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Estate Planning newsletter

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DON'T LET YOUR BENEFICIARY DESIGNATIONS TORPEDO YOUR ESTATE PLAN

Traditionally when we think of estate planning, we think of transferring assets upon death pursuant to wishes conveyed as part of a Last Will and Testament or a Revocable Trust. Assets held in a revocable trust will pass directly to beneficiaries named in the trust agreement without the need for probate. Some assets held in your individual name will be subject to probate and will pass according to your Last Will and Testament or by law if you do not have a Will. However, many people hold a significant portion of their wealth in assets which do not pass through the probate system – appropriately called "non-probate" assets. It is therefore important to know what those non-probate assets are and how to manage those assets so that you can be sure they are conveyed upon your death in a manner that is consistent with the rest of your estate plan.

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GISLASON & HUNTER LLP
ATTORNEYS AT LAW
www.gislason.com

DON'T LET YOUR BENEFICIARY DESIGNATIONS TORPEDO YOUR ESTATE PLAN

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By Sara N. Wilson
763-225-6000
swilson@gislason.com

By Abigail A. Pettit
763-225-6000
apettit@gislason.com

1. What Are Non-Probate Assets?

Non-probate assets include real or personal property owned jointly with another person or personal property that is designated by contract to go a designated beneficiary upon the owner's death. Examples of non-probate assets include real property owned as joint tenants, jointly held bank or brokerage accounts, payable-on-death or transfer-on-death accounts, retirement accounts (e.g. IRAs, Roth IRAs, 401(k)s, 403(b)s and life insurance death benefits, residual value of annuities, and pension benefits with a designated beneficiary. A beneficiary designation is specific to an individual asset, and is not affected by how you choose to distribute your property in any other testamentary document, such as a will or a trust.

2. List both Primary and Contingent Beneficiaries.

For many non-probate assets, upon your death the asset will be transferred either to your joint tenant or your designated primary beneficiary, who will then become the owner of the asset. If you hold an asset in joint tenancy, then upon your death title to that asset will pass outside of probate to the surviving owner(s). If you hold an asset with a beneficiary designation, the asset will be distributed to your named primary beneficiary upon your death. If that primary beneficiary predeceases you, the asset will instead be transferred to your contingent beneficiary. However, if you have not listed either a primary or a contingent beneficiary the non-probate asset will likely be considered a probate asset. In many instances, a retirement account may have a "default" beneficiary if none is named, or if your beneficiary designations otherwise fail. The default is almost always the surviving spouse or your estate. Distributing a large retirement account, for example, directly to your estate, can result in large tax consequences, which would otherwise be avoided through the proper use of beneficiary designations. If the asset and/or the value of your estate as a whole is large enough, probate will then be required.

3. Be Certain to Update Beneficiary Designations.

Often we either forget who we may have named as a beneficiary on a non-probate asset, or fail to review beneficiary designations after certain life changes. If you do not ensure you have properly designated beneficiaries, you may inadvertently leave the asset to someone unintended or inadvertently create the need for probate. Review beneficiary designations often and certainly upon such life changes as divorce, death of a designated beneficiary and birth of a child or grandchild.

4. Minors and Individuals with Special Needs.

You need to think about the situation of your beneficiary. For instance, if you name a minor child as a direct beneficiary of a non-probate asset, the proceeds will likely be paid directly to that child when they turn 18. Providing an 18 year old with immediate access to a large sum of money may not be in their best interest. Therefore, if you have minor children and no living trust, it may be better to name a testamentary trust designated in your will as your beneficiary. Likewise if you name an individual who is receiving a governmental benefit based on a disability as a direct beneficiary, you could unintentionally disqualify that individual from receiving their necessary governmental benefits. You are still able to provide an inheritance for an individual receiving this type of assistance by creating a special needs or supplemental needs trust within your will or revocable trust.

5. Include Beneficiary Designations as Part of your Overall Estate Planning.

Assets not formally transferred to the trustee of a revocable trust will probably not be considered part of the trust and may still be subject to probate upon the grantor's death. Likewise, non-probate assets that either do not have a beneficiary listed or do not have a proper beneficiary designation may mean that the asset does not go to the person you would like or ends up subject to probate. Finally, an outdated beneficiary designation could cause just as many problems as no beneficiary designation, with a significant asset bypassing your preferred heirs because you haven't changed your designations in accordance with your life changes and the rest of your estate plan. You should simultaneously review your current estate plan alongside the beneficiary designations of your non-probate assets to ensure your estate plan goals are met. ■

ESTATE PLANNING FOR RETIREMENT BENEFITS

By Christopher J. Kamath
507-387-1115
ckamath@gislason.com

More and more individuals are holding the bulk of their wealth in employer sponsored and individual retirement plans. Yet most people do not give the same level of care and consideration to these assets as they do in designing a Will or creating a trust. In order to maximize these assets for the benefit of yourself, your spouse, your children and other beneficiaries, it is essential that you incorporate these assets into your existing estate plan. A proper estate plan should consider the type of plan holding the assets, the required minimum distributions ("RMDs") under the plan, beneficiary designations, and your retirement and legacy goals.

