

5 Common Estate-Planning Pitfalls and How to Avoid Them

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Estate planning is a process designed to help you manage and preserve your assets while you are alive, and to conserve and control their distribution after your death pursuant to your goals and objectives. This article will provide a brief overview of 5 common estate-planning pitfalls and how to avoid them.

Life Insurance Policies Are Included as Part of Your Estate

You may not realize that your taxable estate includes any life insurance policies that you own or control. The total value of any such policies increases the value of your taxable estate dollar for dollar—including term life insurance policies.

Action Step

One of the most basic tenets of a tax-efficient estate plan is that all life insurance policies should be owned, not by the insured, and not by the insured's spouse, but rather by an irrevocable life insurance trust (ILIT). The purpose of holding all life insurance in ILITs is to avoid having any death benefit subject to taxation as a part of the insured's estate. An additional benefit for physicians, many of whom are extremely aware of creditor risk, is that the ILIT will also protect the

value of any life insurance policy from any creditors of the insured, as well as any creditors of his or her beneficiaries.

If you have existing policies, you can transfer the ownership to an ILIT for the benefit of your loved ones, because as long as you survive 3 years after the transfer, the value of the life insurance proceeds will be removed from your taxable estate, thereby making the insurance proceeds fully available to your spouse and/or children without requiring them to pay any taxes on the policy.

However, if your health is still good and premium rates are similar to what you are currently paying, you can avoid the 3-year rule by replacing your current insurance policy or policies. The ILIT can apply for a new policy on your life. The trustee is the applicant and the trust is the owner and beneficiary of the policy. This guarantees that you have no "incidents of ownership" in the policy that would cause it to become part of your taxable estate.

Know Your State's Estate Tax Exemptions, Estate Taxes, and Marital Deductions

Estate tax exemptions vary widely from state to state. For example, New Jersey's exemption from estate tax is only \$675,000, while neighboring New York's exemption from estate tax is \$1 million. If you die with an estate worth in excess of your state's exemption (that does not pass to your spouse or to certain qualifying trusts for his or her benefit), these states will collect estate taxes at rates between 4% and 16%, respectively. Furthermore, spouses who are not

US citizens will not receive a full estate tax exemption for property.

In addition, there is a \$5.25-million exemption from federal estate tax (the "applicable exclusion amount"). Once your estate exceeds \$5.25 million, the combined federal and state estate tax rates rise steeply, peaking at 40%.

Furthermore, a married person may leave an unlimited amount of assets to his or her spouse (provided that both spouses are US citizens) free of estate taxes and without using any of the estate tax exemption. Unfortunately, when thinking about their estate plan, too many married couples see the unlimited marital deduction as their solution. This strategy can cost one's children and/or other beneficiaries hundreds of thousands of dollars in unnecessary state and federal estate taxes if the surviving spouse's estate is worth more than the estate tax exemption.

Action Step

Simply including what is often referred to as a "credit shelter trust" in your will, or drafting your will to permit your surviving spouse to disclaim property into a credit shelter trust (or "disclaimer trust") for his or her own benefit (and often also for your children's benefit) safeguards the decedent spouse's applicable exclusion amount. This enables both your exemption and your spouse's exemption to pass estate tax-free to the next generation, effectively doubling the amount of assets that pass to your children estate tax-free. The surviving spouse can still have access to the property in the credit shelter trust, but upon that spouse's death,

the property will not be included in his or her estate, and such property will pass estate tax-free to your descendants or to the other beneficiaries of the trust.

By giving your spouse the power to disclaim assets into a credit shelter trust, you preserve maximum flexibility in deciding whether to fully fund the credit shelter trust with the applicable exclusion amount, or whether to partially fund the trust with only the maximum state exemption from estate taxes (eg, either \$1 million or \$675,000 in New York and New Jersey, respectively).

Of course, this same tax savings can be achieved by leaving the applicable exclusion amount directly to your descendants or other beneficiaries who are not your spouse. This is generally advisable when your spouse will have sufficient assets to live on after your death.

The Necessity of Retitling Assets

Often, credit shelter trusts are included in wills but assets are not retitled in a manner that enables the credit shelter trust to be funded upon death. Are your and your spouse's assets titled such that a credit shelter trust can be funded?

Action Step

To achieve the maximum tax savings when the first spouse dies, you and your spouse should have sufficient assets in each of your own individual names to fund a credit shelter trust (\$5.25 million in each of your own names, if assets are sufficient to do so, or if assets are not sufficient to do so, the assets should be split such that each of you own half of them). This is because jointly owned property, retirement accounts (with designated beneficiaries), and insurance proceeds (that are not payable to your estate) typically cannot be used to fund a credit shelter trust because such

assets pass outside of your will. Therefore, adjustments with respect to how your assets are titled (eg, splitting of brokerage accounts or retitling a home) may be advisable to ensure that a credit shelter trust or a disclaimer trust can be funded upon you or your spouse's death.

Don't Wait—Create Trusts for Your Children

It is important to protect assets for your children after your death. If trusts are not set up, you risk an immature child wasting his or her inheritance, potential creditors gaining access to these funds, and future ex-spouses taking your family's assets.

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Action Step

We generally steer our clients toward fully discretionary trusts. These trusts grant the trustee(s) flexibility to distribute trust property for a child's health, education, support, and maintenance, or for any other reason that the trustee deems appropriate. Trustees are forbidden from making any discretionary distributions to themselves and are bound to carry out the provisions of the trust, only making distributions for the trust's beneficiaries pursuant to the trust's authority, which grants broad discretion to the trustee. In addition, in the event that your children or other heirs are successful enough that they never need to use the inheritance, certain assets can pass to their children free from estate tax (by reason of the generation-skipping tax exemption).

Periodically Update Your Estate-Planning Documents

Many people fail to update estate-planning documents to reflect life-changing events such as a divorce, remarriage, or the birth of a child or additional children. It is important for you to ensure that your current estate-planning documents (including life insurance beneficiary designations and 401(k) and IRA beneficiary designations) still embody your present wishes.

Action Step

Every 3 to 5 years, you should review your documents to ensure that they still match your wishes.

Conclusion

By working with an attorney who specializes in estate planning as well as a financial planner, you can ensure that your wishes regarding property distribution are respected and honored. In addition to legal documents, your attorney might also incorporate other legal instruments and/or strategies to take advantage of further estate tax savings opportunities and/or to protect your assets from the claims of creditors. ●

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