased joint tenant with the Register of Deeds office with respect to real estate, and present the death certificate to third parties holding the title records with respect to personal property. If there are more than two joint tenants on the title, the surviving joint tenants will continue owning the entire property in joint tenancy with each other.

Joint tenancy ownership is beneficial in that it is not only simple and inexpensive to create, but also to establish ownership in the surviving joint tenant or joint tenants after death. Joint tenancy ownership avoids the cost and inconvenience of probate because the succession of ownership at death in the surviving joint tenant is automatic under joint tenancy law.

Notwithstanding its benefits, joint tenancy ownership has several disadvantages. Setting up joint tenancy ownership with individuals other than a spouse can be financially hazardous. Joint tenants become co-owners and obtain full rights of co-ownership. This means that joint tenancy property is subject to the claims of co-owners, the creditors of co-owners in the event of a garnishment or attachment, and spouses of co-owners in the event of a divorce.

In addition, if joint tenancy property consists of an account with a credit union, savings and loan, or bank, normally any joint tenant can withdraw the entire balance of the account at any time. The possibility of a joint tenant making a withdrawal increases if the creator becomes incapacitated or dies. If there are more than two joint tenants and one of them withdraws the entire balance in the account, the other joint tenant or joint tenants on the same account would be disinherited.

If an account owner wants to put another person on a financial institution account to pay bills, sign checks, etc., on the account owner's behalf, the problem of potential withdrawal can be minimized by adding the person as an additional signatory, rather than as a joint tenant. This also prevents such person from becoming a co-owner, and thus the account does not normally become subject to the claims of such person's creditors and spouse. Alternatively, if the account owner wants the account balance to pass to another person upon the owner's death, but does not want to give the other person present ownership rights in the account, the owner can use a payable on death ("POD") beneficiary designation, as discussed in the next section.

Joint tenancy ownership also requires the signatures of all joint tenants (and their spouses with regard to real estate) if the property is to be sold, transferred, mortgaged or otherwise encumbered. This can pose not only logistical problems, but can be particularly problematic if all parties are not willing to execute the necessary documents or if a joint tenant becomes incapacitated.

One of the most significant problems of joint tenancy ownership arises because joint tenancy ownership does not provide for coordination of affairs following the creator's death. When the creator of a joint tenancy ownership dies, no authority has been reposed in any person or entity to sell property, pay the decedent's debts, or file the decedent's final income tax return or any required Federal or state death tax returns. This problem is much greater in circumstances where an unmarried parent with more than one child has placed property in joint tenancy. Family disharmony may result and disagreements over coordination of the estate can result in substantial legal expenses and delays. These disagreements often become particularly acute with regard to the distribution of non-titled personal property, such as jewelry, furniture and other personal effects. Placing titled property in joint tenancy will not govern the disposition of non-titled personal property following death. Such disagreements can be mitigated, if not completely avoided, by planning for the disposition of one's estate under a Will or Revocable Trust, as an Executor or Trustee is named to coordinate the affairs of the decedent's estate.

Another potential problem arises because joint tenants may not die in the anticipated order. For example, if joint tenancy ownership is established as part of an estate plan to pass property to a parent's children upon the parent's death, a child's family would be unintentionally disinherited if the child predeceased the parent.

Even if all children survive their parents, unless all children are joint tenants on property placed in joint tenancy, the parent's estate plan still may be distorted. The surviving joint tenant child or children succeed to the ownership of the parent's interest in the joint tenancy property in addition to whatever the surviving joint tenant may receive from the parent's probate estate. For example, if a parent executes a Will giving his or her two children an equal share of the parent's estate, and the parent titles a property in joint tenancy with only one of the two children, the child whose name is on the joint tenancy will receive more than the other child upon the parent's death. In addition, the shares of the children who take property outside probate may be enhanced with respect to the children who take under the Will because property passing outside probate is generally not primarily liable for death taxes, the decedent's debts and taxes, or the costs of post-death administration, and there may not be an effective legal means of enforcing payment against a surviving joint tenant.

As another example, a parent may create a joint tenancy with one child on one asset and a joint tenancy with another child on an asset of equal value. If the parent would have died on the date the joint tenancy was established, the two children would have received equal shares of the parent's estate. However, variances in investment returns and changes in property values will almost always result in the two children receiving different proportions of the parent's estate when the parent dies. Moreover, if the parent sells an asset or the asset is sold by the parent's legal representative (e.g., a conservator or agent under a financial power of attorney) following a disability, the child named as a joint tenant on that asset would be disinherited.