QUALIFIED RETIREMENT PLANS

Retirement plans are divided into two broad categories: defined benefit plans and defined contribution plans. Defined benefit plans, more commonly known as pensions, are rare for non-government employees. This article focuses on defined contribution plans, such as 401(k) plans and 403(b) plans, and traditional individual retirement accounts ("IRAs"). Defined contribution plans are funded by the employee/participant with contributions taken directly from the employee's paychecks. Sometimes an employer will match a portion of the employee's contributions. Defined contribution plans do not guarantee a specific amount of benefit; the ultimate payout depends on the underlying performance of the plan's investments.

The greatest advantage of these plans over other investments is their preferential tax treatment. The money contributed to a qualified retirement plan or traditional IRA is generally not subject to income tax when it is earned. Instead, the money is taxed when the participant receives a distribution from his or her account. This deferral of income tax allows the plan administrator to invest your money *and* the money that would have gone to the IRS. The longer these assets stay in the plan, the more money Uncle Sam's share earns for you through investment.

REQUIRED MINIMUM DISTRIBUTIONS

In order to prevent participants from using these plans as a vehicle to accumulate and transfer wealth (versus actually spending money for their retirement), Congress established a series of rules known as the Required Minimum Distribution rules. The RMD rules require that a participant begin withdrawing money from their retirement account after he or she turns 70 ½ years old. The amount of the RMD is determined each year by dividing the previous year-end account balance over the life expectancy of the participant, as listed in the Uniform Lifetime Table or the Joint Life and Last Survivor Table, depending on the age of the spouse.

For example, if Margaret is 71 years old and has a 401(k) balance of $1 million, she would only be required to withdraw $37,735.85 (3.7% of the account balance) based on her life factor of 26.5. Depending on the investment return, there is a good chance that the retirement account will be worth more when Margaret dies than when she started drawing on the account, assuming she only takes the Required Minimum Distribution each year.

RMDs must be withdrawn every year by December 31st. If a participant fails to take their RMD by the due date, the IRS will charge a penalty equal to 50% of the late distribution. There is no limit on the amount of distributions that can be taken in a given year and a participant may withdraw the entire balance of the account after he or she turns 59.5 years old. However, distributions are taxable as ordinary income to the recipient, and liquidating a large account would likely have negative income tax consequences.

TRANSFERRING RETIREMENT BENEFITS TO BENEFICIARIES

One of the most important things to consider when setting up or reviewing a retirement account is who are going to be the beneficiaries. If you're married, in most circumstances it will make sense to name your spouse as the sole and primary beneficiary of your qualified retirement plan, because spouses receive special treatment under the rules. For example, if the participant dies before he or she reaches 70.5 years of age and the surviving spouse is the sole beneficiary, the spouse can elect to postpone RMDs until December 31st of the year the participant would reach the commencement age for RMDs (70.5 years old). If the participant dies after commencement of the RMDs, the surviving spouse's RMDs will be calculated through a preferable method that results in smaller required distributions.

The surviving spouse also has the unique ability to roll over the inherited plan to one of her own retirement plans, such as an IRA. As the owner of the retirement plan, her RMDs are determined using the more favorable Uniform Life Table. Assuming she only draws the Required Minimum Distribution, the assets in the account are guaranteed to outlast the life of the spouse and will likely be worth more at her death. Her beneficiaries can then inherit the retirement benefits and stretch the distributions out over their lives.

Some beneficiaries other than spouses can also take advantage of special rules for inherited retirement accounts. A "designated beneficiary" is any individual named in the retirement plan as a primary or contingent beneficiary. Required Minimum Distributions are accelerated when you name a non-designated beneficiary to receive retirement benefits after your death, such as your estate or a non-qualifying trust. Designated beneficiaries, other than your spouse, can have the benefits stretched out over their life expectancy based on the factors in the Single Life Table. If the beneficiary dies before receiving the entire benefit, the successor will step into the shoes of the deceased beneficiary and receive distributions based on the deceased's actuarial life expectancy.

