

Nine Common Estate Planning Mistakes

(and how to avoid them)

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Estate planning mistakes can result in families incurring untold heartache and financial costs. The following are common mistakes I encounter in my estate planning practice, with my suggestions how to avoid them.

First Mistake: Incorrect Use of Joint Ownership

As the classic "poor man's will," joint ownership of property is highly effective (but not bullet-proof) at avoiding probate in many cases. However, it is no panacea, and in my experience, it is often used by people who do not understand its potential tax and non-tax problems.

1. Non-tax problems. Often, an elderly widow or widower will tell me that all financial assets, even the home, have been put into joint ownership with a trusted son or daughter who "knows what I want when I die." Usually, what the client wants is for joint assets to be divided by the surviving child among other family members in some fashion, and joint ownership is thought to be a good, nonprobate way to accomplish that. Sometimes this does work, but it seems to me that it is looking at the world through rose colored glasses to assume that after you die, your descendants will implement your exact estate plan without accurate written instructions from you through a will or trust. It is no secret that inheritance brings out the worst in some folks. Even if there is a will or trust, joint property passes outside their terms. Under state law, joint property presumptively becomes the sole property of the surviving owner. This presumption may be especially strong in situations where some, but not all, a decedent's property was transferred to joint ownership. The surviving owner is under no obligation to treat the property as though the will applied to it. If the beneficiaries under the will challenge the survivor's ownership, that may require litigation. In a second marriage situation, joint ownership with new spouse is ineffective to protect

the children's inheritance. The surviving spouse may simply ignore the decedent's wishes.

In addition to the risk that the decedent's plan will not be followed, jointly owned assets are normally subject to the claims of both owners' creditors, so the parent's interests are in jeopardy if the joint owner child develops credit problems of any kind. This may prevent the assets from being distributed to the other children, even if the joint owner has the best of intentions.

2. Tax problems. With jointly owned property, the potential exists for federal gift and estate tax implications. Normally the decedent will be the older owner whose assets were the only ones used to fund the account. Tax law assumes the decedent furnished all the assets in the account, and the entire account is included in the decedent's estate (except for accounts owned jointly with a spouse). This is the correct result when the actual owner dies first. But the same presumption causes the assets to be included in the other joint owner's estate if he or she dies first, and that is the wrong result. In an estate audit, the survivor will have to overcome the presumption by proving he or she funded the account.

The most overlooked tax problem created by using jointly owned assets as a will substitute is that the redistribution of the decedent's estate by the surviving joint owner typically creates taxable gifts by the survivor to the other recipients. Since the surviving owner owns the property outright, giving it away is gift-taxable to the surviving owner to the extent the transfers exceed the annual exclusion amount to each subsequent donee.

What are the solutions? To avoid probate costs and delays, bank assets can be registered in "payable on death" (POD) form and brokerage and security assets can be registered as "transferable on death" (TOD). These are beneficiary designations, allowing the assets to be individually owned during your lifetime, but to pass quickly, outside probate, to your named beneficiaries upon your death. This protects the assets from your children's creditors and allows you to name all of them as beneficiaries. An inexpensive power of attorney normally is fine to give an adult child access to accounts to pay your bills and manage your financial affairs. In more complicated financial situations, and where real estate ownership is involved (since most jurisdictions do not yet permit

real estate to be titled in TOD form), or where dementia or other degenerative disease may become a factor, a professionally drafted living trust may be the best way to avoid probate while protecting the interests of all involved in the meantime. In many situations, probate costs are not so high as to be a primary consideration anyway.

When is joint ownership appropriate? Spouses in first marriages will normally hold all assets in joint ownership, since they usually have identical estate plans. This technique is effective to avoid probate at the first death, and it is usually appropriate when the couple has a nontaxable estate. Of course, both spouses cannot be the first to die, so a professionally written estate plan is still necessary. Occasionally, a very elderly individual wishes to leave his or her entire estate to his or her only child, who has good credit. Assets that cannot be registered POD or TOD to the child can be jointly held to avoid probate, with acceptable risk. Other than these limited situations, joint ownership of all assets as a will substitute is never the best plan.

Second Mistake: No Will or Outdated Will

Anyone who dies without a valid will or living trust has made a decision to adopt the estate plan enacted by the legislature of his or her state of residence – called "intestacy." Under intestacy, the state's plan is to divide your assets among your surviving family by a statutory order of priority that in most cases is not what you would choose. Second marriages, minor or young adult beneficiaries, disabled beneficiaries receiving government benefits, are all family situations where it is safe to conclude that intestacy will *never* correspond to your true wishes. Many old wills have become outdated, or have been revoked by the occurrence of important life events. Marriage revokes a prior will by law in Oregon. Every estate plan should be reviewed upon:

- (i) Birth, death, or adoption of a child;
- (ii) Marriage, separation, or divorce of anyone named in the will, including named guardians, personal representatives, and trustees;
- (iii) Every major tax law change affecting estates;
- (iv) Moving to a new state;
- (v) Significant change in wealth of the testator or of a beneficiary;

- (vi) A beneficiary begins receiving means tested government benefits such as Medicaid.

Third Mistake: Improperly Arranged Life Insurance

Aside from the mistake of the primary or secondary breadwinner not having life insurance (or not enough insurance), the most common mistake I see as an estate planner is naming the wrong beneficiary. In long term, stable marriages where both spouses have basic financial management skills, naming the other spouse as primary beneficiary is fine. But it is *never* correct to name minors as beneficiaries. Why? Minors cannot receive life insurance proceeds. A conservator will be appointed by the court, resulting in unnecessary legal fees, ongoing court supervision, annual bonding expense or frozen assets, and most scary – the entire proceeds will be turned over to the child upon reaching adulthood – at age 18. Why would you do that? In over fifteen years of asking that question, no one has ever given me an acceptable answer; most cringe at the thought. Sometimes people will avoid that problem by naming one of their siblings as alternate beneficiary, "knowing" the sibling will use the proceeds for the children. Perhaps so, perhaps not. If your children are minors with both parents deceased, with their life insurance benefits in the hands of an uncle or aunt outside a trust, it just seems to me the chance of problems, which the children are powerless to prevent, are unacceptably high.

The solution is to create a trust for your minor and young adult children in your will or living trust, and then to name the trustee of that trust, in that capacity, as the alternate beneficiary of life insurance and all other beneficiary assets intended to go to the support of your children. Beneficiary updating is easily done, often on line, always without cost.

Fourth Mistake: Choosing the Wrong Personal Representative or Trustee

Choosing the wrong person to administer your estate can have serious problems. Following your death your personal representative must quickly, without immediate compensation, and without favoritism, collect your assets, pay your debts and obligations including taxes, and distribute your remaining estate according to your estate plan. The most important

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character qualities of a good personal representative are diligence and honesty. Family members serving in the role may find themselves facing conflicts of interest in that as personal representative, they must protect the interests of the creditors and the other beneficiaries of the estate ahead of their own. A good personal representative must understand this and be prepared to deal with it over the months (or longer) it takes to administer an estate. Ideally, the personal representative should live nearby, but this is not always critical. Emptying a residence and dividing the personal property does normally require the personal representative's temporary presence. Out of state relatives may be reluctant to travel to do that, but travel expenses are an administrative expense of the estate, immediately reimbursable to the personal representative. Subsequent responsibilities can usually be performed anywhere under the supervision of the estate's attorney and accountant. Email and overnight delivery services have largely eliminated the need for personal representatives to be present in the decedent's community, or near where the administration is occurring.

Similarly, choosing the wrong person as the trustee of a trust for your descendants can be disastrous. This person is charged with the ongoing responsibility to manage and distribute funds for the benefit of your children or other beneficiaries, and that requires a set of skills, integrity, and longsuffering (resisting pleas from beneficiaries that are inconsistent with their best interests) that not everyone possesses. If you do not have at least *two* such individuals named as trustee (one primary, one alternate, or as cotrustees) then consider naming an institutional trustee.

It is especially dangerous to name the same person as guardian of your children and trustee of their trust assets. When one person fills both roles, no one else may be looking out for the children's best interests. Probate judges tell horror stories of trustee/guardians stealing from their protected persons. Do not assume the best. It is normally better to separate the function of guardian and trustee, so each can look over the other's shoulder, ensuring your children's interests are better protected.

Fifth Mistake: Leaving Everything to Your Spouse

The federal and Oregon estate tax systems provide a substantial exemption from imposition of the tax on

estates passing at death. But it is not unlimited – many couples have a combined net worth greater than the individual exemption, especially under the Oregon system. When couples have simple "honey I love you" wills that leave everything to the surviving spouse, estate tax can unnecessarily be incurred when the second spouse dies. While the estate tax system provides an unlimited deduction for gifts to U.S. citizen spouses, when the survivor dies later, only that spouse's outright exemption from estate tax is used – the first spouse's lifetime exemption is wasted.