Joint tenancy ownership between non-spouses can also cause adverse gift and income tax consequences. The act of naming a person as a joint tenant is normally a gift unless the other joint tenant or joint tenants either paid full consideration for a proportionate interest in the joint tenancy property or the joint tenancy is revocable, such as a joint tenancy account in a bank, savings and loan, or credit union. These accounts are normally revocable because any joint tenant, including the creator, can withdraw the entire account at any time. Although a donor does not incur a gift tax for a gift to a spouse, gifts to other parties, to the extent of their undivided share of the joint tenancy property, constitutes a taxable gift if the gift exceeds the annual gift tax exclusion.

Adverse income tax consequences may also result if a personal residence is placed in joint tenancy ownership with someone other than a spouse. The Taxpayer Relief Act of 1997 grants an exclusion of gain on the sale of a personal residence up to the amount of $500,000 for married couples, or $250,000 for single individuals. However, placing a personal residence in joint tenancy ownership jeopardizes the exclusion because the exclusion is not available for the interests of joint tenants who do not reside in the residence.

Joint tenancy ownership also passes the title to property outright to joint tenants. As noted above, this is frequently undesirable if the joint tenants are too young to manage the property or are financially irresponsible. If a surviving joint tenant was a minor, a conservatorship through the courts would have to be created. Even if the surviving joint tenants are of substantial and financially mature and responsible, outright ownership subjects the property to the claims of their spouses and creditors, and places the property in their estates for Federal and state death tax purposes. It could also disqualify a joint tenant from available governmental resource benefits such as Medicaid and Supplemental Security Income (SSI). Normally, all of these problems can be minimized by leaving property in trust for a beneficiary instead of outright.

For the foregoing reasons, joint tenancy ownership is generally not desirable as a probate avoidance device between non-spouses. Even between spouses, joint tenancy ownership can cause a number of similar problems. For example, as joint tenancy property passes outright to a surviving joint tenant and not in trust, it subjects the joint tenancy property to the surviving spouse's potential mismanagement, to the claims of the surviving spouse's creditors, and to the claims of a subsequent spouse upon a remarriage. Spousal joint tenancies also cause potential Medicaid eligibility problems for the surviving spouse if the surviving spouse needs long-term nursing home care, as assets left outright to the surviving spouse will be considered for Medicaid eligibility. In addition, the total estate of both spouses would be subject to potential estate tax liability upon the surviving spouse's death if the total estate of both spouses exceeds the Federal estate tax applicable exemption amount.

Even though joint tenancy ownership between spouses avoids probate upon the first spouse's death, probate would still be required upon the surviving spouse's death unless the surviving spouse subsequently creates a Revocable Trust, puts the property in joint tenancy with others, or uses beneficiary designations to dispose of all titled property. If the creator of the joint tenancy and his or her spouse die simultaneously, probate also would normally be required because there would be no surviving joint tenant. In the event of simultaneous death, one-half of the joint tenancy would pass through each spouse's probate estate.

In short, joint tenancy ownership creates many potential problems. These potential problems can be mitigated, if not entirely avoided, by executing a Will or Revocable Trust to coordinate the decedent's affairs and in certain circumstances, leaving property in trust for the beneficiaries of the estate. For instance, leaving property in trust can protect the property from the claims of the beneficiary's spouse should there be a divorce, and at death a trust can protect the property from the claims of the beneficiary's creditors and any forced inheritance claim of a spouse. In addition, a trust can keep property out of the beneficiary's estate for Federal estate and state death tax purposes, and it can maximize eligibility for governmental resource payments such as Medicaid and SSI. Trusts can protect beneficiaries from these potential problems while making trust assets available for a beneficiary's health, support, maintenance, and education needs. If so desired, the trust can additionally provide for the similar needs of other members of the beneficiary's family. Such a trust can be created following death in only one of two ways: (1) by Will, which is also known as a Testamentary Trust; or (2) by Revocable Trust, as discussed below.

