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Feature

COMMON ESTATE-PLANNING MISTAKES

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Failing to Have an Estate Plan at All (Dying without a Will)

If you die without a will and you have assets passing through probate, state law determines who gets the assets, as follows:

If there are no issue or parents surviving, a surviving spouse gets everything.

If there are surviving parents, but no issue, a surviving spouse gets the first \$100,000 and everything else is split 50-50 between the surviving spouse and the parents.

If there are surviving issue, all of whom are from the marriage, a surviving spouse gets the first \$50,000 and everything else is split between the surviving spouse and the issue.

If there are surviving issue from a prior marriage and a surviving spouse, everything is split 50-50 between the surviving spouse and the issue.

If there is no surviving spouse, the surviving issue get everything.

In addition, a surviving spouse would be entitled to claim a \$3,500 personal property allowance, a \$6,000 homestead and a \$6,000 family allowance off the top. Let's look at an example of how this may work.

What happens if you die with a modest \$100,000 house as your only asset and you are survived by a spouse and children from a prior marriage? The surviving spouse can claim \$15,500 in allowances, but after that, everything has to be split 50-50 with the children, making a forced sale of the residence the most likely outcome, a result which probably is not the desired outcome.

Failing to Have a Comprehensive/Coordinated Plan

Often people will add one child to a large bank or brokerage account so that it passes by survivorship to that child outside of probate and then die with a will that says everything goes equally to all three of his or her kids. This creates confusion about the decedents true intent and leads to litigation.

leaving Assets to Minors

Of course, a minor cannot hold title to assets so leaving assets to a minor necessitates the opening of a conservatorship. A

conservator has to post bond and file an inventory, tri-annual accountings and a final settlement with the probate court. Further, a conservator is limited to investing in so-called legal investments. A trust is a much more flexible vehicle, allowing the trustee to have broad discretion and investment authority with little or no court supervision, which may be good or bad depending on the trustee. A trust is generally much more cost-effective.

***266 Granting Someone Ownership, rather than Power off Attorney over An Asset**

Often, people will add a child as a joint owner on their bank or brokerage accounts to pay bills if they get sick, or add the child to real estate to avoid probate at death. There are several problems with this approach. First, it subjects the assets to the claims of the creditors of the joint owner. Second, as noted above, it may conflict with the person's overall estate plan. Third, it may constitute a taxable gift. Remember, adding a child as a joint owner to a piece of real estate is permanent, and it is a gift for tax purposes. If the donor changes his or her mind after the fact, he/she can only obtain sole title through the child's consent.

Failing to Use Trusts to Ensure that Assets Pass to Whom You Ultimately Want Them To Go

If you have children from a prior marriage and you want them ultimately to receive your estate at your current spouse's death, why would you leave everything to your current spouse and trust him or her to leave it to your children, rather than to his or her children? By using a trust, you can benefit the surviving spouse, but control the ultimate disposition at the death of the surviving spouse.

leaving Assets Outright to Spouses, Children or Grandchildren Who Have Creditor Problems, Disabilities, Drug, Alcohol or Gambling Problems, Marital Problems or Who Manage Money Poorly (Spending Problems)

If you leave money outright to someone receiving SSI or some other need-based program, it will probably disqualify him or her. The better practice is to leave it in a discretionary supplemental needs trust. You cannot leave it to him or her in a trust that requires distributions for his or her support and maintenance.

Spendthrift law allows you to leave assets in a discretionary trust for a spouse or child which will be protected from creditors.

Why would you leave assets to a child outright whom you know has a drug, alcohol or gambling problem? This is like throwing gas on a fire. A better approach is to leave such assets in a discretionary trust and give an independent trustee the power to withhold distributions if needed. This allows you to address the problem, not enable it to get worse.

Some people will always spend more than they take in, like the federal government. For these people, why not leave their assets in trust and pay out a certain percentage annually?

All of the above situations cry out for an independent trustee to assist with managing the assets.

Wasting the Applicable Credit off The First Spouse to Die

Everyone can leave the applicable exclusion amount to the next generation without estate tax. The applicable exclusion amount is \$5.12 million in 2012, but reverts to \$1 million after that unless Congress takes some action to change it. Historically, clients have been advised not to overfund the amount left to the surviving spouse outright because this would lead to the wasting of the applicable exclusion of the first spouse to die. Rather, it was typically recommended that the applicable exclusion amount be placed in a trust for the surviving spouse, which was designed to be excluded from such spouse's estate at death, to make use of the applicable exclusion of the first spouse to die, thereby using the exclusion of both spouses. This type of trust is commonly called a "bypass" trust because it bypasses the surviving spouses estate for estate tax purposes. A recent tax law included portability, which allows the credit of the first spouse to die to be used at the second spouse's death even if everything was left outright to the surviving spouse. However, last fall, the IRS announced that estates must file Form 706 to elect to make the unused exclusion portable, even for those with under \$5 million (\$5.12 million in 2012) in assets. Portability is set to expire at the end of 2012 as well, absent action by Congress. There are still compelling

reasons to use a bypass trust, even if portability becomes permanent, for those that do not want to waste the generation-skipping tax exclusion of the first spouse to die (see below) and because of the ability to control ultimate disposition of the assets at the subsequent death of the surviving spouse.

