Top 5 Estate Planning Mistakes

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Mistake No. 1 ***Failing to Understand Estate Taxes***

Federal Estate Tax Basics.

1. Right now there are no Federal Estate Taxes effective 1/1/2010. Coming back in 2011 with a $1,000,000 exemption.
2. Until the end of last year, the Federal estate tax exemption was $3,500,000. Estate tax may come back this year!
3. Transfers between U.S. Citizen spouses are exempt from Federal estate taxes. This is often referred to as the unlimited marital deduction. See I.R.C. §2056.
4. Transfers to non-spouses (e.g. children) are subject to Federal estate taxes on amounts in excess of the Federal estate tax exemption. This amount had been increasing from $675,000 in 2001 to $3,500,000 in 2009.
5. A properly planned estate for a husband and wife should allow the family to utilize both credits and pass two times the amount of the Federal estate tax exemption.

Use of Two Share Wills.

1. Implementing an estate plan that utilizes “two-share wills” or “bypass wills” is the most effective technique to ensure the use of both spouses’ estate tax credits.
2. Must be planned in advance.

3. A surviving spouse cannot bank the first spouse's unused credit.

Mistake No. 2 ***Failing to Consider New Jersey Estate and Inheritance Taxes***

The Bush Tax Cuts of 2001 ("EGTRRA") made significant changes to the Federal estate and gift tax system.

1. Increased the estate tax exemption from $675,000 to $3,500,000 (2009).
2. Prior to EGTRRA, the Federal estate tax provided each estate with a credit for death taxes paid to any state (the "State Death Tax Credit"). The State Death Tax Credit was a dollar-for-dollar credit. New Jersey's estate tax, pre-EGTRRA, consisted of requiring the payment of the amount of credit which the Federal system permitted. In effect, instead of paying the IRS, you paid a portion of the money that would have been payable to the IRS, to Trenton.

Beginning in 2005, the State Death Tax Credit was completely eliminated and replaced with a deduction.

The reduction, and then elimination, of the State Death Tax Credit effectively took money out of New Jersey coffers. So on January 1, 2002, New Jersey decoupled its estate tax from the Federal credit system.

Now, New Jersey taxes all estates as if the decedent died on December 31, 2001, regardless of when they actually die. Thus, all estates over $675,000 are subject to New Jersey estate tax.

Taxable Estate	Tax
$1,000,000	$ 33,200
$1,500,000	$ 64,400
$2,000,000	$ 99,600

$3,500,000	$ 229,200
$10,000,000	$ 1,067,600

New Jersey also imposes an Inheritance Tax on transfers to certain individuals based upon the relationship between the deceased individual and the beneficiary

- **Class A beneficiaries** include the decedent's spouse, civil union partner, children, grandchildren, great-grandchildren, step-child, mother, father or grandparents. Bequests to Class A beneficiaries are wholly exempt from New Jersey Inheritance Taxes.
- **Class C beneficiaries** include the decedent's siblings, half-siblings, son-in-law, daughter-in-law, widow of a deceased son, and widower of a deceased daughter. Bequests to Class C beneficiaries are taxed on amounts in excess of a $25,000 exemption to each. The first $1,075,000 over the exemption, received by a Class C beneficiary, is taxed at 11% and the amount in excess of that figure is taxed at rates from 13% to a maximum of 16%.
- **Class E beneficiaries** include tax exempt entities such as charities and not-for-profit organizations. Bequests to Class E beneficiaries are wholly exempt from the New Jersey Inheritance Tax.
- **Class D beneficiaries** include anyone who is not a Class A, C or E beneficiary. So, for example, a nephew, niece, cousin, fiancé, best friend, or non-civil union partner are all Class D beneficiaries. Bequests to Class D beneficiaries are taxed on the first dollar (unless the bequest is less than $500) at rates of 15% up to $700,000 and 16% in excess of that amount.

Mistake No. 3 ***Failing to Properly Title Assets and Failing to Have the Proper Beneficiary Designation***

Contrary to popular belief, a Last Will and Testament is not the most common way of disposing of one's estate. Property passes to an heir in four ways:

1. By operation of law to a surviving joint tenant
2. By contractual beneficiary designation
3. By provision of a Last Will and Testament
4. By intestacy

Operation of Law:

1. ***Tenants by the Entirety and JTWROS Accounts*** – Spouses frequently own assets jointly. This means that regardless of the provisions of the spouse's Will, the assets will pass to the surviving spouse upon the first death.

Problem – Because these jointly held assets pass to the surviving spouse regardless of the terms of the Last Will and Testament, an estate plan that includes "two-share will" or a "bypass will" becomes frustrated.

Example – Assume that we are in the year 2011 and John and Sally own two assets, a residence worth $1,000,000 titled as tenants by the entirety, and a brokerage account valued at $1,000,000, titled as joint tenants with rights of survivorship (JTWROS). They visit the law firm of Dewey, Cheatum and Howe, to have wills prepared that provide for the first $1,000,000 to go into trust for the surviving spouse at the death of the first spouse (typically referred to as "two-share wills"). Unfortunately, when John dies, all of the assets pass to Sally as the surviving owner, and the bypass trust under John's will goes unfunded. Sally now has a $2,000,000 estate, and will pay taxes on the amount over $1,000,000 after 2011. If the assets were divided between the spouses, a trust of $1,000,000 would have been established upon John's death and that trust would not be included in Sally's estate at her death. Thus, at her death, only $1,000,000 would be included in her estate, not $2,000,000, and there would be no Federal estate taxes due.

