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Top 10 Estate Planning Mistakes

by Burton A. Mitchell and Jill M. Henderson

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When we review estate plans, there are some common mistakes we come across. You may think some of these are obvious, but we have seen them enough to assure you that they are not. Here is our list of the 10 mistakes we see most often.

1. **Skipping the basics.** With the increase in the gift and estate tax exemptions to $5,00,000, which under current law is in effect through December 31, 2012, we are experiencing a renewed interest from clients in estate ***tax*** planning. Many clients are intrigued by the idea of using their $5 million lifetime gift tax exemption (or a portion of it) to transfer wealth to their children now. Is this a good idea? In many cases it is, but first things first.

The best made estate plan is built from the ground up, so make sure the basic estate plan is in place before diving into the more complex, and often irrevocable, estate planning. Why is this important? The process of planning the basic documents, such as the Will and revocable living trust, should uncover most issues. That process is the time to review the client's financial picture and family dynamics, which is an essential consideration in any estate plan. If the basics are skipped, you increase the likelihood of missed issues or oversights. Typically, the more advanced estate tax planning involves irrevocable steps that cannot be easily undone, if at all.

The more advanced estate tax planning should be pursued in many cases, but it is important to slow down the pace if necessary and get the basics in place. A thoughtful plan is a more efficient and accurate plan.

2. **Skepticism about life insurance.** It is fairly common for clients to be hesitant about incorporating life insurance into their estate plan. Often clients have a negative view toward life insurance, because they are distrustful of life insurance agents and do not see the value in paying premiums on a policy that may never may pay or on paying large premiums over a potentially long period of time. However, there are many situations where life insurance is an invaluable aspect of an estate plan and, if properly explained to the client, can alleviate the client's hesitation.

> Don't ignore healthcare directives, the assignment of personal effects or the title to assets.

For example, a term life insurance policy is a relatively inexpensive way to provide a non-working or lower income earning spouse with comfort that they would not have to sell the family residence or dramatically change his or her lifestyle in the event of the death of the higher earning spouse. A "second to die" policy can provide the liquidity needed to pay estate taxes, so the beneficiaries do not have to sell assets they may prefer to retain. The use of an irrevocable life insurance trust should always be considered, although it may not always be necessary.

3. **Ignoring the retirement plan coordination.** In every estate plan, the beneficiary designations for the retirement plans must be coordinated with the wishes of the client. In some cases, the retirement plans are a critical part of the estate plan and in other cases they are only a small piece. Either way, an incorrect beneficiary designation, or no beneficiary designation at all, is a problem in the event of a death. The clients often

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need assistance completing these forms. Most importantly, the client should obtain written confirmation of the designations from the retirement plan administrator and should provide a copy of that confirmation to their estate planning attorney. The written confirmation ensures that both the client completed the form properly and that the retirement plan administrator processed the form correctly.

In the event of a marriage or divorce, new beneficiary designation forms must be completed. Forgetting to complete new forms when the marital status changes can result in the wrong person receiving the retirement plan.

In addition to making sure the beneficiary designations are correct, the income and estate tax aspects of retirement plans need to be considered. If the beneficiary is a trust, will the retirement plan proceeds be held in a "conduit trust" to extend the period of time over which the beneficiary will receive distributions? For the clients who are charitably inclined, should the beneficiary of the retirement plan be a charity? These income tax aspects should be considered. With respect to estate taxes, the living trust should be reviewed to ensure that the right party is paying any estate taxes related to a retirement plan.

Also, since the retirement plans pass outside of a living trust, this must be considered in the drafting. If the bulk of a client's net worth is in a retirement plan, then the desired result may not be obtained under the living trust. While this sounds obvious, it is easy to overlook if focused on drafting the estate plan.

4. **Overlooking the impact of federal and state estate tax.** We all know there is a federal estate tax and we advise our clients about the current federal estate tax exemption and how it impacts them given their net worth. The federal estate tax exemption is not likely to be overlooked. However, what can be overlooked is what the estate plan says about payment of estate tax. Suppose there is a piece of real property held in joint tenancy. What does the living trust say about payment of the estate taxes on that joint tenancy asset? If it is supposed to be paid by the joint tenant, how will the trustee collect the estate taxes from that joint tenant? If there are specific distributions to be made to individuals, does the estate plan address whether or not those distributions are made free of estate tax? There are real economic consequences that result from these issues, so the boilerplate estate tax provisions need to be reviewed in each case to ensure the correct result.

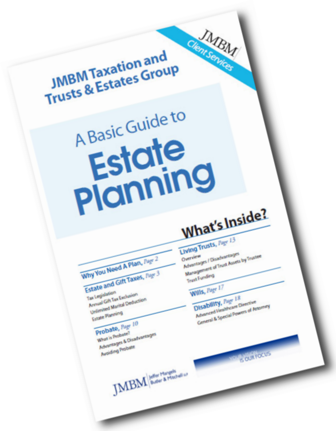
In addition to the federal estate tax, some states have a state estate tax. We no longer have a state estate tax in California, but that does not mean we can ignore the issue for our clients. If a client owns real property in another state, we must evaluate if that state has an estate tax and how it would apply to our clients.

5. **Too many seats at the table.** A fairly common approach to dividing assets among different groups of beneficiaries is to give the separate groups a percentage. This creates a number of problems by giving that beneficiary a seat at the table, so to speak. A beneficiary that is entitled to a percentage of the estate will be concerned with any and all issues that effect the value of the estate, such as valuation issues and costs of administration, because each of these will impact the amount ultimately received by that beneficiary. On the other hand, a beneficiary that receives a specific dollar amount need not be concerned with issues, since it does not change his or her distribution. Where possible, encourage clients to stay away from percentages or formulas that can back fire. Instead, select a dollar amount that they are comfortable with and review it periodically.

6. **Giving one child control over another.** A typical response from clients about the question of who should be trustee is often followed with "can my responsible child be the trustee?" This is appealing, because it keeps the burden off other family members or friends and it avoids the trustee fee that would be paid to a financial institution. While we have no doubt that there are many situations where the child is perfectly capable of handling the job of trustee, we advise against giving one child control to the exclusion of another child. Our experience is that it can be a costly mistake that causes disputes that could have been avoided.

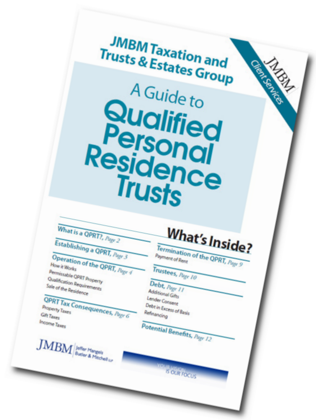
Even in the best family situations, the child that is left out of the decision making process will most likely not be pleased. There are important decisions that need to be made in the trust administration process, such as *Continued on page 3*

JMBM Resources on Trusts & Estates



JMBM publishes *A Basic Guide to Estate Planning*, which describes many important estate planning issues, and introduces some principal estate planning techniques. Click on the image to the left to download a copy.

JMBM also publishes *A Guide to Qualified Personal Residence Trusts*, which discusses how owning your residence through an irrevocable trust can reduce your estate tax. Click on the image to the right to download a copy.



How You Can Benefit by Funding an Irrevocable Life Insurance Trust

by Jeffrey Berkowitz

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On December 17, 2010, President Obama signed the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 ("Tax Relief Act") that included sweeping estate, gift and generation-skipping tax ("GST") changes for 2011 and 2012. These changes included increasing the estate tax, gift tax and GST exemption amount to $5 million per person and $10 million per married couple. The Act also reduced the maximum tax rate to 35 percent on these transfer taxes. The estate tax exclusion for 2012 is $5.12 million per person.

These increased exemptions have provided many unprecedented tax planning opportunities, including the ability in 2011 and 2012 to fund Irrevocable Life Insurance Trusts ("ILIT") in significant amounts, free of gift tax. (An ILIT is a type of irrevocable trust specifically established by the grantor to purchase and own life insurance policies.)

Purpose and Tax Treatment of Life Insurance

Life insurance proceeds generally are not subject to income tax or estate tax, if the ownership of a life insurance policy is properly structured. However, such ownership structures often result in a gift tax liability on the funds used to pay the premiums on the life insurance policies.

Traditionally, life insurance has been purchased to create or preserve an estate. For individuals in their 30s and 40s, life insurance has customarily been purchased on the life of the primary income earner to provide for a sufficient estate in the event of an untimely death. For older individuals, life insurance customarily has been purchased to provide for the funding of estate taxes. However, given today's economic climate and the tax-favored treatment of life insurance policies, life insurance also should be viewed as a stand-alone investment alternative.

Use of an Irrevocable Trust

Life insurance policies are often acquired by an ILIT established for the benefit of an insured's family, because this is one of the ownership vehicles that can ensure that life insurance proceeds will not be subject to estate tax. However, amounts transferred to an ILIT to fund life insurance premiums likely will be subject to gift tax, because (i) transfers to an ILIT do not qualify for the annual exclusion from gift tax as the transfer is not a transfer of a present interest, which is required in order to qualify for the annual exclusion and (ii) oftentimes the individual making the gift did not have enough remaining gift tax exemption ($1 million pre-Tax Relief Act) to shelter the gifts made to the ILIT.

When the cost of gift tax, which has ranged from 45 to 55 percent in recent years, is added to the cost of life insurance premiums, it has often made the total cost of insurance prohibitive. Consequently, a number of techniques were developed to avoid the gift tax. One of these techniques was for an ILIT to include a "Crummey Provision" that would allow a gift to the ILIT, up to a certain amount, to be considered transfer of a present interest and thus eligible for the annual gift tax exclusion. However, many found this technique to be too cumbersome, because it required the early funding of amounts needed to pay for insurance premiums and mandated that letters be sent to beneficiaries notifying them of their right to withdraw gifts to the trust.

Another common technique was for an ILIT to enter into a split-dollar arrangement pursuant to which loans were made to the ILIT or an economic interest in the insurance policy (owned by the ILIT) that was owned by a third party. In either case, a portion of the death benefit that would otherwise be exempt from taxes would have to be paid to a third party, thus subjecting that portion of the death benefit to income and/or transfer taxes. These complex techniques resulted in many individuals shying away from purchasing life insurance through an irrevocable trust.

As a result of the increased gift tax exemption, individuals have the opportunity during 2011 and 2012 to transfer significant sums of money to an ILIT free of gift tax and without the necessity of complex planning techniques. Those who suffer from "complexity

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Estate Planning Mistakes

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whether to sell certain assets, valuation issues and when to make distributions. Giving one child control over these economic decisions to the exclusion of another creates an unpleasant dynamic even when everyone has good intentions. It is generally a better practice to name a financial institution, if practical, given the size of the estate, or a trusted and responsible family member or friend (other than a beneficiary), or even naming all children as co-trustees, rather than giving one child control over another.

7. **Ignoring the personal effects.** The personal effects can be the most difficult asset to divide and distribute. Beneficiaries can have strong personal feelings about what items of the personal effects they want and they can disagree about the value of certain items. It is important to have a system in place in the estate plan to resolve these disputes. There may also be special circumstances resulting from the structure of the estate plan that require consideration. For example, if a residence

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is left in trust for use by a beneficiary such as a second spouse, with the residence to ultimately pass to children, then the contents of that residence should be specifically addressed. Otherwise, you may have an unpleasant situation where the beneficiary of the residence has the contents immediately removed by the beneficiaries of the personal effects. If there are any items with a large value, they should be addressed specifically.

> Don't underestimate the importance of specifying how estate taxes will be paid—and by whom.

8. Not following through on title to assets. A fully funded living trust is the desired goal in any estate plan. An hour of time now can save thousands of dollars later. In California, if the client signed a Will and a general assignment of assets to a living trust, we often can petition the Court for confirmation that an asset is owned by the living trust, but this process takes months and is not guaranteed. The professional advisors should help the clients with completing this process. It is tedious to the clients and they may not understand the significance or the ultimate cost for failing to follow-through, so this is an area where the assistance of professional advisors is critical.

9. Letting the client avoid the Advance Health Care Directive. The process of thinking about and completing an Advance Health Care Directive can be unpleasant. The client has to consider health issues and topics such as life support and organ and tissue donation. The health care power is a critical part of everyone's estate plan. When the health care power is needed it is invaluable. If the client resists completing the health care power or wants to think it over, encourage them to complete one now and change it whenever they want. It is generally better to have something in place, rather than nothing.

10. Not doing an estate plan at all. If your client is going to live forever and will never be disabled, then skip the estate plan. For everyone else, make sure your estate plan is in order to protect your family.

An estate plan is essential to the long-term well-being of your family and heirs. Because your family's needs change and the legal and regulatory environment continues to evolve, your estate plan should be reviewed and amended periodically.▪

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intolerance" should be advised to take another look at setting up an ILIT to purchase insurance on their lives.

Why Life Insurance Can Be an Attractive Investment

Life insurance policies should be viewed as an investment, rather than solely as a vehicle to provide liquidity upon the death of an insured. As discussed above, insurance policies can be owned by an ILIT so that the death benefits are not subject to transfer taxes, and in 2011 and 2012, it is possible to gift large amounts to an ILIT free of gift tax. The ability to avoid gift tax on funds used to pay premiums on a life insurance policy makes such insurance a much more attractive investment.

The internal rate of return ("IRR") for a life insurance policy varies depending on when the insured passes away. If the insured dies earlier than expected, the IRR will be much higher than it would be if the insured lived longer than expected. With an early death, the life insurance policy will achieve an IRR that other investments are unlikely to achieve on an after-tax basis. With a later death, the IRR on a life insurance policy will likely be comparable to, and possibly higher than, what other investments can reasonably expect to achieve on an after-tax basis.

Real-Life Example

As an example, assume a 55-year-old in excellent health gifts $1 million to an ILIT in 2011 and the ILIT invests $100,000 per year, over a 10-year period, in a life insurance policy that provides for a death benefit of $3.5 million. Assuming the individual uses part of his or her $5 million gift tax exemption to shelter the gift, the gift is free of gift taxes. This death benefit is free of all income and transfer taxes.

If the insured dies 10 years after the policy is issued, then the IRR on this investment would be approximately 22.2 percent. If the insured dies 25 years after the policy is issued, then the IRR on this investment would be approximately 6.2 percent.

If instead, over the 10-year period, the same $1 million

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is invested in stock and bonds that are subject to income and/or estate tax, and one assumes that the value of the investment at the date of the insured's death would have to double the $3.5 million death benefit in order to have a net amount after all taxes equal to $3.5 million, then an investment would have to generate an IRR of approximately 35.5 percent to achieve a $7 million value after 10 years, and an IRR of approximately 9.4 percent to achieve a $7 million value after 25 years.

Obviously, the actual IRRs will depend upon the age and health of the insured, the kind of life insurance products that are available, the assumption that amounts transferred to an ILIT are not subject to any gift tax, the kind of other investments available to the insured, and the income and transfer tax rates.

From a risk assessment standpoint, it is fair to say that it is more likely that a financially sound life insurance company will be able to pay the death benefit on one of its life insurance policies than an insured will be able to earn an IRR on investments over a period of time that will yield a net amount, after taxes, equal to an insurance policy's death benefit.

Get the Best Insurance Advice

Proper care should be taken to ensure that individuals obtain the best insurance product given their circumstances. One must consider whether to obtain term or permanent life insurance and the specific features of the policy. If permanent insurance is selected, one must consider whether to purchase whole life or universal life insurance and whether to obtain the policy from a stock company or a mutual company. Therefore, it is important to select the proper life insurance professional to assist in obtaining the best life insurance policy. Some individuals will ask a family friend or general insurance agent to assist in obtaining life insurance. However, these people do not have the specialized knowledge required to obtain the most suitable product at the best ratings. Experienced brokers are better able to design programs that better fit the needs of each client, and certain brokers—who are members of an elite life insurance group—have access to proprietary products not available to other agents.

> Given today's economic climate and the tax-favored treatment of life insurance policies, life insurance also should be viewed as a stand-alone investment alternative.

Use an Independent Advisor

It is generally best to engage an independent advisor who is a life insurance specialist to review different life insurance policies and companies suggested by a qualified insurance broker. This is particularly important when one is considering purchasing a policy requiring a substantial investment and providing for a large death benefit. Brokers may have special relationships with specific companies with whom they do more business and may attempt to steer clients to a particular product offered with one or more of these companies because of a more favorable commission arrangement, even though there may be other products better-suited for the insured. Independent advisors usually are paid on an hourly basis and have no incentive to recommend one policy over another.

Life insurance policies are complex contracts, and independent advisors are often more skilled than attorneys, accountants or other financial professionals in reviewing and fully understanding the terms of the policy, including guarantee and lapse provisions. Finally, these specialists are generally better-versed about the financial conditions of major life insurance companies and may have knowledge that may be relevant in determining which life insurance company to select. ▪

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Volatility Can Kill Your Variable Life Policy

by Gordon A. Schaller

You or your spouse or parents may have purchased a life insurance policy several years ago. You always thought life insurance was a bad investment with returns of only 3 - 4 percent. However, this policy was supposed to be different — the premiums could be flexible and you could invest the cash value in the stock market where returns had historically averaged 10 percent. The promise of "stock market returns" would reduce the premiums you were required to pay for the insurance death benefit. Life insurance finally seemed attractive, based on what your financial advisor was saying, so you made the

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investment in something called "variable universal life insurance."

The stock market performed well for several years and the cash value of the policy increased. There were some market "corrections," but the stock market recovered and continued to prosper, and so did the variable life insurance policy.

Then a significant prolonged stock market decline occurred; one that caused your 401-K to shrink dramatically. However, you did not notice the impact on your variable life insurance. You thought you just needed to keep paying the premium your financial advisor had provided and the insurance would be fine. The stock market recovered over time and so did your 401-K and the cash value of the life insurance policy seemed to bounce back. You didn't really pay attention to the statements that came from the insurance company to notice that the insurance policy cash value did not recover as much as your 401-K.

Years passed and the stock market went into another prolonged decline, with substantial negative returns, followed by a period of significant volatility. Your retirement funds and your retirement seem extremely vulnerable. One day the life insurance company sends a letter that captures your attention — your policy may lapse unless you pay a substantial additional premium.

You contact your financial advisor who confirms the grim facts — you have to pay substantially greater premiums for the rest of your life, or you may have no life insurance. You cannot afford the huge premium increase, as you are trying to save enough in your last working years to retire; or maybe you have already retired, and the required premiums are impossible. Your financial advisor tells you that you can decrease the face value of the life insurance policy and continue to pay the same premium or just let the policy "lapse" if you cannot afford additional premium payments. How could this happen to your life insurance? When you purchased the policy years ago, your financial advisor showed you how it would work if the stock market continued the historic trend of a 10 percent return over time. Of course, there was no guarantee, but after all it had been true for 70 years. Your financial advisor gave you a very thick disclosure document required by federal securities law that explained it all. Another massive legal document not read or understood.

The devastating, insidious truth is that your variable life insurance was never guaranteed to last and to provide the death benefits you counted on for your family. You bought in part because of lower "premiums" and stock market returns. No one, not even the federal securities law prospectus, disclosed the hidden and toxic effects of negative stock market returns and volatility on your variable life insurance. Many policy owners have faced this dilemma in recent years. Some have surrendered or reduced the face value of their policies or exchanged into safer types of policies. Some have died and their families have not received the death benefits they expected and needed. Why?

The hidden truth about variable life insurance is that mortality and expense charges ("M&E Charges") have been deducted from

the cash value of the policy by the insurance company every month. This was true when the stock market flourished and when it sank. However, when the stock market "rebounded" after a significant decline, your life insurance cash value rebounded less, since it had been reduced by M&E Charges. The same was true when the stock market suffered prolonged volatility. Negative returns, volatility and M&E Charges created a death spiral for your variable life policy. Computer analytical tools could have predicted the probability of this result, even when the policy was originally acquired.

The devastating, insidious truth is that your variable life insurance was never guaranteed to last and to provide the death benefits you counted on for your family. Many policy owners have faced this dilemma in recent years.

If this has not yet happened to your variable life policy, review its status and your choices now. If this has been your experience, consult with your financial and legal advisors. If you are considering life insurance products, to paraphrase Aristotle, "avoid the attractive impossibility, as compared to the less attractive probability." ▪

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