The net result is that you can "stretch" out the life of the retirement benefits for a longer period of time and maximize the tax-deferred growth of the assets.

TRUSTS

Properly using a trust to distribute retirement plan benefits is incredibly complicated. Although a full discussion of trusts as they pertain to retirement benefits is beyond the scope of this article, there are a few basic rules to consider. As a general matter, even if a trust qualifies for the "stretch" treatment available individual beneficiaries, if a qualifying trust has more than one beneficiary, the life expectancy of the oldest beneficiary is used to calculate the RMDs for the entire group, reducing the amount of money ultimately transferred to your heirs. A higher portion of distributions also go to the IRS because trusts are generally taxed at higher income tax rates than individual beneficiaries. As a result, it is not advisable to name a trust as a beneficiary of a retirement plan unless there is a compelling reason, such as the beneficiaries being minors, having special needs, or needing asset protection from a future bankruptcy proceeding. In those cases, it's important that the trust be designed to have only one beneficiary if possible, and that the trust document include the technical provisions required for it to be qualified to elect to "stretch" payments.

COORDINATING RETIREMENT ASSETS WITH OTHER ESTATE PLANNING DOCUMENTS

Most individuals are surprised to learn that their Will usually has no bearing on who will receive benefits under their retirement plan. This is because retirement benefits are generally non-probate assets. A non-probate asset is an asset that does not need the help of a probate court to transfer title out of the name of the deceased/participant and into the name of the beneficiary. Retirement assets always follow the beneficiaries named on the account's designated beneficiary form. You could name your estate as the primary beneficiary of a retirement plan, but this is not a good idea. Estates cannot be a designated beneficiary eligible to "stretch" distributions, even if all of the individual beneficiaries of your estate would qualify as designated beneficiaries. The assets will be distributed to your beneficiaries at an accelerated schedule and possibly subject to higher income taxes.

Typically, your spouse must be named the beneficiary of a qualified retirement plan, unless he or she signs a valid waiver or consent. If your estate plan calls for the majority balance of your retirement plan to be distributed to a non-spouse beneficiary, it is important to request a waiver from your spouse so that your estate plan can be fully implemented.

It is also important to note that a retirement plan is not required under law to offer all of the payment options discussed above. Even if your beneficiary qualifies to stretch out distributions, the plan can require that the beneficiary take the distribution in a lump sum. In fact, many qualified retirement plans offer death benefits only in the form of lump sum distributions.

Whether your beneficiary should receive retirement plan distributions in an annuity form, lump sum, or as a roll over distribution is an important consideration in drafting a comprehensive estate plan. Factors to consider when making this decision include the beneficiary's expected income tax rate, the life expectancy of the beneficiary, the expected return on investment in the retirement plan, your estate tax rate, whether your estate will need liquid funds to pay death and funeral expenses, and the degree of control you wish to keep over the assets. One way to deal with the uncertainty of selecting a beneficiary and payout method is to incorporate disclaimers into your beneficiary designations so that the retirement assets can be moved down the line of your intended heirs.

CONCLUSION

This article is intended to provide a general overview of estate planning for retirement assets. There are many exceptions to the rules described above and new regulations are being proposed all the time. Consequently, it is important periodically review your retirement accounts with the plan administrator and your estate planning attorney to ensure the current plan is consistent with your long-term goals. ■

YOUR ESTATE PLANNING TIMELINE

By Kaitlin Pals
507-354-3111
kpals@gislason.com

When do you need to get a Will? The answer is, probably earlier in your life than you think, and just getting a Will signed is not enough; it needs to be updated throughout your life. Additionally, there is so much more to estate planning than Wills. Powers of Attorney, Health Care Directives, trusts, beneficiary designations, and business succession plans are all essentials in the estate planner's tool box that may be appropriate for you at different points in your life. Below are some lifetime events when you should consider creating an estate plan or revising your plan with your attorney.

Age 18.
An individual can make a Will as early as when he or she turns 18. While few teenagers need Wills at this stage in their lives, it's definitely not too early to get a Health Care Directive. Once a teenager is legally an adult, he or she needs to decide whether Mom, Dad, or someone else should make health care decisions for him or her if he or she can't.

Starting your own business.
Estate planning is especially important at this phase if you're starting a business with one or more partners or co-owners. Buy-sell agreements and other documents can help you plan how the business will move forward if something happens to one of you.

Marriage.
A Will is a great (albeit not terribly romantic) wedding gift to yourself, but this is also a good time to review how real property you and/or your spouse own is titled, as well as beneficiary designations on insurance policies and retirement accounts.

