

Common Estate Planning Mistakes and How to Avoid Them

An Educational Resource From
Solid Rock Wealth Management

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Estate planning mistakes can cost you and your heirs a tremendous amount of money and stress. This Wealth Guide will discuss common mistakes and suggestions on how to avoid them.

No plan

Not having an estate plan may be the most common mistake. Unfortunately, far too many people put off estate planning until it is too late. There are many estate preservation tools and strategies you can use to maximize an inheritance for your heirs, but it's up to you to take action.

Outdated plan

An outdated plan could be as bad as not having any plan at all. Changes such as the birth of a child or grandchild, an adoption, death, marriage, divorce, new property acquisition, inheritance, or change of address may require changes to your plan. Additionally, tax law changes and/or changes to rules regarding investments, trusts, and retirement and estate planning may warrant an update to your plan.

Dying without a will

Similar to dying without a plan is dying without a will. If you die without a will it is called dying intestate and your assets will be distributed under the Law of Intestate Succession in your state. These laws may not be in line with your wishes.

Failure to plan for potential incapacity

A durable power of attorney will allow you to select in advance who will handle your financial affairs in the event of your later incapacity. Likewise, a medical power of attorney will allow your selected person to arrange for medical care if you become incapacitated. Lack of such documents might require a costly guardianship proceeding. If you do not want to be kept alive on life support if your condition is terminal or irreversible, a directive to physicians should be considered.

Lack of a coordinated plan

Today's complex financial world requires a comprehensive and integrated approach for the effective preservation of your wealth and assuring that the needs of, and distribution to, your heirs are properly taken care of. An effective estate plan must take into account all areas of one's life, including investments, retirement planning, tax strategies, risk management, wealth preservation and other components. No single person can be an expert in all these different areas. This is why it is wise to work with a team of professionals that collaborate with each other. A team approach will help ensure all areas of your financial life are properly addressed and that your estate plan effectively achieves your goals.

Lack of a coordinated plan could result in conflicts between your estate plan, property titles and other beneficiary designations. Contracts with beneficiary designations and ownership of assets override what is stated in a will. Unless your property titles and beneficiary designations are consistent with your trust or will, your assets may not pass to the desired beneficiary. It is important to make certain that your beneficiary designations and the ownership of your assets are carefully coordinated with your overall estate plan.

Not meeting with an experienced legal, financial, or tax professional.

Estate planning is a complex and ever changing field. Working with an attorney that specializes in estate planning is important for ensuring that the strategy and documents you are using are effective and up to date. Be careful of “canned” documents or documents you download from the internet or purchase at the office supply store. Relying on web-based, do it yourself solutions can be a recipe for disaster

Again, working with an experienced team of tax, legal, insurance and investment professionals is a prudent way to make sure all areas of your financial life are working together in harmony with each other.

Not avoiding probate

Probate is the process of settling one’s estate. Typically, probate involves paperwork and court appearances by attorneys with fees paid from estate property. Probate can be costly and time consuming and the probate files are public record. Avoidance of probate is generally a preferable option. In some states, including Montana, a Uniform Probate Code exists which helps to simplify probate and reduce costs. While this may reduce the costs and time delay of probate somewhat, it does not eliminate them.

Many people think that if they have a will, they will avoid probate. This is not true. If you have a will, your heirs will go through probate. There are several ways to avoid probate. One way to avoid probate is with a living trust. A living trust can avoid probate, significantly shorten the time involved in settling an estate and can keep your affairs private.

Another way to avoid probate with your investment and savings accounts is to establish them as TOD and POD accounts. This way, upon death, the proceeds go directly to the beneficiary you name without going through probate.

In some states, including Montana, you can place a beneficiary deed on real property. This enables you to pass property to the beneficiary you name and avoid probate.

Not funding a living trust

A trust can only control assets to which it holds title. If you establish a living trust, you need to re-title your assets into the name of the trust. If your living trust owns your assets and is set up correctly, when you die, your beneficiaries will receive those assets without having to go through probate. If you fail to transfer your assets into the name of the trust, your heirs may have to go through probate and much of the benefits a living trust offers will be wasted.

Failure to plan for contingencies, such as people dying “out of order”

All documents (including a will and beneficiary designations on retirement assets, annuities and life insurance policies) should cover contingent situations such as a pre-deceasing spouse or children. If minors or incapacitated persons could conceivably inherit, a trustee or custodian should be named.

