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Memorandum 88-25

Subject: Study L -- Creditor Rights Against Nonprobate Assets (Status of Study)

In the process of setting its priorities for 1988 at the January meeting, the Commission considered whether to work on the matter of creditor rights against nonprobate assets. Noting that the State Bar Section has worked on the related matter of a trust claim procedure and has expressed an interest in the more general problem, the Commission inquired what the Bar's intentions might be on this matter.

The State Bar has responded (see letter attached to Second Supplement to Memorandum 88-10) as follows:

> On Memo 88-6 you raise the issue of a comprehensive review of the rights of creditor's in a decedent's assets, in whatever form. We are working on this issue right now with one of our subcommittees under the direction of Ted Cranston. We anticipate to have this review complete sometime late this year or early next year. The review of the LRC's probate project has slowed us down on the review of creditor's rights, but with the completion of the probate project in sight, we will be able to dedicate more of our resources in this direction. Ted Cranston's report resulting in the bill for Trust Creditor's Claims was the first part of this overall project. We would anticipate sharing our work with the LRC and working with you on it.

In light of the State Bar's interest and activity in this area, the staff recommends that the Commission not work in this field but devote its resources to other matters. In this connection, the staff notes that the Commission has been concerned about many aspects of nonprobate transfers, not just creditor rights. We have retained a consultant to prepare background material concerning rules of construction of nonprobate instruments, and the study is ready for Commission consideration now (dealing primarily with anti-lapse and vesting issues).

The Commission may be interested in the attached article published in the Fall 1987 A.C.P.C. Probate Notes titled "Nonprobate Transfers: Pitfalls and How to Avoid Them." The article surveys the range of

types of nonprobate transfers and points out a number of issues concerning them, including the effect of marriage dissolution, adoption, anti-lapse, ademption, simultaneous death, contract to make a will, apportionment of death taxes, and creditors' rights. The article states that "Beneficiary designation properties also present a number of potential pitfalls--most of which could be solved by the courts if they applied to these will substitutes the principles of construction and presumptions of the transferor's intent that have developed in the law of wills."

Respectfully submitted,

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Nonprobate Transfers: Pitfalls and How to Avoid Them

The First of a Series of Four Articles

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The enormous proliferation of nonprobate property.

There are today numerous kinds of property that bypass the probate process on the owner's death — the new owner simply succeeds to the property on death without going through probate. Among these are the following —

a. **Beneficiary designation properties.** A major classification of will substitutes are beneficiary designation properties — as, for example:

(1) Life insurance owned by the insured,

(2) An employee-participant's pension or profit sharing plan death benefit or account,

(3) An accountowner's Individual Retirement Account (IRA),

(4) Accrued but unpaid compensation on death under employment and deferred compensation contracts where local law permits the contract to designate beneficiary payees to receive such unpaid compensation,

(5) Partnership interests where the partnership agreement permits a partner to designate his successor in interest effective on death (or incapacity), and

(6) Pay on death (POD) bonds and accounts and Totten trusts.

b. **Joint tenancy with right of survivorship properties.** Property owned jointly with right of survivorship (JTWROS) passes automatically to the surviving joint owner(s) on death — provided the state involved recognizes joint and survivor property holdings (and/or joint accounts). Such survivorship arrangements typically include:

(1) Stocks, bonds, bank accounts, broker street name accounts, etc.,

(2) Real estate (and interests in real estate such as mineral and oil and gas leasehold interests), and

(3) Tangible personal property (by written agreement among the coowners or by registration in the case of vehicles, boats, etc.).

c. **Revocable trust properties.** Properties owned by a revocable trust do not normally go through probate. This is true whether the revocable trust:

(1) Is to pay out to named beneficiaries following death (perhaps even by reference to the residuary legatees and shares designated from time to time in the settlor's will),

(2) Is to pour over to a preexisting trust (such as an irrevocable or testamentary trust created by the settlor of the revocable trust or by someone else — or even another revocable trust created by the settlor), or

(3) Is the "main vehicle" of the settlor's estate plan (in that it contains all of the dispositive provisions intended to govern all of his properties following death, often including the division of his overall estate between marital and credit shelter shares).

d. **Properties disposable by administrative procedure.** Fortunately for those who seek to avoid probate, certain kinds of property which typically stay in an individual's own name can be transferred after death to an appropriate family member without involving probate. For instance —

(1) Income tax refund claims may be collected by revocable trust trustees without probate by filing form 1310.

