Timely insights that you can use.

"In this world, nothing can be said to be certain, except death and taxes." – Benjamin Franklin

Everyone knows that they should have a will, and most people follow through on this important part of their estate plan. However, it is just as important to review the ownership of financial accounts, the beneficiary designations on retirement accounts, life insurance and annuity policies, and other accounts to ensure that these are consistent with the goals of your estate plan. This paper will explore the implications of several types of account ownership and beneficiary designations.

As always, the information provided herein is intended to be educational in nature and should not be construed as legal or tax advice. You should consult your attorney or tax advisor for advice regarding your personal situation.

Financial Accounts (Non-retirement Accounts)

The first question that is asked when you open a new financial account, including checking accounts, savings accounts, or investment accounts, is who will be the owner of the account. Many people will choose either **joint tenancy with right of survivorship** or **sole ownership,** depending on their personal circumstances**.** Let us explore these options, as well as others, to develop a thorough understanding of the available choices.

Sole Ownership

Sole ownership is just what the name implies. An example would be Joe opening a brokerage account only in his name. When Joe dies, the assets in the account will receive a step-up in their tax basis. If Joe has not designated a beneficiary through a **transfer on death (TOD)** designation, the account will be subject to probate in Joe's state of residence and will pass either according to Joe's will or according to the laws of intestacy if Joe does not have a will.

Also, if Joe becomes **disabled** through illness or injury and is unable to act on his own behalf, only a person acting as his agent through a valid **power of attorney** will be able to act on Joe's behalf. If Joe has not executed a power of attorney that is valid in his state of residence, an interested person or family member must then petition the court in Joe's state of residence to become Joe's guardian of the estate or custodian to manage the account for Joe.

Joint Tenancy with Right of Survivorship (JTWROS)

An account owned as **joint tenants with right of survivorship** is an account owned by two or more people. Each owner has equal rights to the account. Each owner also has survivorship rights, which means that when one of them dies, the account is not includable in the probate estate of the decedent since it passes by operation of law to the survivor. However, there are some significant differences between joint accounts owned by individuals who are married, and joint accounts owned by unmarried individuals.

For example, Caleb and Jada, a **married** couple, open an investment account owned as **joint tenants with right of survivorship.** While both are alive, either of them may act regarding the account. When Caleb dies, Jada, as the surviving spouse, is entitled to a stepped-up basis on one-half the property, with the other one-half having its original basis. One-half of the property is includable in Caleb's taxable estate if state or federal estate taxes are owed.

However, let us look at the example of Sam and Marion, who are not married. When Sam dies, the amount of the property that is entitled to a stepped-up basis is based on Sam's proportionate contribution to the account, and if estate taxes are owed, the amount of the joint account that is includable in his estate is also based on his proportionate contribution to the account. Moreover, if the surviving joint owner cannot prove they contributed to the account, the Internal Revenue Service will assume that the survivor made no contribution, and the entire value of the property will be includable in the decedent's taxable estate. Therefore, it is critical to keep accurate records of each joint tenant's contributions to the account.

It is also important to note that, in the case of unmarried joint owners, if one of the owners takes a withdrawal from the account and did not contribute to the account, the one who contributed to the account will be deemed to have made a **gift** to the one who took the withdrawal from the account. If the gift is over the annual gift exclusion amount ($17,000 in 2023), the donor will need to file a gift tax return.

Finally, some financial service providers, including COUNTRY Trust Bank, allow a **transfer on death (TOD)** on the accounts owned as joint tenants with right of survivorship. Having this type of beneficiary designation means that, after both joint tenants have died, the property passes directly to the beneficiary (or beneficiaries) named in the TOD designation without passing through probate.

Tenancy by the Entirety (TBE)

Tenancy by the Entirety is a form of ownership between spouses that is available in some states[i]. Tenants by the entirety each own an undivided interest in the entire account and cannot unilaterally transfer their interest in the property. Each tenant has survivorship rights, and when the first of them dies, the survivor then has ownership in the whole property and is allowed a step-up in tax basis on one-half of the property. If the couple divorces, the property settlement order will determine how the property is to be retitled since a tenancy by the entirety may only be held by a married couple.

Tenancy in Common (TIC or TC)

Tenancy in common (TC) is another form of ownership between multiple parties. Here, two or more parties own individual, undivided shares of one property. The fractional shares of tenancy in common interests need not be equal amounts. Also, there is no right of survivorship between tenancy in common interest holders, and each owner can sell, gift, or bequeath their share of the property without affecting the interest of the other owners. Finally, only the fractional interest of the decedent will receive a step-up in basis.

Estate planning is one of the common reasons that tenancy in common is used for property ownership. Let's take a look at the example of Marion and Jordan, a high net worth married couple who have been advised by their attorney to change the ownership of their investment account from **joint tenancy with right of survivorship** to **tenancy in common,** with Marion owning a 30% fractional share in the account and Jordan owning a 70% fractional share in the account.