Lack of adequate, up-to-date and organized records

Leaving your family with a financial mess can cause a tremendous amount of stress. It can also increase the amount of estate settlement costs. Grieving over a loved one’s death is hard enough. Don’t subject the people you love with the task of trying to piece together your financial life when you’re gone. Take time now to organize your financial documents and records and to educate your family about what they will need to know and do when you are gone.

In addition to providing your family with written instructions on where to find documents and how to manage financial affairs, take time to write each of them a letter expressing your love for them and what you want them to know when you are gone. This could be the most impactful thing you ever do.

To help families organize their financial affairs and communicate their deepest feelings to the ones they love, I have created a Wealth Guide titled: Family Financial Organizer and Love Letter. You can request this by calling 406-582-1264.

Improper use of jointly held property

Property titled in joint tenancy with rights of survivorship (JTWROS) passes directly to the surviving joint owner by law and avoids probate. Because owning assets in joint tenancy is a simple way to pass assets and avoids probate, people often title assets jointly with family members or friends. Below are some of the problems that can result from this.

1. Capital gain tax issues. When you gift stock or real estate to someone, they receive your cost basis in the asset. When you leave stocks or real estate to someone upon your death, they receive a “stepped-up” cost basis to the fair market value of the asset upon your date of death. Consequently, if you list stock or real estate in JTWROS with someone you are essentially making a gift to them. Consequently, they may end up paying more in taxes than if you left it to them upon your death.

For example, after her husband died, a mother put her daughter on the deed of her home as a joint owner. When the mother dies, the daughter becomes the sole owner of the home but because listing her daughter on the deed was considered a gift, the daughter loses out on a step up in basis on half the value of the home when her mom dies. Therefore, when the daughter sells the home, she may owe more capital gain tax than she would if she inherited the entire property from her mom. So, no matter how well your intentions may be to gift the family home to your child, you may very well end up costing them money. Instead, create an estate plan that passes on the home via an inheritance.

2. Gift tax issues. Unless an exception applies - as is the case when the joint owner is the owner's spouse - listing assets in JTWROS can generate a taxable gift in the current year if the value of the asset is worth more than the annual gift tax exclusion amount (\$14,000 in 2013). This means that one can give cash or assets of that amount or less to another person each year without paying gift tax. When you put your child's name on the deed of real estate, you are essentially giving your child a hefty sized taxable gift. This cannot only cause them to pay more capital gain tax as described above but it can also reduce your lifetime gift exemption amount.

3. Loss of control and disinherit children. Another potential problem arising out of holding property in JTWROS with a spouse is that upon the first spouse's death, the surviving spouse can do whatever he or she wants with the assets, possibly against the wishes of the deceased spouse. For example, a husband and wife own property jointly and the husband dies. The wife could remarry and name her new spouse as a joint tenant on her property or give the new husband her property through her will. The result is your children could end up not inheriting your assets. A potentially better way to own assets with your spouse is in a trust. The instructions of the trust could be set up to allow your surviving spouse to receive income from the assets in the trust while he or she is alive with your kids receiving the money left in the trust when your spouse dies.

Prior to 2010, one of the most common and costly mistakes made by married couples was the failure to utilize the estate tax exemption on each of their lives. Wasting one of the exemptions happened partly as a result of listing assets in joint tenancy with each other. This is currently not a concern because a new “portability” provision allows a surviving spouse to use any of the unclaimed exemption from their deceased spouse.

Up until 2010, the preferred way to make sure each spouse utilized their estate tax exemption was by establishing a Bypass Trust (also referred to as an A-B or Credit Shelter Trust). This trust not only enabled each spouse to use their estate tax exemption, it also helps to ensure the couple's assets would ultimately pass to their children.

It is uncertain if the portability provision will remain. For this reason and for reasons of asset control as mentioned above, it may be wise for a couple to still utilize a Bypass or Credit Shelter Trust.

4. Legal issues. If property is held in JTRWOS with another person and that person is involved in a lawsuit or divorce, the other person's assets are subject to the risk of that person's creditors.

Lack of liquidity upon death

Cash is often needed at death to pay for various expenses such as funeral costs, medical bills, income and estate taxes, legal fees and other expenses. Without sufficient cash to pay for these expenses, heirs may be forced to sell assets. A forced sale often results in the owner receiving a less than desired amount. Being forced to sell one's most prized assets is something to avoid.

One common method for providing liquid cash at date of death is through the purchase of life insurance. However, as we will discuss next, life insurance is often arranged improperly.