2. Beneficiary Designations

Beneficiary designations are another type of probate avoidance device. Due to recent changes in Kansas law which expanded the ability to use beneficiary designations, there are few types of property located in Kansas which cannot have beneficiary designations. These beneficiary designations are frequently termed "POD" (for "payable on death") or "TOD" (for "transfer on death").

As probate avoidance devices, beneficiary designations provide three key advantages over joint tenancies. First, because a beneficiary is not a co-owner, property having a beneficiary designation is not subject to the claims of the beneficiary, the beneficiary's creditors, or the beneficiary's spouse in the event of a divorce. Secondly, for the same reason, no signature of a beneficiary or a beneficiary's spouse is required to convey title to property and naming a beneficiary on property does not result in any adverse gift or income tax consequences. As discussed above, placing property in joint tenancy ownership with someone other than a spouse may constitute a taxable gift for federal gift tax purposes and prevent an interest in a personal residence from qualifying for the exclusion for income tax purposes of gain upon a sale.

As a final benefit of beneficiary designations over joint tenancy ownership, beneficiary designations generally allow for a contingent beneficiary in addition to a primary beneficiary, making it less likely that an individual's estate plan will be distorted if the primary beneficiary does not survive the individual. For example, if a parent has two children and names both of them as primary beneficiaries on property, the parent can name the primary beneficiary's children as contingent beneficiaries. Thus, in the event a primary beneficiary predeceases his or her parent, the predeceased child's interest would go to his or her children as contingent beneficiaries. Conversely, if property is held in joint tenancy ownership, upon a joint tenant's death the property automatically passes to the surviving joint tenants.

Beneficiary designations do not remedy all of the problems of joint tenancy ownership. For married couples, having a spouse as a beneficiary on property means the spouse will succeed to full ownership of the property upon the owner's death. This can subject property to potential spousal mismanagement and the claims of the spouse's creditors or those of a subsequent spouse. It can also place too much property in the surviving spouse's estate for Federal estate tax purposes and create Medicaid qualification problems. For single individuals, outright ownership in a beneficiary can subject the property to a beneficiary's mismanagement, to the claims of a beneficiary's spouse and creditors, to potential Federal estate tax or state death tax liability upon the beneficiary's death, and preclude the beneficiary's eligibility for governmental resource benefits such as Medicaid or SSI. As noted above, these problems may be minimized by placing property in trust under the provisions of a Will or Revocable Trust for the benefit of the beneficiary.

For unmarried individuals, or for married individuals who want a substantial amount of their property to pass to their children at the death of the first spouse, beneficiary designations also fail to provide for the coordination of the decedent's estate.

In addition, if beneficiary designations are part of an estate plan in which it is desired the beneficiaries share proportionately, the estate plan may be distorted unless the beneficiaries are named to share proportionately on each and every item of property that carries a beneficiary designation. Otherwise, a beneficiary's inheritance will depend upon the value of the asset on which he or she is named as a beneficiary and should the owner or the owner's legal representative (e.g., following the owner's incapacity) sell the property having a beneficiary designation, that beneficiary is disinherited.

3. Revocable Trusts

Revocable Trusts solve many of the problems characteristic of joint tenancy ownership and beneficiary designations. A Revocable Trust is an instrument in which a person, called a Grantor (or Settlor or Trustor), creates a trust and names either an individual (normally the Grantor) or a bank or trust company as the Trustee. The Grantor transfers property to the trust, and the Trustee has the legal responsibility of managing, investing, and distributing the property in accordance with the provisions of the trust instrument. Revocable Trusts avoid probate because the title to property placed in the trust is in the name of the Trustee at the time of the Grantor's death, and the Trustee (or the named Successor Trustee if the Grantor was serving as Trustee during the Grantor's lifetime) has full authority under the instrument to sell and transfer the property.

Revocable Trusts are particularly advantageous as probate avoidance devices because, unlike joint tenancies or beneficiary designations, they can be used with virtually all types of property, no matter where it may be located. In addition, by providing for contingent beneficiaries under the trust provisions in the event any trust beneficiary predeceases the Grantor, they avoid the distortion of the disposition of the Grantor's estate which might otherwise occur through the use of joint tenancy or beneficiary designations. Revocable Trusts allow the Grantor to avoid probate, while reserving in the Grantor the right to control the trust property and amend or revoke the trust at any time.

