

The Ten Most Common Estate Planning Mistakes (and How to Avoid Them)

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This entire commentary is devoted to the types of problems that can cost you and your family tens or even hundreds of thousands of dollars and unbelievable heartache. This commentary is dedicated to the person wise enough to profit from the lessons so many have expensively learned the hard way.

Here are ten areas of common (and serious) mistakes that can be easily solved with the assistance of a financial services professional. Have you made one or more of these mistakes? If you haven't checked, how do you know?

Mistake 1: Improper Use of Jointly Held Property

If used excessively or used by the wrong parties (especially by unmarried individuals) the otherwise "poor man's will" becomes a poor will for an otherwise good man or woman. In short, jointly held property can become a nightmare of unexpected tax and non-tax problems including:

- A. When property is titled jointly, there is the potential for both federal and state gift tax.
- B. There is the possibility of double federal estate taxation; if the joint ownership is between individuals other than spouses, the entire property will be taxed in the estate of the first to die—except to the extent the survivor can prove contribution to the property. Then, whatever the survivor receives and does not consume or give away may be included (and taxed a second time) in the surviving joint tenant's gross estate.
- C. Once jointly owned property with right of survivorship has passed to the survivor, the provisions of the decedent's will are ineffective. This means the property passes outright to the survivor who is then without the benefit of management protection or investment advice.
- D. The surviving spouse can give away or at death leave the formerly jointly owned property to anyone he or

she wants regardless of the desires of the deceased spouse. In other words, holding property jointly equates to a total loss of control at death since the surviving spouse can ignore the decedent's wishes as to the ultimate disposition of the property. This loss of control can be especially horrendous when the joint owners are not related or in second marriages.

- E. Since the jointly held property passes directly to the survivor (who then could possibly squander, gamble, give away, or lose the property to creditors), the decedent's executor could be faced with a lack of adequate cash to pay estate taxes and other settlement expenses.
- F. A well drawn estate plan is designed to avoid double taxation—often by passing at least a portion of the estate into a **CEBT** (Credit Equivalent Bypass Trust). In this manner assets can be sheltered from federal estate tax at both the first decedent's death and then again (since the surviving spouse has only an income interest) escape estate tax at the death of the surviving spouse. But holding property in joint tenancy thwarts that objective. Instead of going to a bypass trust to avoid a second tax, the joint property goes directly to the survivor and will be taxed at the survivor's death. So the unified credit of the first spouse to die is wasted.

Mistake 2: Improperly Arranged Life Insurance

- A. The proceeds of life insurance are often payable to a beneficiary at the wrong time (before that person is physically, or emotionally, or legally capable or wise enough financially to handle it) or in the wrong control of their family business. (If you haven't manner (outright instead of being paid over a period of years or paid into a trust).
- B. There is inadequate insurance on the life of the key person in a family (the "breadwinner") or the key person in a corporation (the "rainmaker").
- C. Often, no contingent (backup) beneficiary has been named. The "Rule of Two" should be applied here. In any dispositive document there should be—for every name in the document—particularly beneficiaries - at least two backups.

- D. The proceeds of the policy are includible in the gross estate of the insured because the policy was purchased by the insured and then transferred within three years of the insured's death. The solution is to have the ultimate beneficiary, acting without direction from the insured and using her (or its) own money, purchase and own the insurance from its inception. That party should also be named beneficiary.
- E. When the policy owner of a policy on the life of another names a third party as beneficiary, at the death of the insured, the proceeds are treated as a gift to the beneficiary from the policy owner. For example, if a wife purchases a policy on her husband's life and names her children rather than herself as beneficiary, she is making a taxable gift at her husband's death in the amount of the proceeds payable to the children.
- F. Whenever life insurance is paid to the insured's estate, it is needlessly subjected to the claims of the insured's creditors and in many states unnecessarily subjected to state inheritance tax costs. Probate and legal costs are increased without reason and the proceeds are then subjected to the potential for an attack on the will or an election against the will.
- G. If any life insurance policy—or any interest in any life insurance policy—term or permanent—is transferred for cash or any other valuable consideration in money or money's worth, the proceeds may lose their income tax free status. For example, if a son buys the \$1,000,000 term insurance policy owned on his father's life from dad's corporation or business partner, when the son receives the proceeds, instead of being entirely income tax free, the \$1,000,000 will trigger over \$300,000 of ordinary income tax.