Life insurance mistakes

- 1. Inadequate coverage.** An obvious mistake is the failure to purchase an adequate amount of life insurance to cover a stated need, whether for personal or business purposes. Make sure to take the time to accurately calculate your life insurance needs.
- 2. Not updating beneficiary designations.** Not updating beneficiary designations could result in money not going to whom you want. Make sure to update your beneficiary designations on a regular basis. For young families, rather than naming children by name, it might be better to list "all surviving children of the union of (list parent names) shared equally. Naming a trust as a beneficiary could also be a better solution.
- 3. Naming minor children as beneficiaries.** Life insurance is often paid to children before they are emotionally or legally capable of managing it. One should avoid leaving assets to minors outright. If you do, a court may need to appoint someone to look after the funds, a cumbersome and often expensive process. Additionally, children often receive proceeds in a lump sum when it might be better for them to receive the proceeds in trust so the money can be spread out over a number of years.
- 4. Naming your estate as beneficiary.** If a person's estate is named as the beneficiary, the proceeds are needlessly subjected to probate and claims of the insured person's creditors.

5. Not naming a contingent beneficiary. A life insurance policy has two sets of beneficiary designations, primary and contingent. If the primary beneficiary is not alive when the insured person dies and no contingent (back-up) beneficiary is named, proceeds will be paid to the estate causing them to be subject to probate.

6. Wrong ownership selection. There are ownership issues associated with life insurance that impacts whether or not the proceeds are included in an estate. The IRS states that if there are "incidents of ownership" in a policy, it will be included in a person's estate. Incidents of ownership can include the right to borrow on a policy's cash value, to change the policy's beneficiary, to change a settlement option, and the right to change the dividend selection. If the insured person(s) were to retain outright ownership or merely incidents of ownership in the policy, the proceeds of the policy would be brought into the estate for estate tax purposes.

Life insurance is commonly used to provide cash to pay estate taxes and other costs. However, if the insured person has any incidents of ownership in the policy, the proceeds will be included in his or her estate. The result is that a large portion of the life insurance proceeds could end up going to the IRS instead of your intended beneficiaries.

There are two ways to avoid life insurance proceeds from being included in your estate for estate tax purposes. One is to have your children own the policy. The second (and preferred) way is to have an Irrevocable Life Insurance Trust (ILIT) own the policy. If a life insurance policy and the payments are structured properly with your children or through an ILIT, the death proceeds will not be included in your estate.

7. Losing income tax-free death benefit status. The death benefit proceeds from a life insurance policy are normally received income tax-free. However, if it is found that a person deducted their life insurance premiums, the death benefit may be subject to income taxation. Likewise, a life insurance policy may lose its income tax free status if a policy, or an interest in a policy, is transferred to another party for "valuable consideration". For example, if a child purchases a

life insurance policy on his father that is owned by his corporation or business partner, when the child receives the death benefit proceeds, they may be subject to income taxation.

8. Wrong ownership of business life insurance. Life insurance used for various purposes in a business. A common use of life insurance is to fund a buy-out in a cross-purchase plan. A cross-purchase buy-sell agreement is a written and binding agreement wherein each business partner or shareholder individually agrees to purchase the interest of a partner/owner if one of the conditions that triggers the agreement occurs. Triggering events generally include the death, disability or retirement of a business owner. The agreement outlines the terms of the sale and establishes a formula for determining the actual sales price. It obligates the remaining business owners to buy the departing owner's share of the company and it obligates the departing partner/owner, or his or her heirs, to sell their interest in the company.

Using life insurance to fund a cross-purchase plan, each business owner purchases a policy on the life of each of the other owners in an amount equaling their share of the purchase price of the insured owner's interest. Each business owner is the policy owner and beneficiary of each of the policies on the lives of the other owners. In the event an owner dies, the remaining business owners receive the proceeds of the life insurance policies and use these proceeds to purchase the deceased owner's business interest at a previously agreed upon price. When a deceased owner's interest is purchased, the surviving owners generally receive a "step up" in the cost basis of their business interest. If each partner/owner instead owned their own policy, the surviving owners could lose out on this stepped up basis. This could later result in them having to pay more capital gain tax.

Beneficiary designation mistakes

1. Naming your estate as the beneficiary. If you name your estate as the beneficiary of life insurance policies, annuities or retirement accounts, those proceeds will needlessly subject to the probate process. Same thing happens if you don't name a contingent beneficiary and your primary beneficiary dies before you do or at the same time.