(2) Automobile titles in the decedent's sole name can often be transferred on affidavit, without probate, to the surviving spouse or next of kin under state statutes specifically enacted for that purpose.

(3) Travelers checks — most issuing companies (e.g., American Express) will redeem unused travelers checks following the death of the owner, without requiring the appointment of an executor, on submission of the checks, a death certificate, and an appropriate affidavit by the next of kin indicating to whom payment should be made.

There are a number of background reasons for this proliferation of nonprobate kinds of property, such as:

a. The growth of life insurance — especially employer provided group insurance,

b. The growth of employer provided qualified pension, profit sharing, and similar plans — as well as HR-10 plans and IRAs, and

c. A public dislike of probate (e.g., see Wall Street Journal article on February 4, 1987 entitled "Revocable Living Trusts Become Popular Option in Estate Planning") — catered to by financial intermediaries, such as:

(1) Banks, brokerage firms, and transfer agents,

(2) Insurance companies, plan administrators, etc.,

who thereby reduce administrative costs (but they do fall back on true probate when determination of the proper payee gets "sticky").

Creditors no longer rely much on probate claims procedures — it is an expense they fall back on only in rare instances — and in recent years the typical probate claims filing period has been shortened (only 4 months under the Uniform Probate Code) thereby further reducing creditors' recourse to probate for enforcement of a decedent's debts.

This proliferation has been made possible by the fact that the Wills Act no longer blocks the "nonprobate revolution." The courts usually uphold such deathtime transfers notwithstanding noncompliance with the Wills Act by:

a. Pretending some kind of lifetime transfer has occurred (e.g., the property owner has conveyed to others some "contingent equitable interests in the remainder" of the property, an interest which is sometimes said to be "vested subject to defeasance") and

b. Justifying such action by referring to the "alternative formalities" involved in these nonprobate property arrangements —

(1) Written terms,
(2) The owner's signature, and
(3) Involvement of third parties in a contractual setting.

To quote from three parts of John Langbein's article *The Nonprobate Revolution and the Future of the Law of Succession* [97 HARVARD LAW REVIEW, 1108 (1984)]:

(1) ". . . the courts sympathize with people who want to avoid probate. As the Massachusetts Supreme Judicial Court said in 1944 in one of the most influential discussions of the matter:

'If an owner of property can find a means of disposing of it inter vivos that will render a will unnecessary for the accomplishment of his practical purposes, he has a right to employ it. The fact that the motive of a transfer is to obtain the practical advantages of a will without making one is immaterial.' [*National Shawmut Bank v Joy*, 315 Mass. 457, 471, 53 NE2d 113, 122 (1944) [page 1129]"

(2) "The real state of the law is that the transferor may choose to pass his property on death in either the probate or the nonprobate system or in both.

'The transferor who takes no steps to form or disclose his intent will be remitted to probate, the state system.

'The transferor who elects to use any of the devices of the nonprobate system will be protected in his decision, provided that the mode of nonprobate transfer is sufficiently formal to meet the burden of proof on the question of intent to transfer. The alternative formalities of the standard form instruments that serve as mass will substitutes satisfy this requirement so easily that the issue of intent almost never needs to be litigated. . . .'

"Transferors are free to opt out of probate by selecting any of the well-demarcated nonprobate modes of transfer." [page 1132, footnote omitted]

(3) "Article VI [of the Uniform Probate Code (UPC)] contains a group of sections that deal with multiple-party bank accounts and a general provision, section 6-201, that covers the rest of the will substitutes.

'The sections governing bank will substitutes treat the transferor as the exclusive owner of the account during his lifetime but enforce the transfer to the beneficiary on death. The official comment explains that "a person who deposits funds in a multiple-party account normally does not intend to make an irrevocable gift of all or any part of the funds represented by the deposit." Nevertheless, the Code provides that "the account operates as a valid disposition at death rather than as a present joint tenancy."