The attorney advised Marion and Jordan to create unequal fractional shares to balance their respective projected taxable estates since, before this change, Marion had fewer assets than Jordan. Since the tenancy in common interest of each spouse will pass according to their will, it can then be used to fund a credit shelter trust if needed for estate tax minimization. This option is not available for

assets titled as **joint tenants with right of survivorship** since those assets pass automatically to the surviving joint tenant.

Community Property (CP)

The community property form of ownership, which is only available to married couples, is available in states allowing this form of ownership. In community property states (Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin), property acquired during the marriage is deemed to belong to both spouses regardless of who purchased the property. Further, a surviving spouse acquiring property from their deceased spouse is entitled to a step-up in tax basis as to the entire property, rather than half of the property as in a **joint tenancy with right of survivorship** arrangement. The **community property** form of ownership gives the first spouse to die the ability to direct the distribution of their half of the community property assets through their will, which is a significant difference from **joint tenancy with right of survivorship**.

Trust Ownership

Finally, let us look at ownership of an account by a **revocable living trust.** This is a trust that is created and funded during your lifetime, and as the grantor of the trust, you also retain the power to revoke or amend the trust. Often the grantor serves as the initial trustee, with the document naming another person or financial institution that has trust powers, to serve as the successor trustee. Finally, some clients, particularly higher net worth clients, are advised to have their **revocable living trust** own their investment account since most contain testamentary provisions that designate what will happen to the trust assets after the death of the grantor—whether they will stay in trust for the benefit of beneficiaries or be distributed outright to the beneficiaries. An account owned by a trust that has testamentary provisions is not subject to probate.

Non-qualified Deferred Annuities

People often buy non-qualified deferred annuities to **defer the income tax** on the gain that accumulates inside the annuity after purchase until they take a withdrawal or annuitize the annuity (to create a stream of income for life.) Sometimes people also purchase a non-qualified annuity even if they don't expect to ever need to take a withdrawal from it. Instead, they desire to "kick the can down the road" as far as income tax is concerned. They anticipate allowing the annuity to continue its tax-deferred growth while they are alive and letting the beneficiaries deal with income taxes after they, as the owner and the annuitant, die.

Before we go further, let's clarify the difference between an **owner-driven contract** and an annuitant **driven contract.** First, it is important to know that the **owner** is the person who funds the annuity and decides on who the beneficiaries will be, while the annuitant is the person designated by the owner to receive the annuity payments. Most of the time the annuitant and the owner will be the same person, but that is not always the case. If the contract is owner-driven, it will pay out to the beneficiaries at the owner's death, whereas if it is annuitant-driven it will pay out to the beneficiaries when the annuitant dies.

Annuities can be jointly owned, and an annuity owner can also name more than one annuitant. An annuitant with joint annuitants is called a **joint and survivor annuity.** This type of annuity can provide income based on the lives of both annuitants and could continue until the last annuitant dies.

Let's look at what happens at the death of the owner if they have named a spouse as their beneficiary. In this situation the surviving spouse can choose to put the annuity in their own name and continue to defer income taxation. However, if the beneficiary is an individual who is not the spouse, the beneficiary must then withdraw the proceeds over five years (known as the "five-year rule") or elect to have annuity payments paid over the beneficiary's lifetime. If this option is chosen, payments must begin within one year of the deceased owner's death.

Finally, one should be careful about naming an estate or trust as the beneficiary of an annuity. Here, when the owner/annuitant dies, the only option for payment of the death benefit is payment within five years of death since an estate or trust is not a living person and therefore, has no life expectancy. For a trust, this will result in the trust realizing all the gain in the contract within five years, and depending on the provisions of the trust, this can result in more income tax liability for the trust than if the decedent had named an individual beneficiary.

Retirement Accounts

Last, we are going to look at beneficiary designations for retirement accounts. It is important to know the complex rules about required distributions after the death of the account owner of Individual Retirement Accounts or plan participant of employer retirement plans to avoid unintended consequences.

Individual Retirement Accounts

Account owners are asked to designate a beneficiary when opening an Individual Retirement Account of any type (Traditional IRA, Roth IRA, SIMPLE IRA, or SEP-IRA.) If the account owner designates their spouse as the beneficiary and the owner dies before starting their **required minimum distributions (RMD's),** the surviving spouse may either elect to treat the IRA as their own and start required distributions after reaching their required beginning date, or they may treat themselves as the account beneficiary. If they treat themselves as the **account beneficiary**, they must begin taking distributions **by the later of** December 31 of the year that the deceased owner would have reached their required beginning date for taking a distribution (had he or she lived) **or** by December 31 of the year following the account owner's death. These distributions are based on the life expectancy of the surviving spouse. Sometimes a surviving spouse will choose to treat themselves as the account beneficiary, rather than electing to treat the IRA as their own, particularly if they are under age 59 ½ and need funds from the IRA, as death of the account owner is an exception to the 10% early withdrawal penalty.

If the account owner has designated someone other than their spouse as the account beneficiary[ii], unless that beneficiary qualifies as an **eligible designated beneficiary[iii],** the beneficiary will be required to take distribution of the entire **inherited IRA** balance within ten years following the year of the deceased account owner's death. Moreover, if the deceased account owner was subject to RMD's, the beneficiary must also take RMD's based on the deceased account owner's attained age at their death.

