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A Perfectly Good Estate Plan Gone Awry

By Abbe I. Herbst

The estate plans of the new clients (a husband and wife) seemed to make perfect sense: each will established a credit shelter trust for the other, designed to take advantage of current law, which, in effect, does not tax the first $1,000,000 of property. The balance of each estate (called the "residuary estate") would pass outright and free of trust to the surviving spouse. When we looked at how their assets were owned, however, it became very clear that, unless changes were made, the tax savings that their attorney had in mind would be impossible, and here is why.

A will is effective only as to assets registered in the name of the testator alone. It does not operate on assets such as real property owned as joint tenants or as tenants by the entirety, joint bank or brokerage accounts, accounts held "in trust for" another, life insurance payable to a designated beneficiary, or individual retirement accounts or other retirement plans for which a beneficiary designation is effective.

As it turned out, virtually all the assets (totaling about $2,000,000) owned by the couple in this story were either owned jointly or were payable to the survivor by virtue of the beneficiary designations of the retirement plans and life insurance policies. Unless the assets were re-titled and the beneficiary designations changed, the combined federal estate taxes after both had died (assuming they were to die this year or in 2003) would be $435,000. If the changes were made, the combined federal estate taxes would be zero, and each spouse would still enjoy the use of the assets.

Moreover, the surviving spouse as the co-owner of joint accounts would lose significant income tax benefits when the first spouse died. For assets held in the decedent spouse's name alone, current federal tax law generally provides that the assets receive a new basis, equal to their value on the date of the decedent's death. For joint assets, however, the rule is that the assets receive a split basis: one-half valued using the date of death value, and the other half using one-half of the cost basis. For example, assume that the investments in a brokerage account are worth $500,000 on the date of death, having appreciated substantially over the years from their cost basis of $300,000. If the brokerage account were in the name of the decedent alone, the person who received the assets pursuant to the will would inherit a so-called "stepped up" basis of $500,000 for purposes of measuring gain or loss on sales made after the decedent's death. If, on the other hand, the brokerage account were owned in joint names, the beneficiary's new basis in the assets would

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be only $400,000 (½ of $500,000 plus ½ of $300,000), resulting in significant —and perhaps unnecessary — capital gains tax when the assets were sold.

Could this story be yours? The lesson to be learned by it is that it is not enough to have what, in theory, is a well-designed estate plan. It is important that care be taken at the time an estate plan is made to examine how assets are owned. As time goes by, it is also important to monitor how new assets are titled, in order to make certain that the outcome sought to be achieved will in fact result.

Helpful Tip: Many people enjoy the convenience of joint accounts, knowing that either party can have complete access to the accounts at any time. They may not realize the unfortunate tax consequences that go along with such accounts, as this article has sought to demonstrate. But there are alternatives! The true owner of the account can give the spouse a durable general power of attorney over the accounts, so that the spouse can continue to have full access to the accounts during the owner's lifetime, but they will be included as probate assets in the estate of the owner, so that the terms of the will determine how they are disposed of, and the "stepped up" basis rules will apply. Another alternative, under section 678 of the New York Banking Law, is to establish the accounts as "For the Convenience of" the owner. Accounts for the convenience of the owner are similar to joint accounts, but they do not confer any survivorship rights on the part of the other party to the account, and they do not result in a split basis upon the owner's death. ■

We hope you have enjoyed this first issue of AKO Estate Planning & Tax Advisor. It signals the addition of the Trusts and Estates Department to Anderson Kill & Olick, P.C., offering a complete range of estate and retirement planning and income, gift and estate tax services. We invite you to contact the members of our Department, listed below, with your questions and concerns.

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