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Efforts to Avoid Probate Can Carry Their Own Risks

MARILYNN K. YEE/THE NEW YORK TIMES

DOTTING ALL THE I'S Jill Miller, a lawyer, said clients who didn't coordinate their nonprobate assets with the rest of their plans could undo their work, citing the case of a woman who died before changing some account beneficiaries.

Efforts to Avoid Probate Can Carry Their Own Risks

THE new tax law signed by President Obama in December gives many people a reason to revise their estate plans. In the process, some will try to avoid probate. Others may be surprised to find that much of what they leave behind will not go through probate anyway.

Either way, traps await the unwary.

Probate is the system through which a court determines that a will is legally valid, something that must be done before the inheritances it covers can be given out. The process varies by state and is not necessarily costly or time-consuming. Still, it creates a public record of matters you may prefer to keep private, including what you owned, to whom it was left and the terms of a prenuptial agreement.

Passing assets outside of probate keeps them private, avoids will contests — for instance, when blood relatives are hostile toward a domestic partner or new spouse — and simplifies planning for elderly people with just one child they wish to benefit.

A living trust is the most widely publicized tool for bypassing probate. It can hold assets for your benefit while you are alive — for example, in case of dementia — and specify who gets what after you die.

However, a living trust avoids probate only for assets put into the trust. And inevitably, something is left out, said Joanne Fanizza, a lawyer in Fort Lauderdale, Fla. So lawyers recommend a will that can cover everything else, whether or not you listed it. Of course, this will must be probated.

Other assets will not go through probate no matter what a will or living trust says. These include retirement assets, life insurance and savings bonds, as well as jointly titled bank accounts, brokerage accounts and real estate.

Misunderstandings about who is entitled to these nonprobate assets, as they are called, can lead to unintended consequences, said Michel W. Nelson, vice president and senior trust officer at the Iowa Savings Bank in Carroll, Iowa. He recalled cases in which an aging parent with several adult children depended on one of them as the primary caregiver. To facilitate bill-paying, the parent opened a bank account of which that child was the co-owner, not realizing that the co-owner would automatically receive all the money in this account when the parent died.

That child has no obligation to share the money with siblings, Mr. Nelson said. If the child wants to share it, the money is considered a gift, and the limits on yearly and lifetime tax-free gifts apply. To avoid this situation, a parent should give the child a power of attorney over the account instead of naming the child a co-owner, Mr. Nelson said.

Forgetting to coordinate nonprobate assets with the rest of your plan can also "completely unravel and thwart your objectives," said Jill Miller, a New York lawyer. That is what happened in one case she handled, involving a couple who married late in life. The wife suddenly became ill and died.

The paperwork for her life insurance and retirement accounts named other family members to receive the benefits, and that superseded her will. Under New York law, her husband had some recourse, but he wound up with about 60 percent less than he would have received had his wife changed the forms to make him the beneficiary, Ms. Miller said.

Another issue that gets neglected is who should pay expenses. Even if federal estate taxes are no longer an issue, heirs incur many costs, including state estate taxes (in 16 states and the District of Columbia), professional fees and the funeral bill. These typically come out of the pot of money covered by a will or living trust. When most of an estate passes outside of probate, there may not be enough money allocated for expenses, said Bernard A. Krooks, a lawyer with Littman Krooks in New York.

To steer clear of these and other mishaps, make a list of all your assets, the type of account they are in and details about how they are titled. Here are issues to consider:

JOINT ACCOUNTS With bank and brokerage accounts, the most frequent form of joint ownership is joint tenancy with rights of survivorship. It appears on some account statements with the abbreviation J.T.W.R.O.S., and on others by naming the owner as one person or the other (for instance, Lucy or Ricky Ricardo). Both owners have access to the assets during life, and when one joint tenant dies, everything goes to the survivor.

This form of ownership, though usually appropriate for spouses, poses many pitfalls to other people. Indeed, Iowa Savings Bank developed an information sheet outlining them for its customers, Mr. Nelson said. For the last several years, bank employees have been instructed not to open joint accounts until customers read about the risks.

One risk is that either person can withdraw all the money without the other's consent. Another is that unless the joint tenant is a spouse, there may be gift-tax costs of adding someone's name to an account, and joint title could expose each co-owner to the other's potential liabilities, Mr. Nelson said.

In about 20 states, married couples may be able to use a special form of joint ownership called tenancy by the entirety to protect these assets as well as real estate, said Gideon Rothschild, a lawyer with Moses & Singer in New York. (A handful of other states allow it only for real estate.)

With this form of ownership, only the couple's joint creditors have access to the account. The trouble is, "If the nondebtor spouse dies first, then the creditors of the debtor spouse can reach the whole asset," Mr. Rothschild noted.

CO-OWNED REAL ESTATE Many issues that apply to bank accounts also affect real estate held as joint tenants with rights of survivorship. Another concern that can be difficult to navigate is that joint owners must agree before the property can be sold.

ASSETS PAYABLE (OR TRANSFERABLE) ON DEATH Although many people use these terms interchangeably, the exact wording may depend on state law and the type of asset. For example, you can make savings bonds "payable on death" to the person you name, while brokerage accounts are labeled "transfer on death." The net effect is the same. When the owner dies, the person named can promptly collect the money by presenting the death certificate and filling out any paperwork the institution requires. In contrast with joint ownership, the named people have no access to the money while the account owner is alive.

A common trap goes something like this: A mother wants to provide equally for her three children. Shares in General Electric constitute a third of her estate. So she leaves the stock to one child in a transfer on death account and names the other two as the beneficiaries of her individual retirement account. Several months before she dies, she sells the stock. The child who was supposed to get it receives nothing.

BENEFICIARY DESIGNATIONS This is a document given to an insurance company or financial institution, indicating who should inherit certain assets that do not pass under a will or trust, like the proceeds of a life insurance policy and retirement accounts. Note that with an I.R.A., you can readily name any beneficiaries you want, but for a 401(k) or other workplace plan, you must get your spouse's written permission to leave it to anyone who is not your spouse, Mr. Krooks said.

It is important that you keep these forms up to date. To change a beneficiary — for example, if you get married or divorced or your spouse dies — make sure to file an amended form.