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7 Major Errors In Estate Planning

It never fails to amaze me that so many otherwise savvy individuals, many of whom have their financial lives otherwise buttoned-up, use poor judgment (or no judgment) when it comes to their estate planning. The list of major estate omissions and poor choices is almost infinite. Here are some of the mistakes that are frequently made.

1. Not having a plan

In a sense, everyone does have an estate plan; state law makes this point a certainty. It simply may not be the plan that you had in mind, or that your family would have preferred. Not having a will means that at your death the distribution of your assets will be dictated by the inheritance laws of the state where you were domiciled when you died. These "intestacy laws" vary from state to state but, typically, leave percentages of your assets to various family members. There is always a remote chance that these laws will accomplish what you would have intended – but not likely. It is highly improbable that, by chance, your dispositive intentions as to who gets what, when and in what form will be fulfilled. This is true even if your estate is below the tax threshold. Your will applies to the disposition of your "probate assets" – those assets NOT otherwise following a beneficiary designation or the titling of the asset. Non-probate assets will pass by operation of law or contract. For example, whoever the beneficiary designation may have been when you originally began your 401(k) or IRA at the start of your work life will override either your will or the laws of intestacy. Even a simple plan that is well thought out and results from the identification of your personal objectives will be much more successful than nothing at all.

2. Online or DIY rather than professionals

There has been a noticeable uptick in the number of people who will look to the Internet to prepare their own wills and trusts. There are dozens upon dozens of websites that will profess to offer you just the right discounted estate planning documents. Even wealthy clients who stand to benefit the most from expert planning advice have been impacted. Unfortunately, relying on web-based, do it yourself solutions is a recipe for disaster (see my previous column: "Do It Yourself Estate Planning–A Uniquely Bad Idea!"). Estate planning documents should represent the culmination of a well thought out financial and estate plan. An amalgam of stand-alone documents does not a plan make. Furthermore, those pesky nuanced requirements (i.e. the "formalities") for a validly written and executed document will vary from state to state. Internet sites can provide you with documents but no actual advice that fits you in the context of your specific financial and personal life. What happens when the laws change? Does the document create an unnecessary tax if the state and federal tax laws diverge substantially? Also, use an experienced estate attorney. All wills are perfect documents while they are in your desk drawer. Only when examined post-mortem are the inadequacies revealed.

3. Failure to Review Beneficiary Designations and Titling of Assets

One of the most basic and most overlooked items on every estate-planning checklist is the review of beneficiary designations and the proper titling of accounts. Unwittingly, many people will often let beneficiary designations and asset titling determine their estate plans for them, contrary to their intentions. Why? Regardless of what your well developed wills and trusts say, your beneficiary designations and the title of your assets will control the ultimate distribution of those assets. Most investment accounts allow for the designation of a beneficiary (IRAs, 401(k)s, company plans, etc.). More recently, many states have enacted legislation to convert even otherwise ordinary brokerage accounts into accounts with beneficiary designations via Payable/Transfer Upon Death Registrations. All of these beneficiary designations absolutely control who gets the asset at your death. The titling of assets is a property law concept with estate implications. An account that is held jointly with right of survivorship will pass automatically to the survivor of the joint owners. Why does this matter? Assets can flow to the wrong people due to old, wrong and/or out-of-date designations, often with unintended estate and income tax implications.

4. Failure to Consider the Estate and Gift Tax Consequences of Life Insurance

Life insurance proceeds are included in the estate when owned by the insured at death. However, the insured may choose to transfer all incidence of ownership during his/her lifetime thereby avoiding any potential estate tax inclusion. Notwithstanding this accessible planning fix (usually via trust), relinquishing ownership and control is not necessarily an automatic decision. In some instances, large sums of available, tax-advantaged and asset-protected cash has accumulated in permanent life insurance policies (i.e. whole life). Accordingly, the decision as to how an insurance policy should be owned and, as importantly, controlled, can be complex and is highly individualized. In the right fact patterns, especially when tax is not the only important consideration, credible arguments can be made for both trust ownership and direct ownership. As in most estate planning, it is very much dependent on individual circumstances: family dynamics, net worth, financial / liquidity position, personal preferences and, even, your philosophy on the transfer of assets to future generations.

5. Maximizing annual gifts

Gifting is, probably, the oldest and best way to minimize future estate taxes. The entire universe of exemptions and deductions available for the reduction of estate taxes consist of: the lifetime exemption ($5.12 million in 2012), the marital deduction (for gifts to citizen spouses during life or at death), the gift and estate tax charitable deduction, annual exclusion gifts ($13,000 in 2012) and direct transfers (not to be treated as gifts) for education (tuition) and medical care (both theoretically unlimited). For the wealthy, maximizing all of these is smart planning. Making annual exclusion gifts every year to as many family members (this includes anyone close to you) as is financially prudent (given your financial situation) is good planning. Over the long run, you can transfer significant sums of money out of your estate along with any appreciation, thereby reducing the tax. Even better planning would be to use your annual exclusion gifts, strategically, so that each annual gift can be leveraged into larger sums being transferred out of your estate. Strategiessuch as sales/ gifts to defective grantor trusts, the use of LLCs/FLPs in the case of hard to value assets and life insurance are just a few ways to leverage the annual exclusion gifts. In the case of gifting, leverage is a very good thing and strategies that allow you to leverage this scarce resource – tax-free gifts – are crucial to successful estate planning.

6. Failure to Take Advantage of the Estate Tax Exemption in 2012

As every estate and financial planning practitioner will tell you (and probably already has told you), making lifetime gifts is a simple and effective estate tax minimization strategy. Simply giving away assets at no gift tax cost will allow both the corpus and its appreciation to escape the Federal estate tax on the passing of the donor (see my previous columns on acting this year starting with: "Tax Free Gifting During 2012 – A Great Deal!"). Using the exemption equivalent amount during your life is better than leaving it for use at death. The urgency is to act now to take advantage of the current estate tax regime that it is set to expire at the end of 2012. Above and beyond the annual exclusion gift limit of $13,000, the federal applicable exemption amount for transfers during life (gifts) and death (estates) has increased (by indexing) to $5,120,000 per person for 2012 — by far the highest it has ever been since the establishment of the estate tax. Wealthy individuals who have both the means and desire to do so, should plan on making these gifts during 2012.

7. Leaving assets outright to Adult Children

In recent years, there has been a growing opinion among advisors for wealthy families that assets should remain in trust, even for adult children, for as long as possible for the asset protection and other benefits that a trust can offer. For a wealthy couple with adult children, the question may no longer be a one of legal capacity or maturity (although those issues may still remain). The bigger questions may, more accurately, become: who should really benefit from the fruits of my labor and how do I protect those assets from creditors, potential creditors and ex-spouses. Depending on your perspective, dictating from the grave may or may not be a pejorative expression. For as long as trusts have been in existence (800+ years), the idea of controlling assets for as long as allowed with a set of instructions has been considered acceptable and often sought after planning. In fact, centuries ago, keeping assets in trust forever was, more likely than not, the goal; hence the genesis of the "rule against perpetuities." This rule was law in all 50 states to prevent perpetual or "dynasty" trusts. Over the last several years, many states have been modifying this rule to allow for longer trusts or have outright abolished the rule. Whether or not to leave assets in trust for adult children depends on many factors; not the least of which is personal preference. However, in our litigious society of high divorce rates, leaving some assets in trust with fairly liberal access is certainly worth consideration.