Revocable Trusts have a few disadvantages, including: (i) a greater initial cost and effort in titling assets in the trust; (ii) possible adverse income tax consequences, although these are normally quite minor; (iii) lack of court supervision; and (iv) the potential for probate if the trust property is not properly titled in the trust. The risk of probate with Revocable Trusts is minimized with proper supervision of the retitling process and the use of universal assignment documents. While Revocable Trusts avoid probate, they have no estate or death tax planning advantage over Wills, nor do they normally significantly accelerate the disposition of the estate upon a decedent's death over property passing through probate, as the Trustee still must file required tax returns, sell property of the decedent not passing directly to family members, and settle the decedent's debts.

In addition to the foregoing advantages, there are two situations in which Revocable Trusts are particularly desired over other probate avoidance devices: (1) when the owner of property wants to avoid probate, but wants to leave assets in trust for beneficiaries following the owner's death; and (2) when the owner of property wants to avoid probate, but desires coordination of the affairs of the estate after death. These two situations constitute the majority of estate planning situations.

When an individual leaves assets in trust for beneficiaries, as noted above, asset protection planning can be achieved. The trust provisions normally protect the assets from the claims of the beneficiary's creditors or spouse, exclude all or a substantial portion of property from the beneficiary's estate for Federal estate and state death tax purposes, and preclude trust assets from being considered a resource for governmental resource benefits such as Medicaid or SSI. If there is no desire to protect the trust assets from the beneficiary's mismanagement, the beneficiary can be named as Trustee and be given authority to expend trust assets for the beneficiary's health, education, support and maintenance needs, as well as providing for such needs for the beneficiary's family members. If protection against mismanagement is desired, the Grantor would name a third party as Trustee.

Even if a Grantor desires to leave assets outright following the Grantor's death, a Revocable Trust is beneficial in that it can be used to coordinate the affairs of the estate after the Grantor dies. The Grantor may name a Trustee to file any required tax returns, pay any debts of the Grantor, sell any property that must be sold upon the Grantor's death, and distribute the remainder of the trust estate (including the personal effects) as directed by the Grantor in the trust instrument. As discussed above, joint tenancy ownership and beneficiary designations do not provide for coordination of affairs following death. A Will provides for coordination of affairs upon death, but not without probate. Thus, a Revocable Trust is the only estate planning technique which both avoids probate and provides for coordination of the decedent's affairs and property distribution following death.

Conclusion

The simpler probate avoidance devices-joint tenancy ownership and beneficiary designations-have significant drawbacks. They can cause disruption in family harmony and do not coordinate the decedent's affairs or provide any asset protection for family members following the owner's death. They also may result in a distortion of the estate plan and create adverse tax consequences. In situations where an individual wants to avoid probate but also desires to minimize potential problems which can result from joint tenancy ownership and beneficiary designations, a Revocable Trust is normally the probate avoidance device of choice.

The foregoing discussion is an introduction to the use of joint tenancy ownership, beneficiary designations, and Revocable Trusts as probate avoidance devices. However, the estate planning process is very complex, involving many legal and tax factors which are often highly technical. It also involves balancing numerous, often conflicting, interests, and comparing the risks and benefits of numerous options and alternatives for which space did not permit a full discussion herein. Consequently, no probate avoidance device should be implemented without the advice of an estate planning attorney.

Foulston Siefkin's Estate Planning and Probate Group

Foulston Siefkin LLP, the largest Kansas law firm having offices exclusively in the state of Kansas, has more than 90 attorneys and is headquartered in Wichita, Kansas. The firm has additional offices in Kansas City and Topeka. The firm's Estate Planning and Probate Practice Group currently consists of eleven attorneys who collectively practice in all significant estate planning, probate and trust areas. Viewers are invited to click here for information on the Group's practice areas and attorneys, law summaries of estate planning areas of special interest, regional and national estate planning articles authored by Group attorneys, related links and other estate planning information which may be of interest.

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For Further Information

Foulston Siefkin regularly counsels clients on issues relating to Estate Planning and Probate. If you are interested in additional information regarding these matters, please visit our website at **www.foulston.com** or if you would like to discuss specific ways in which Foulston can help you, contact Tim O'Sullivan at 316.291.9564 or **tosullivan@foulston.com**, or Stewart Weaver at 316.291.9736 or **sweaver@foulston.com**, or Matt Bish at 316.291.9729 or **mbish@foulston.com**.

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