2. Not updating beneficiary designations. If beneficiary designations are not updated after a life change such as a birth, death, adoption, marriage, or divorce, proceeds may end being received by someone not intended or to not be received by someone for whom you did intend.

3. Losing out on the stretch provisions of a retirement account. If you name an individual as a beneficiary of a qualified retirement plan such as an IRA, they may be allowed to stretch the proceeds of that retirement account over their life expectancy, potentially reducing income tax consequences. If you name your estate, the full amount in the plan must be paid out (and taxed) within five years.

4. If you have a disabled or special needs child and name that person as a beneficiary, they may lose out on government benefits. Setting up a Special Needs or Supplement Needs trust and naming that trust as the beneficiary may preserve their ability to receive government benefits.

Besides regularly checking to make sure your beneficiary designations are correct, some other tips with beneficiary designations are: Make sure they are clearly readable and that you list the percentage for each beneficiary along with their relationship to you and their contact information. In an attempt to divide money between beneficiaries, avoid naming different beneficiaries for different accounts. It is usually better to name them all in each contract and specify percentages to go to each one listed.

Selecting the wrong executor

An executor (called a personal representative in some states) is the person named in a will or appointed by a court to administer a person's financial affairs after their death. This person is responsible for collecting and taking care of the deceased person's assets, paying bills, taxes and other obligations, and making sure that assets are transferred to their new rightful owners.

Selecting the wrong person may result in conflicts and beneficiaries receiving less than their fair share. Choosing a beneficiary of your estate as your executor may cause a conflict of interest because that person may make deci-

sions favoring their interest over the interest of another beneficiary. Likewise, selecting a business associate as executor may present a problem if the estate beneficiaries' interests don't line up with that person's best interest.

You should choose your executor based on their skills and availability, not by virtue of their birth order, business relationship or a perception that someone will feel left out.

Improper disposition of assets

Distributing assets to the wrong people, at the wrong time and in the wrong manner are all examples of improper disposition of assets. Some spouses and children are good with money and others aren't. For those that aren't, leaving assets in trust to them so they're only able to access money at specified time intervals may be a better solution. Likewise, if you have multiple children with vastly different needs, it may be wise to leave different amounts to each depending on those needs.

Most parents desire to be fair to all of their children; however, leaving everything to each of your children equally can be a disaster. For example, agricultural families will often have "on and off farm children." The on-farm child has stayed and worked on the farm/ranch and the other children have left home and found other careers. If the parents leave the entire farm/ranch (which typically represents the majority of their net worth) equally to all their children, the off-farm children will often want their share of the value of the family farm right away. This may force the on-farm child (who desires to keep the farm/ranch) to sell, resulting in bitter feelings among the siblings. Conversely, the parents may leave the entire farm to the on-farm child, leaving little inheritance for the off-farm children, possibly resulting in bitter feelings.

Various planning strategies exist that may allow a family to achieve their financial goals while maintaining harmony within the family.

Business planning mistakes

Inadequate planning in one's business can create costly estate planning mistakes. A common mistake among many businesses is the lack of a good succession plan. Succession planning is critical for a person to receive sufficient value for their business. Buy-sell agreements are a key element of succession planning and are essential for a business to survive the death of one of its owners. Many businesses, however, do not have a buy-sell agreement. Or, if they do, it is not structured properly, the price doesn't reflect the current value of the business or the agreement is not properly funded.

To help ensure that your heirs will receive the full value of your business, it is critical to have a written and up-to-date buy-sell agreement and to have it properly funded. Incorrect ownership of life insurance policies to fund a buy-sell agreement is a common mistake and was discussed in the section on life insurance mistakes.

Not planning for cost of long term care

The cost of long term care is one of the greatest financial risks people face today. Many assume the cost of home care, assisted living and nursing home care will be covered by Medicare when in fact Medicare covers only a very limited amount of these expenses. Not being prepared for the cost of long term care can throw a wrench into a good estate plan.

Not maximizing annual gift allowances

Gifting is one of the best ways to minimize future estate taxes. In 2013, a person is able to gift up to \$14,000 per year (\$28,000 for a married couple) without reducing their lifetime exemption (\$5.25 million per person in 2013). Making annual gifts every year to as many family members (or others) as is financially prudent is smart planning. Over the long run, you can transfer significant amounts of money out of your estate along with any appreciation, thereby reducing future estate tax.