Major property purchase.

Birth of first child.
Young couples may not think they need a Will because if both spouses die, they assume their children will automatically inherit everything. Even if that's the case in your particular situation (and it may not be), the law really doesn't have a "default" for determining who raises children and takes care of their money if something should happen to both parents. Naming a guardian, custodian, and/or trustee in your Will is one of the best ways to make sure that if something happens to you, your children's futures are stable and secure.

Receive an inheritance.

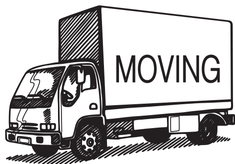
Custodian named in your will becomes unavailable.
While naming a custodian or guardian for your children in your Will is an important first step, planning for your children's care doesn't end there. It's important to update your Will if the custodian or guardian you have designated has passed away or has otherwise become unable to care for your children in the event of your death.

Regular Check-Ups

Just as regular doctor visits are important to maintaining your physical health, regular "check-ups" with your estate planner ensure your plan still meets your needs, even if you haven't had a major change to your family status or assets recently.

Separation or divorce.
The last thing you probably want to do when going through the stress of a divorce is add yet another legal issue to your plate, but consider: do you want your soon-to-be ex-spouse to inherit all of your property if something should happen to you before your divorce is finalized? If you've already been through a divorce, it's time to update your Will to reflect major changes to your family's needs. Talk to your family law attorney about when the best time to do estate planning is in your particular situation.

Subsequent marriage.
Wills and other estate planning devices are vitally important for blended families. Depending on you and your spouse's family situations and individual property, anything from step-parent adoption to special trusts or life estates to split inheritance between your new spouse and your children may be in order.



Move to a different state.

Long-term committed relationship.
Wills, Powers of Attorney, and Health Care Directives are also vitally important to couples in long-term committed relationships but who are not married to one another. Inheritance laws aren't equipped to determine how close a relationship between two unmarried people is unless you've made it clear in your estate planning documents.

Birth of first grandchild.

Spouse's death.

Poor health/last illness.
Don't wait this long to get a Will, Power of Attorney, and Health Care Directive, if you can help it. Though an attorney may be able to put basic documents together for you quickly, this ideally should be a time to just review your already-in-place estate documents to provide you peace of mind and perhaps make a few minor changes. The key to estate planning is to *plan.*

Did You know?

According to Forbes, 64% of Baby Boomers don't even have a simple Health Care Directive or similar document in place.

Gislason & Hunter Estate Planning Services

Estate Planning is important to ensure the orderly transfer of family assets, as well as to protect those assets from unnecessary taxation. The Gislason & Hunter Estate Planning Practice Group offers a variety of services to assist you in creating the best plan for you, your family, your business or your farm.

Some of the many services our attorneys offer include the following:

- Drafting wills, trusts, codicils and powers of attorney
- Preparing health care directives and living wills
- Creating family business succession plans with emphasis on each family's particular goals and values
- Farm estate and succession planning
- Evaluating estate and gift tax issues and structuring planning options to minimize tax obligations
- Administering and assisting clients with probate proceedings, conservatorships and guardianships
- Advising on Medicaid, Medicare, nursing home and elder law issues
- Handling disputed estate and probate matters in litigation, arbitration or mediation formats

Gislason & Hunter Wills, Trusts, Estate Planning & Probate Practice Group:

Daniel A. Beckman	dbeckman@gislason.com
Reed H. Glawe	rglawe@gislason.com
David Hoelmer	dhoelmer@gislason.com
Kaitlin M. Pals	kpals@gislason.com
Abby Pettit	apettit@gislason.com
Andrew M. Tatge	atatge@gislason.com
Wade R. Wacholz	wwacholz@gislason.com
Andrew A. Willaert	awillaert@gislason.com
C. Thomas Wilson	twilson@gislason.com
Sara N. Wilson	swilson@gislason.com
Chris Kamath	ckamath@gislason.com
Rhett Schwichtenberg	rschwichtenberg@gislason.com

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LOCATIONS

Minneapolis Office
Golden Hills Office Center
701 Xenia Avenue S, Suite 500
Minneapolis, MN 55416
763-225-6000

Des Moines Office
666 Walnut Street, Suite 1710
Des Moines, IA 50309
515-244-6199

Mankato Office
Landkamer Building
124 E Walnut Street, Suite 200
Mankato, MN 56001
507-387-1115

New Ulm Office
2700 South Broadway
New Ulm, MN 56073
507-354-3111

www.gislason.com

GISLASON & HUNTER LLP
ATTORNEYS AT LAW
www.gislason.com