"The UPC's section 6-201, entitled "Provisions for Payment or Transfer at Death," extends to most of the other mass will substitutes: it brings within its coverage "an insurance policy, contract of employment, bond, mortgage, promissory note, deposit agreement, pension plan, trust agreement, conveyance." For good measure the section lengthens its reach to whatever future products of financial intermediation may emerge: it includes "any other written instrument effective as a contract, gift, conveyance, or trust." Each of these will substitutes is declared testamentary, "meaning valid though ineffective as a probate transfer under the Wills Act." [page 1133, footnotes omitted]

It should be noted that section 6-201 of the Uniform Probate Code does not explicitly reach stock transfers and mutual fund shares. The National Conference of Commissioners of Uniform State Laws currently has a drafting committee at work to extend section 6-201 to such property, with appropriate stakeholder protection for the transfer agent.

It should also be noted that the rule that life insurance (and other nonprobate) beneficiary designations may not be altered by will is a rule that is not universally applied [compare *Cook v Equitable Life Assurance Society*, 428 NE2d 110, 25 ALR 4th 1153 (Ind App 1981) with *Connecticut General Life Insurance Company v Peterson*, 442 F Supp 533 (WD Mo 1978)].

"Joint tenancy should be utilized only where the creator is informed (1) that joint tenancy property will not be subject to the provisions of the creator's will; (2) that the creator will lose absolute control over the property; (3) that the use of trusts and disclaimers may be restricted; (4) that unintended disinheritance may result; (5) that the property may be subject to the claims of the noncontributing joint tenant's creditors; (6) that gift tax consequences may result; (7) that unfavorable income tax results may occur; and (8) that unfavorable consequences in regard to inheritance taxes and the interest of a surviving spouse may result." [page 1002]

Beneficiary designation property pitfalls.

Beneficiary designation properties also present a number of potential pitfalls — most of which could be solved by the courts if they applied to these will substitutes the principles of construction and presumptions of the transferor's intent that have been developed in the law of wills — including questions of:

(1) The effect of divorce (where the former spouse is still named as a beneficiary) [e.g., see *Grelle v Nationwide Life Insurance Co.*, 63 Ohio App 2nd 144 (1979)],

(2) Adopted (or illegitimate) issue inheriting when the beneficiaries are described as a person's "issue, children, or descendants",

(3) Anti-lapse, ademption, simultaneous death, contracts to make a will, and so on,

(4) Apportionment of death taxes, and

(5) Creditors' rights.

Where the amounts involved are significant enough in the client's view to warrant a little planning, these questions can be resolved by changing the beneficiary designation on *all* such properties to make them payable after death:

(A) To the client's revocable trust — which is drafted to deal specifically with each of those problems — or to one or more of the trusts to be created under that revocable trust arrangement following death (such as directly to his marital trust or nonmarital trust),

(B) To one or more of the client's testamentary trusts — but:

(1) Such a trust's trustees must obtain their credentials of authority after death before the trust can receive benefits and

(2) The arrangement may not work well if a decision as to which testamentary trust (e.g., marital or nonmarital) is to be named beneficiary must be made before death, or

(C) To the client's probate estate — but at the consequent:

(1) Loss of some creditor and inheritance tax exemptions that might otherwise prevail under the laws of some states as to life insurance, qualified plan death benefits, and so on, and

(2) Loss of the simplicity, privacy, expedience, and administrative savings that would often otherwise result from avoiding probate.

Qualified plan and IRA death benefits are especially important kinds of nonprobate beneficiary designation properties to integrate into a client's overall estate plan because they typically (i) are 100% taxable income when collected after death and yet (ii) often present an opportunity for continued taxfree compounding growth if left invested in the plan or a rollover IRA. The second article in this series (to appear in the next issue of *Probate Notes*) suggests a standardized method of integrating these ever more prevalent death benefit properties into a revocable trust type estate plan in a way that defers making the difficult planning decisions until after death when the facts are better known and when the constantly shifting tax law rules governing these benefits become fixed insofar as that particular plan participant is concerned.

Funded revocable trusts.

Revocable trusts which are funded before death to avoid probate (or to avoid problems otherwise encountered on incapacity under guardianship or where the only management vehicle is a durable power of attorney) themselves have many potential pitfalls. Most of these potential pitfalls can be avoided by proper planning and draftsmanship. The third article in this series (to appear in a future issue of *Probate Notes*) will be devoted to:

(1) Alerting the practitioner to these potential pitfalls and

(2) Making practical suggestions for avoiding or coping with them.