Gifting the wrong assets

The choice of how you give and what assets you give are very important decisions. For example, if you would like to leave assets to your church upon your death and you have a choice of leaving a \$100,000 certificate of deposit owned personally or a Traditional IRA account valued at \$100,000, which would be the better asset to give? The answer is your IRA because you've already paid tax on the money in the CD but you haven't on the IRA. While you would likely have to pay tax on money distributed from your IRA, your church would not because it is a tax-exempt entity.

A smart gifting strategy is to leverage your annual gifts into larger sums. That way, you can potentially increase the amount of your gift and further reduce future estate tax by getting the asset with high appreciation potential out of your estate. Be careful about making a gift of stock or real estate that is already highly appreciated though because as discussed previously, if you gift an asset, the person you make the gift to receives your cost basis in the asset.

Strategies such as sales/ gifts to certain types of trusts, the use of LLCs or Family Limited Partnerships with hard to value assets are a few ways you can leverage your annual exclusion gifts. Another potential way to leverage a gift and provide estate tax liquidity is through the purchase of life insurance. By owning a life insurance policy in an Irrevocable Life Insurance Trust (ILIT) and using the annual gift allowance to pay the premiums, you could potentially turn a \$28,000 annual gift to a \$2 million gift. And, if structured properly, proceeds received in an ILIT are received free of both income and estate taxes.

Not utilizing planned giving instruments

You can give while you are alive or at death through your will. Planned Giving instruments such as a Charitable Remainder Trust (CRT) or Charitable Gift Annuity allow you to make a gift during your lifetime and receive tax benefits while you are alive. If you leave an asset to charity through your will, you will not receive the same tax savings you could if you had gifted the asset through a planned giving instrument while you are alive.

A CRT is especially attractive if you have highly appreciated assets. For example, if you have real estate or stock that you purchased for \$100,000 that is now valued at \$1 million and you sell that asset, you will owe capital gain tax on the \$900,000 gain. If you sell the asset through a CRT instead, you avoid the capital gain tax on the sale and the full proceeds can be used to generate retirement income. You also receive an immediate charitable income tax deduction that can be used to offset income the year the gift is made and up to five subsequent years. Additionally, some states, including Montana, offer tax credits for planning giving to qualified organizations. For more information, request our Wealth Guide on Charitable Remainder Trusts.

Failure to deal with blended family issues

Blended families often create special considerations for one's estate plan. While many spouses believe there won't be problems when their significant other passes away, quite often that is not the case. It is best to plan for the worst and then hope for the best.

Most blended families desire to have some of their assets go to their new spouse and to the children of their union (if they have any), but also want some of their assets to go to children from a previous marriage. If one simply leaves their assets to the surviving spouse, hoping they will take care of his or her children from a previous marriage, it could set the stage for heartache and conflict.

One possible solution to this dilemma is to own assets in trust. Upon the death of the first spouse, assets would be placed in trust and the surviving spouse would be entitled to receive income from the assets in the trust while he or she is alive. When the surviving spouse dies, the remaining assets in the trust would pass to the desired children. Life insurance is an easy tool to equalize estates with a blended family. A person would simply purchase an amount of life insurance they desire their children to receive when they die and leave the rest of their assets to their current spouse.

Not planning for state estate taxes

Many states, including Washington, have a state estate tax with a transfer credit substantially less than the \$5.25 million federal transfer tax exemption equivalent. In such states, it might make sense to continue the use of the mandatory credit shelter trust, or a partial disclaimer by the surviving spouse into such a trust.

Conclusion

Estate planning can be a difficult subject to deal with. It is uncomfortable to talk about death, money, property ownership, business arrangements, marriage, and family relationships. No matter the size of your estate, you owe it to yourself and your family to discuss these matters and to engage in planning. There are powerful estate planning tools and strategies that you can use to preserve your assets but it is up to you to take advantage of them.

Working with an attorney that specializes in estate planning along with a competent team of other financial professionals can help ensure your plan is cohesive and that your goals are achieved in the most effective manner possible.

Chris Nolt is the owner of Solid Rock Wealth Management, Inc. and Solid Rock Realty Advisors, LLC, with offices in Bozeman, Montana and Fountain Hills, Arizona. Solid Rock Wealth Management and Solid Rock Realty Advisors are dedicated to helping people effectively grow and preserve their wealth. We use a comprehensive planning approach with a team of financial professionals, which addresses retirement planning, investment planning, estate planning, tax planning, charitable giving and risk management. Our wealth preservation strategies are designed to help our clients reduce taxes, increase retirement income and maximize the amount of wealth they pass on to their heirs and favorite charitable organizations.

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