Mistake 3: Lack of Liquidity

- A. Most people don't have the slightest idea of how much it will cost to settle their estate or how quickly the taxes and other expenses must be paid. Worse yet, they don't realize that an insufficiency of cash may result in a forced (fire) sale of their most precious assets, highest income producing property, or loss of checked, how do you know your executor will have enough cash to avoid a forced sale?)
- B. Liquidity demands have increased significantly in the last few years and should be revisited by those who have not done a "what if" hypothetical probate. Among the expenses that demand large amounts of cash from the estate's executor are Federal Estate Taxes, State Death Taxes, Federal Income Taxes (including taxes on pension distributions), State Income Taxes (including taxes on pension distributions), Probate and Administration Costs, Payment of Maturing Debts, Maintenance and Welfare of Family, Payment of Specific Cash Bequests, Funds to Continue Operation of Family

Business, Meet Payroll and Inventory Costs, Recruit Replacement Personnel, and Pay for Mistakes Made While New Management is Learning the Business, and Generation Skipping Transfer Tax

Mistake 4: Choice of Wrong Executor

- A. Naming the wrong people to administer the estate can be disastrous. The person who administers the estate must—with dispatch—often without compensation, with great personal financial risk, and without conflict of interest (1) collect all assets, (2) pay all obligations, and (3) distribute the remaining assets to beneficiaries. Although this three step process seems simple, in reality these tasks can be highly complex, time consuming, and in some cases technically demanding. Is the named executor capable? Willing?
- B. Selection of a beneficiary as an executor can result in a conflict of interest. That person may be forced to choose between his interest and that of the other beneficiaries. This problem can be solved by adding an independent third party such as a bank trust department to serve along with, or in place of one or more family members.
- C. Selection of a business associate may result in a conflict of interest. If the executor's job is to decide whether or not to sell the business interest or the task is to obtain the highest possible sale price, the executor will be responsible for the course of action that will best serve the beneficiaries' interests. Yet that may be diametrically opposed to the interests of your executor. He may be selling himself out of a job or demanding a higher price for the business as an executor than he is willing to pay as a surviving shareholder.

Mistake 5: Will Errors

- A. One of the greatest mistakes is dying without a valid will. This results in "intestacy" which is another way of saying that the state will force its own will upon the heirs it chooses.
- B. Too many wills have not been updated for years. A will should be reviewed at least:
 1. At the birth, adoption, or death of a child,
 2. Upon the marriage, divorce, or separation of any one named in the will,
 3. Upon every major tax law change,
 4. Upon a move of the testator to a new state,
 5. On a significant change in income or wealth or health of either the testator or any beneficiary,
 6. On any major change in the needs, circumstances, or objectives of the testator or the beneficiaries.

Mistake 6: Leaving Everything to Your Spouse

- A. Many people, because there will be no federal estate tax at the first spouse's death due to the unlimited

estate tax marital deduction for U.S. citizen spouses, leave their entire estates to their spouses. But upon the death of the surviving spouse, everything that he or she received (assuming it has not been consumed or given away) is then piled on top of the assets that spouse personally owned. It is then that the so-called “second death wallop” occurs.

The solution can be simple: The establishment of a CEBT (Credit Equivalent Bypass Trust). Assets can be left to a trust that provides income to the surviving spouse as well as other financial security but will not be taxed in her estate no matter when she dies or no matter how large the trust fund grows. The balance of the estate can go in trust or outright to the surviving spouse. If the tax on that amount together with the surviving spouse’s own assets doesn’t exceed the allowable credits, this portion will also pass estate tax free when the surviving spouse dies.

- B. Some individuals leave huge amounts outright to a surviving spouse that they themselves have never managed (few people have ever managed huge amounts at one time). Often the survivor doesn’t have the slightest training or experience in handling and investing a large stock portfolio, real estate holdings, or running a family business.

Mistake 7: Improper Disposition of Assets

- A. An improper disposition of assets occurs whenever the wrong asset goes to the wrong person in the wrong manner or at the wrong time. Leaving an entire estate to a surviving spouse or child or leaving a large or complex estate outright to a spouse unprepared or unwilling to handle it is a good example. Leaving a sizeable estate outright to a teenager is another.
- B. “Equal but inequitable” distributions are common. If an estate is divided equally among four children who have drastically different income or capital needs, an equal distribution can be very unfair. Consider, for example, four children, the oldest of which is a brilliant and financially successful medical doctor and the youngest of which has serious learning disabilities and is still in junior high school. Think of a family with a physically handicapped child and three healthy children with no physical problems. Obviously, their needs and circumstances are not the same. Should each child receive an equal share? The proper solution may be a “sprinkle” provision in a trust that empowers the trustee to provide extra income or principal to a child that needs more in a given year.
- C. Obvious examples of improper dispositions include the gift of a high powered sports car to a child or senior citizen who no longer drives. “That can’t happen in my estate,” many people would be tempted

to say: But upon the death of a primary beneficiary at the same time or soon after the testator, quite often there is no secondary beneficiary or the second beneficiary who is named shouldn’t receive the asset in the same manner as the primary beneficiary. The solution is to consider a trust or custodial arrangements and to provide in the will or other dispositive instruments for young children and legally or emotionally or physically incompetent people.

Mistake 8: Failure to Stabilize and Maximize Value

- A. Many business owners have not stabilized the value of their businesses in the event of the disability or death of key personnel. What economic “shock absorbers” have been put in place to cushion the financial trauma caused if a key employee was lured away by competition at the wrong time? Who will pay for the fixed expenses of the practice or business if the key employee is not there to generate income? Key employee life and disability insurance coupled with good business overhead coverage will certainly help.
- B. Buy-sell agreements are essential to a business that is to survive the death of one of its owners. Yet many businesses have no such agreement. Or the agreement is not in writing. Or the price (or price setting mechanism) doesn’t reflect the current value of the business or the agreement isn’t properly funded. So there is no guarantee that the heirs will receive the price they are entitled to—or no assurance that the surviving owners will have the cash they need to buy out the heirs (especially the dissident ones who want to tell them how to run their company).
- C. Wills, trusts, life insurance contracts, HR-b (Keogh) plans, IRAs, tax deferred annuities, without “backup” beneficiaries mean that money that could otherwise pass outside of the probate estate may instead be subjected unnecessarily to such costs and risks. The value of all those instruments and wealth transfer tools can be enhanced at no cost merely by naming secondary beneficiaries.

Mistake 9: Lack of Adequate Records

- A. It can drive your executor crazy—and cost thousands of dollars of expenses—if estate and financial documents are hard—or impossible—to find. Rent a safe deposit box, tell your executor where it is, and make sure your executor has or can get the key. Put all your important documents in that box. Each year, put an updated list of the names and phone numbers of advisors your family can count on in the box.
- B. It is possible for an executor to obtain new copies of old income tax returns from the IRS—but why put the executor to the trouble and expense? Be sure to keep tax returns and records at least seven years.

Mistake 10: Lack of a Master Strategy Game Plan

Do-it-yourself estate and financial planning is the closest thing to do it yourself brain surgery. Few people can do it successfully. Yet taking adult education courses or reading books on the subject is often far preferable to no planning. Actually, an intelligent layman can learn and do quite a bit if the time is taken at least once a year to quantify in dollar terms financial needs and objectives (“here’s what we must have and here’s what we’d like to have”), current financial status (“here’s where we are”), and a game plan for getting to your goal in the most efficient and effective way. Using the right team of CPA, attorney, life insurance agent, trust officer, and other financial services professionals to conduct an annual **Financial Firedrill** to help formulate and execute that plan can make all the difference.

The Bottom Line

The key principle in the **The Book of Trusts—4th Edition** and **How to Settle an Estate**, (610) 924-0515 is that you can’t eliminate the big mistakes in your estate until you’ve identified them. Every family (and single person)—every year—should stage a “financial firedrill.” Become informed. Educate yourself now. Educate your survivors—before they are your survivors! Teach them how to handle money and make decisions. Show them, by example, how to read the bottom line on where their financial security stands.

A “financial firedrill” means that, with the assistance of competent financial services professionals—(1) you annually measure your needs, (2) establish an order of priorities, and then (3) develop and put into effect plans to make certain that you are on target to meet your financial security needs.

References

To learn more about these and other common (and costly) estate planning mistakes, and the solutions to them, contact us at **Mathews Law Firm, P. A.** at (850) 681-9303 and we will be happy to discuss your particular situation.