Leaving Assets Outright to a Child Who May Have a Taxable Estate or Is in A High-Risk Profession

Everyone can utilize the applicable generation-skipping exclusion to pass assets down multiple generations without tax. Like the estate tax applicable exclusion, the generation-skipping exclusion is \$5.12 million in 2012, but reverts to \$1 million after that, absent Congressional action. If you have a child who already has or may have an estate tax problem, why compound the problem by leaving him or her any assets outright? Instead, you should consider passing the assets to him or her in a trust designed to be excluded from their estate for estate tax purposes. In many cases, such child can be a trustee of the trust, if desired, and receive most, if not all, income, and limited principal.

The same reasoning holds true if you have a child who is in a high-risk profession, like a doctor. Why leave assets outright to him or her when these assets could be subjected to a malpractice claim? Isn't it better to give such child the use of the assets, but not full ownership, to give them protection from a judgment creditor?

Failing to Plan for the liquidity Weeds of Your Estate

Too often people die with plenty of assets, but not enough liquid assets to pay debts and taxes, causing an untimely liquidation of assets. Real estate and closely-held businesses are by their nature illiquid. Although liquid by nature, retirement plan assets are not a good source of the *267 funds, because accessing the funds will generate an income tax on any amounts distributed (assuming previously untaxed contributions to the plan or account). If you have a taxable estate and most of the estate consists of assets that fall in these categories, you have to plan for paying the estate tax due nine months after death and the claims that will be filed by your creditors, including mortgage lenders.

This problem can be exacerbated by the manner in which the assets are valued for estate taxes purposes. The value is set either as of the date of death or six months thereafter. What happens when a person dies at the height of the market or, worse, the height of a bubble, as recently seen in the real estate market? The reported and taxed value is based upon a date of death appraisal, which always uses comparable sales as one of the valuation methods. Thus, even though you may not be able to sell it for that price, you are still taxed on it.

The estate may qualify to pay the tax over a 10-year period if certain requirements are met. Too often, the assets have to be sold.

Failing to Implement a Gift-Giving Program (if You Have a Taxable Estate)

You can give away \$13,000 per year per donee without gift tax. These are called non-taxable gifts. You can make a one-time taxable gift using your lifetime gift applicable exclusion amount, which is \$5.12 million in 2012, but is set to go down to \$1 million unless Congress acts. Thus, a couple can make a one-time gift of \$10.24 million this year without incurring any gift tax. Taxable gifts are added back to your taxable estate at death on the estate tax return to arrive at the tentative tax base. The result is that a taxable gift generally only removes future appreciation from tax, but not the value of the gift itself. The purpose of this add-back is not to subject lifetime gifts to additional tax, but rather to adjust the tax bracket to be applied to the estate that remains after lifetime gifts were made. A tentative estate is then determined, which is reduced by any gift tax paid, to determine the tentative estate tax, which is then reduced by the applicable estate tax credit to determine the tax due. Many experts interpret the new law as requiring this calculation to be made based on the gift tax that would have been incurred using a \$1 million tax exclusion regardless of whether any amount was actually paid for gifts made in 2012. If accurate, this creates a unique window of opportunity to remove up to \$8.24 million from a married couples estate without tax (assuming the applicable estate tax exclusion amount is \$1 million at death). Of course, if the \$5 million gift and estate applicable exclusion amounts are extended permanently, it will make no difference. It is expected that future legislation will have to address this issue if the applicable exclusion amounts decline.

Gifting the Wrong Assets

There may be non-taxable reasons to make a gift, but you have to remember that there are tradeoffs from a tax standpoint to making a gift. If you die owning an asset, the basis of the asset for income tax purposes is reset to equal its fair market value on the date of death. This could be up or down depending upon what you have invested in the asset. If the value has appreciated over its basis and you gift it, the donee receives your basis, called a carry-over basis. Thus, if the donee sells it immediately after the gift for its value, he will owe capital gains tax on the difference between the sales price and its carryover basis. On the other hand, if you transfer the asset to the same person at death, he would receive a basis stepped up to fair market value. If he sold it for fair market value the next day, no tax would be due because there is no difference between sales price and basis. Thus, a gift of the wrong asset could create a tax when none would otherwise be due, assuming you died without a taxable estate. A gift of a low-basis asset, on the other hand, may make sense if you have a taxable estate, if there are no high-basis assets that can be gifted instead and if the estate tax rate is higher than the capital gains rate.

Life insurance is a perfect asset to give away. Contrary to common belief, it is includable in your taxable estate and is subject to estate tax. The value of the gift is based on its cash value, which is generally less than the death benefit. It is not subject to income tax so the fact that the donee receives a carryover basis does not matter.

Because of Internal Revenue Code (IRC) § 1014(a), any appreciation of the affected property that occurred during the decedent's lifetime will never be taxed. This provision provides an incentive for taxpayers to retain appreciated property until death and sell depreciated property while they are alive to recognize the loss.

Failing to Have a Proper Beneficiary Designated for Your Retirement Account

If you die before your required beginning date (i.e., April 1st of the year after turning 70½, a defined term under the IRC) and designate your estate as beneficiary of your retirement account, it will all have to be paid out in five years under the required minimum distribution rules, thereby triggering income tax on the entire account. If you have passed your required beginning date and designate your estate as beneficiary, the retirement account can be paid out over the remaining single life expectancy of the deceased owner. If you designate an individual as beneficiary, however, they can leave it in your name and begin taking distributions over their life expectancy. A spouse could roll it over tax free into their own IRA. Certain trusts can qualify for extended payouts and thereby defer payment of the income tax over the life expectancy of the oldest beneficiary.

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