Finally, account owners must be especially careful when naming a charity, their estate, and most trusts[iv] as a beneficiary of their IRA's. These types of beneficiaries, known as **non-designated beneficiaries**, must take distribution of the entire balance of their **inherited IRA** within five years of the year after the death of the deceased account owner. Finally, these beneficiaries must also take RMD's based on the deceased account owner's attained age at their death.

Qualified Retirement Accounts (401(k)'s, Profit Sharing Plans etc.)

By law, qualified retirement plans, such as 401(k)'s, require the participant's spouse to be the sole beneficiary of the participant's account. For a non-spouse beneficiary to be named, the spouse must execute a written waiver of their rights, and the waiver must be notarized. The rules for required distributions to non-spouse beneficiaries align with the rules for distributions from IRA's. In addition, the retirement plan may impose additional rules regarding distributions from the accounts.

Other Beneficiary Designation Matters

Per Capita and Per Stirpes

It is important that an account owner understands what these terms mean if they choose to use one of these terms to further define how an asset will be distributed among a group of beneficiaries. If an account owner designates that an account passes to their children **per capita,** each surviving child will receive an equal share of the account, but if the beneficiary designation is to their children **per stirpes**, then a deceased child's share will pass to that child's heirs.

Let's look at the following examples of the difference in a per capita versus a per stirpes designation. Martin had three children…John, Anthony, and Susan. Susan had two children, Jeffrey and Lyn. Susan died **before** Martin. Look at the following examples that illustrate the difference between the **per capita** versus **per stirpes** designations:

"I leave my estate, after payment of expenses, to my children, per capita."

Here, only John and Anthony will inherit from their father since only the children that survive receive a share of the estate.

"I leave my estate, after payment of expenses, to my children, per stirpes."

In this example, John and Anthony will each inherit one-third of the estate, and Susan's children will split the one-third that Susan would have inherited had she been alive when her father died.

Minors as Beneficiaries

Many people name children or grandchildren as beneficiaries of financial accounts and retirement accounts. However, if the child or grandchild is still a minor, it is important to consult with one's estate planning attorney for advice, as minors are not allowed to inherit IRA accounts or financial accounts outright.

If a minor is named as a beneficiary and death of the account holder occurs, it will become necessary to go to probate court to have a guardian of the estate or conservator of the account named to manage the account until the child reaches the age of majority. The alternatives for naming a minor directly include naming a trust for the benefit of the minor (but see the discussion above for cautions for retirement accounts) or naming a custodian for the minor's funds under the Uniform Transfers to Minors Act (UTMA).

	Step-Up in Cost Basis	Subject to Probate	Included in Taxable Estate	Number of Possible Owners	Entity Ownership Possible
Sole Ownership	Yes, Full	Yes	Yes	1	Yes
Sole Ownership with TOD	Yes, Full	No	Yes	1	No
JTWROS	One-half if married, proportional if not.	No	One-half if married, proportional if not.	2+	No
JTWROS with TOD	One-half if married, proportional if not.	No	One-half if married, proportional if not.	2+	No
TC	Proportional	Yes	Proportional	2+	No
Community Property	Yes, Full	No	One-half	2	No
Trust Ownership	Full step-up available, depending on Trust provisions.	No	Yes	Typically, 1 or 2, but possible to have more.	n/a
NQ Deferred Annuities	No	No, unless estate named as beneficiary	Yes	1 or 2	Yes
Retirement Accounts	No	No, unless estate named as beneficiary	Yes	1	No

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Review Your Beneficiary Designations

It is important to review beneficiary designations frequently, especially after changes in your financial situation or major life events, such as marriage, divorce, having a child or grandchild, or the death of a loved one. Moreover, designating beneficiaries of accounts is as important to your estate plan as the execution of a will or trust. Remember to seek the assistance of your attorney to ensure that your beneficiary designations support your personal legacy goals.

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[i] Alaska, Arkansas, Delaware, District of Columbia, Florida, Hawaii, Illinois, Indiana, Kentucky, Maryland, Massachusetts, Michigan, Mississippi, Missouri, New Jersey, New York, North Carolina, Ohio, Oklahoma, Oregon, Pennsylvania, Rhode Island, Tennessee, Vermont, Virginia, and Wyoming.

[ii] IRA owners residing in a community property state must obtain their spouse's written consent if the account owner desires to designate a non-spousal beneficiary for one-half of the account or more.

[iii] Other than the spouse of the deceased owner, **eligible designated beneficiaries** include the minor child of the deceased account owner, a disabled or chronically ill person, or an individual that is not more than 10 years younger than the original account owner. Once a minor child reaches the age of majority, they have ten years to receive the remaining balance of the account.

[iv] A see-through trust with a beneficiary that qualifies as an eligible designation beneficiary may stretch the distribution over the eligible beneficiary's life expectancy. Also, to qualify as a see-through trust, the trust must be valid under state law, irrevocable or become irrevocable upon the death of the account owner, all the trust's beneficiaries must be identifiable at the account owner's death, and documentation of the trust must be provided to the IRA custodian by October 31 of the year following the IRA owner's death.

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