The fourth and last article in this series (also scheduled to appear in a future issue of *Probate Notes*) will describe a simple method for converting joint property into revocable trust owned property (without disturbing record title registrations) in order to integrate those properties into the client husband and wife estate plan. This technique, and the revocable trust-disclaimer method of integrating qualified plan and IRA death benefits into the estate plan (separately described in the next issue of *Probate Notes*) give the revocable trust, whether or not funded before death to avoid probate, many advantages as the "main vehicle" of a client's estate plan into which all probate and beneficiary designation properties "pour over" after death.

The pitfalls in nonprobate arrangements — an overview.
Worst of all — there is no cohesive plan!

The key pitfall of these nonprobate arrangements, often having the *most* adverse consequences, is the failure to integrate all properties into one cohesive plan. Where a person has many separate:

(i) beneficiary designation properties (insurance policies, employee benefit plans, IRAs, partnership successor provisions, etc.) and
(ii) joint accounts and joint properties,

a failure to integrate these properties with his probate properties into one cohesive plan can have many unfortunate results. Chief among these are the following —

a. **Underfunding the credit shelter share of the estate.** The principal cause of failure in the typical will (or revocable trust) plan for dividing the taxable estate between:

(1) A credit shelter share (either continuing in a bypass or nonmarital trust or passing outright to descendants or collaterals) and
(2) A marital deduction share (either continuing in a Q-TIP or other marital trust or passing outright to the surviving spouse)

Is finding on death that there is too much property passing *outside* the will (or revocable trust) formula. If too much passes outside the plan to the surviving spouse — for example, joint property to the surviving spouse, beneficiary designation insurance, employee death benefits, IRAs, etc. going directly to the surviving spouse, and so on — some of the unified credit is wasted. Conversely, if too much passes outside the plan to other beneficiaries, some death taxes that could have been avoided (or postponed) by the marital deduction will have to be paid.

b. **Defeating Q-TIP objectives.** If the client decided on a Q-TIP trust for the marital deduction share either:

(1) Because it assures that, on the surviving spouse's death, the remaining property will not be diverted from the client's descendants (or family) or
(2) Because it affords postdeath tax elections that may reduce death or generation skipping taxes in the future,

these purposes will be defeated to the extent that nonprobate joint and beneficiary designation properties pass outright on death to the surviving spouse.

c. **Missing the full generation skipping trust exemption potential.** Use of a generation skipping trust arrangement to take advantage of the $1M/$2M generation skipping tax exemption for one's children and their descendants will be rendered inoperative to the extent that outright distributions to the children of joint and beneficiary designation properties prevent the full $1M/$2M exemption amount from going into the trust arrangement.

d. **Liquid assets may become unavailable for death taxes, debts, etc.** To the extent cash death benefits are paid directly to family members (rather than to the executors or trustees), the liquidity represented by those death benefits may not be available to help in paying the estate's death taxes, debts, and expenses.

e. **The "plan" becomes hard to review and amend.** When a client who uses numerous will substitutes tries to describe his "estate plan", he must refer to numerous separate property arrangements — and overall changes in his plan require changing many will substitutes, not just revising one will by codicil or a new single will.

The message is plain — drafting a will alone is no longer enough. To quote again from Langbein:

> ". . . a decedent now effects many wealth transfers at death, through instruments that have been executed at different times and that may reflect different circumstances of family and property. . . . it is not enough to simply write someone a will. The client now has many "nonprobate wills" that the draftsman must consider and sometimes revise when drawing up the "probate will." [page 1140]
> ". . . the federal transfer-tax rules . . . obliterate the probate/nonprobate line for purposes of determining what transfers should be subject to estate taxation." [page 1139, footnote omitted]

Joint property pitfalls.

Joint property holdings present a whole series of pitfalls unique to that form of property ownership. When the joint tenants are husband and wife, the potential problems are chiefly:

(1) Failure to integrate those properties into either spouse's plan —

(a) As described above (primarily a tax consideration) and

(b) As to which spouse's family will ultimately inherit any remaining properties (absent surviving issue of the marriage and absent wills that take this into account),

(2) Creditor claims uncertainties, and

(3) Potentially adverse consequences (from the point of view of a spouse who brings significant properties into the marriage) in the event of divorce.

When a joint tenancy is between nonspouses, the pitfalls are potentially much more numerous. To quote from an excellent article on the subject [Johnson, *Survivorship Interests With Persons Other Than a Spouse: The Costs of Probate Avoidance*, 20 REAL PROP, PROB & TR J 985 (1985)]: