COVID-19 Alert: Three Major Mistakes Often Made When Drafting Your Own Last Will and Testament

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With the COVID-19 pandemic turning life upside down, social media is abuzz with people looking to prepare their Last Will and Testament. Inevitably, someone will respond to the post and recommend that the individual draft their own. While the Internet provides the do-it-yourselfer with a plethora of forms of drafting software to ***inexpensively*** prepare legal documents, the potential traps and misunderstandings in preparing your own Last Will and Testament may prove much more expensive in the long run. Let's look at the following example and three of the most common mistakes people make when preparing their own estate planning documents:

Facts

Jennifer (40) and Michael (42) Smith are married and have two children, Alexandra (13) and Jacob (10). Jennifer is an insurance agent and has a 401(k) valued at $100,000. Michael is a middle school teacher and has a 403(b) valued at $50,000. They jointly own a house worth $500,000, which is encumbered by a $350,000 mortgage. They have joint bank/brokerage accounts with cash and securities worth $150,000. Additionally, Jennifer was able to get them a great deal on life insurance policies for $1,000,000 each. The Smith's estate and their wishes are relatively straightforward. Like many married couples with kids, they want everything to go to the surviving spouse on the first death and to be split among the kids on the second death.

Plan I

The Smiths download and sign a form of a Last Will and Testament on the Internet, which states that all assets pass to the surviving spouse on the first death and then to the kids on the second death. They name Jennifer's sister, Lynn, as the executor of each estate and the guardian of Alexandra and Jacob. Additionally, when they established the retirement accounts and life insurance policies, Jennifer and John had each designated the other as the primary beneficiary and the kids as the contingent beneficiaries.

A week later, Jennifer and Michael tragically pass away in a car accident. Here is what initially plays out:

- Lynn qualifies as the executor of each estate and as the children's guardian;
- The Smiths' house is sold, which satisfies the mortgage, and the children move in with Lynn;
- The retirement accounts are converted into Inherited IRA accounts for each child ($75,000 each);
- The net proceeds of the house, the cash and securities and the death benefit from each life insurance policy are gathered and deposited into new financial accounts for each child ($1,150,000 each); and
- Depending on state law, Lynn may be required to deposit the Smiths' assets with the surrogate court to be held until the children reach the age of majority (generally 18 years old), which typically requires an application to the surrogate each time that Lynn needs to withdraw money for a minor child's benefit. Alternatively, Lynn may be able to post a bond (i.e., an insurance policy) as the guardian in order to hold all of the Smiths' assets for the benefit of the children, which is a significant yearly cost paid out of those assets.

At first glance, it seems like Plan I succeeded. The Smiths left their children in Lynn's capable hands and each child has a significant 7-figure inheritance. However, what the Smiths did not foresee happening was the amount of trouble which Alexandra would face dealing with the loss of her parents.

Over the next 5 years, Alexandra suffers greatly. Her grades slip, she hangs out with the wrong crowd and she experiments with drugs. Alexandra graduates from high school about the time she turns 18. At this point, Lynn is required to turn over to Alexandra all of the assets she was holding as Alexandra's guardian. Let's assume there is $1,000,000 remaining after expenses and growth. Alexandra is now an 18-year-old who likes to party with her friends and has $1,000,000 in her pocket. The rest of that story can write itself.

Plan I failed for two reasons. First, the Smiths did not appreciate the changes which children go through during adolescence, especially when dealing with the loss of parents. Second, the Smiths may have been overwhelmed with the various forms of Wills found on the Internet and, as such, they were unaware of their options for planning a minor child's inheritance. Had they instead met with a competent attorney specializing in estate planning, the attorney would have raised these issues during a consultation and, more importantly, planned for them.

Plan II

Suppose, instead, the Smiths thought to themselves, "there is no way an 18-year-old should inherit over $1 million outright. The money should be held in trust." They proceed to draft their own Wills, which direct Lynn, as the trustee, to hold each child's share in a separate trust and use the funds for such child's benefit. The terms of the trust provide that each child can withdraw 1/3 of their own trust at the age of 25, 1/2 of what is left at the age of 30 and the remainder of the trust at the age of 35 (i.e., a traditional, "staggered" trust).

Plan II solves the problems presented in Plan I, right? Unfortunately, the Smiths did not understand that a Will does not control the disposition of all of their assets upon their death. Retirement accounts and life insurance DO NOT pass under a Will. Rather, these types of assets pass by beneficiary designation, which, in this case, still named Alexandra and Jacob as the contingent beneficiaries, rather than designating their respective trusts as beneficiaries. As a result, each trust will be funded with only $150,000, representing the net proceeds of the house and the cash and securities. The remaining $2,150,000 from the retirement accounts and life insurance will be split among each child and held by Lynn as each child's guardian (or by the surrogate). Once again, Alexandra will receive outright what remains of her share when she turns 18.

Under Plan II, the Smiths should have executed new beneficiary designations for their retirement accounts and life insurance policies directing that the proceeds of each be split into separate shares for each child and held in separate trusts for each child under the terms of their Wills. Properly specifying a trust as a beneficiary of a retirement plan or a life insurance death benefit can be very tricky. This is where a lawyer well-versed in the subject matter can be of great assistance.

Conclusion

Plans I and II illustrate two of the most common mistakes people make when preparing their own estate planning documents. So, where is the third mistake? The third mistake was actually made by the Smiths before they even embarked on the preparation of their Wills. ***The Smiths did not appreciate what they did not know***. The Smiths could have greatly benefited from a conversation with an attorney who would address the issues raised in the fact pattern and ensure their wishes are carried out. Moreover, the Smiths would have likely benefited from a discussion and education on the following:

- The use of a staggered trust vs. a lifetime or dynastic trust (which does not payout/terminate at a specific age) to protect the inheritance from the children's creditors, including potential ex-spouses;
- Allocating a portion of the estate to a "sprinkle" or "pot" trust for the collective benefit of the children to be used specifically for education and health expenses until all children graduate from college (in the Smiths' case, it may have made sense to split the life insurance and retirement accounts into separate trusts for each child and hold the remainder of the estate in a pot trust for the collective benefit of the children);
- The use of a conduit vs. accumulation trusts to hold retirement assets in light of the new SECURE Act which changes the manner in which inherited retirement plans (including IRAs) are taxed; and
- The use of a disclaimer trust in the plan as back-up estate tax planning in the event that the New Jersey estate tax is reinstated, or the couple moves to another state which still has an estate tax.