The solution to this problem in appropriate cases is to include a simple credit shelter trust (CST) in the will or living trust of both spouses. Often this trust will be funded when the surviving spouse (who otherwise inherits all assets outright) makes an optional disclaimer of some or all the inheritance from the deceased spouse. The CST is named as the alternate beneficiary of marital assets, thereby receiving the disclaimed assets. In this plan, if it appears when the first spouse dies that the estate tax will likely not be a problem later, the CST can be ignored and the survivor inherits everything. Even if the CST is used, the surviving spouse can often serve as trustee and he or she receives the CST's income and access to its principal for necessary purposes. The remaining CST assets ultimately pass to your beneficiaries at the second spouse's death *without* being included in the second spouse's taxable estate. In this fashion, a great deal more of the couple's assets (double or more, generally) can be transferred to the ultimate beneficiaries free from estate taxes.

Sixth Mistake: Leaving too Much to Your Children

When I meet with clients whose net worth (including insurance and retirement assets) is substantial, I ask "how much of your estate do you want to leave to your children?" The answer I am looking for is "something less than all of it." Not everyone appreciates the wisdom of limiting children's and young adults' inheritances to amounts that will not damage a developing work ethic, but most agree that leaving too large an inheritance at too young an age can be extremely destructive. Even older adult children who have well established work histories may not be the best beneficiaries for your entire estate.

If you have an estate large enough to be concerned

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about this problem, why not make a substantial gift to charity when the second spouse dies? It is fully deductible for estate tax purposes. There are nearly a million public charities in the United States, not counting churches. Or, set up educational plans for your grandchildren or other family members less fortunate than yourself. Better yet, do both.

Qualified retirement plans and traditional IRA assets make ideal charitable gifts because they become entirely tax free when given to a qualified charity. But when inherited by your children, they remain subject to income and estate taxes. The combined "hit" of federal estate tax, Oregon estate tax, federal income tax, and Oregon income tax can reduce them by as much as seventy percent. Instead of giving your children thirty cents, why not give your favorite charity the full dollar?

Seventh Mistake: Incorrect Disposition of Assets

Leaving a large estate outright to a surviving spouse and leaving assets to a minor child are examples of incorrect asset dispositions. So is leaving the wrong asset to the wrong person. Your sixteen year old son probably cannot handle your Porsche. Leaving the bulk of your furniture and household effects to your son serving in the armed forces overseas may create a substantial moving and storage bill until he returns. Carefully consider the *appropriate* disposition of your estate.

Appropriate disposition also includes making careful decisions about the size of each beneficiary's inheritance. The fact you have three children does not necessarily lead to the conclusion they must each inherit one third of your estate. If you have a special needs child, his or her inheritance may need to be held in a specially drafted trust to preserve eligibility for public benefits. One of your children may be a highly successful entrepreneur with no financial needs (indeed, with estate tax problems that would be compounded by inheriting from you!), whereas another child may have substantial ongoing financial needs and could benefit greatly from receiving a larger share. Nowhere is it written that all inheritances must be equal. Your estate is yours to dispose of as you determine.

Eighth Mistake: Lack of Liquidity

There are myriad needs for cash after someone dies. Paying funeral and final medical expenses, supporting a spouse and children, paying administrative expenses of settling the estate, paying debt, and providing cash for continuing operation of a business at the death of an owner are a few common examples. Each person's situation is different, but one thing is always true: nothing gets done without cash. A forced sale of illiquid assets generally brings less than actual value. Most people do not know how much cash their heirs would need after their death for any of these purposes. The solution is to discuss these needs with your estate planning and financial planning professionals as part of the estate planning process. Sometimes existing resources are adequate and adequately liquid. Other times additional insurance is needed to solve particular liquidity problems that will be identified during this process.

Ninth Mistake: Lack of Adequate Records

One of the hardest parts of administering an estate is collecting full and complete information about the decedent's estate plan and assets. You can assist your personal representative by keeping full and up to date information about your advisors, your assets, and your wishes in a single location. Have a single location where your trust, your will, your power of attorney, your advance directive (health care power of attorney and living will) and a detailed inventory of your assets, list of estate planning documents, your military history, funeral instructions, and significant medical history are kept together. If this is a safe deposit box or a safe, be sure your personal representative and trustee are authorized to obtain access to the box and they have access to your safe. Your estate planner should be able to provide you with a resource to record all this information in a single location. Discuss these matters with your spouse, your children, and your personal representative and make sure your personal representative knows the location of the information. It does no good to have it unless it can be found!

The information in this report is educational only, not legal advice. Everyone's estate planning needs are different, so you should consult qualified counsel to design an appropriate estate plan for your unique needs.

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