Joint Tenant Accounts With a Child – Typically a client will establish a joint bank account with a child for convenience.

N.J.S.A 17:16I-1 et seq. - The New Jersey Multiple-party Deposit Account Act

N.J.S.A. 17:16I-5(a) – Sums remaining on deposit at the death of a party to a joint account belong to the surviving party or parties against the estate of the decedent unless there is **clear and convincing evidence** of a different intention at the time the account is created.

Beneficiary Designation.

1. Life insurance and retirement benefits typically pass by way of contract through the use of a beneficiary designation.
2. May be the only asset available to fund a bypass trust.
3. Naming a minor as a beneficiary under a life insurance policy and expecting it to be held in trust for the minor is a mistake. These funds will be held in the Surrogate's Intermingled Trust Fund until the child reaches age 18.

4. Beneficiary designations for minors should designate that the funds be held in trust under the will or an inter-vivos trust for the benefit of the minor until more appropriate ages.
5. Complex beneficiary designations may be a hassle, but they serve a very useful purpose.

Intestacy.

Don't rely upon the New Jersey intestacy statutes as a method of distributing your estate.

Mistake No. 4 ***Failing to Make Lifetime Gifts***

The Lifetime Gift Tax Exemption.

The current lifetime gift tax exemption is $1,000,000. This applies even though there is presently no Federal estate tax imposed.

Annual Exclusion Gifts.

1. Each year, each individual can give to any other individual a gift of $13,000, provided that the gift qualifies as an "annual exclusion gift" under Section 2503(b) of the Internal Revenue Code.
2. In order to qualify as an "annual exclusion gift" the gift must be of a present interest.
3. Through the use of various trusts, gifts can be held in trust for the benefit of minors (or others) and still qualify as "annual exclusion gifts". A Crummey Trust is one type of trust that we typically use to receive annual gifts, the present use of which is intended to be restricted.

Gift Splitting.

1. Section 2513 of the Internal Revenue Code authorizes spouses to treat gifts made by one of them as if they are made equally from each.
2. Requires the consent of both spouses.
3. In a second marriage, consider using the credit of a spouse with no children to make gifts to the children of the spouse who has children.

Discounting.

1. The ability to use discounts to reduce the value of lifetime gifts, is a significant benefit weighing in favor of gifting during life as opposed to waiting until death.

2. The ability to use discounts at death is lost, because the tax is imposed upon the value of the estate assets, rather than the value of the bequest.
3. Minority Discount – A discount attributed to a gift of a non-controlling interest in an entity, business or parcel of real property, because the fractional non-controlling interest will generally be worth less than the pro-rata portion of the underlying assets.
4. Marketability Discount – A discount of a gift of a fractional interest in a closely held business attributed to the fact that there is extreme difficulty in attempting to sell such an interest when there is no readily established market.

Example: John Smith owns a widget business worth $10,000,000. He plans to give the business to his two sons at his death. However, John is not opposed to making non-controlling gifts of interests in the business to his sons during his lifetime. Since he has a $1,000,000 lifetime credit, and he doesn't want to pay any gift taxes, how much of an interest can he give to each son without incurring a tax?

Assume that an appraiser indicates that a gift of a fractional, non-controlling interest in the business should be discounted at 40% (applying both minority and marketability discounts).

John would be able to give a 16.67% interest in the business to his children, effectively removing $667,000 from his estate tax free.

If John's wife joins in the gift splitting, he could give away a 33% interest in the company and pay no gift tax, effectively removing $1,334,000 of value from his estate tax free.

Additionally, using annual exclusion gifts going forward, John could gift .867% interests each year to his children tax free (10,000,000 x .867% x 60% = $52,000 annual exclusion gifts).

Not only did we discount the gifts on the way out of John's estate, the future appreciation of these interests is also removed from John's estate.

Tax Free Gifts for Education and Health.

1. Section 2503(e) of the Internal Revenue Code provides that "qualified transfers" are not considered as a transfer of property by gift.
2. A "qualified transfer" is ***any amount*** paid on behalf of an individual
    1. (A) as tuition to an educational organization (which need not be for higher education), or
    2. (B) to any person who provides medical care with respect to such individual as payment for such medical care.
3. Payment must be made directly to the institution or to the medical provider.

Mistake No. 5 *Incorrect Ownership of Life Insurance Policies*

Life insurance is generally not subject to income tax to the beneficiary. However, most people don't realize that life insurance owned by the insured is included in the insured's **taxable estate** for Federal and State estate tax purposes.

Having the insured's spouse own the life insurance policy does not generally accomplish the result of getting the death benefit to the next generation tax free. If the spouse owns the policy, then the death benefit will be included in the spouse's taxable estate.

Life insurance owned by the insured's children and payable to the insured's children, may avoid Federal estate taxes. However, what if the intent is to provide continuing lifetime benefits to a surviving spouse?

What if the children are minors and you want to protect the assets?

Life insurance owned by an Irrevocable Insurance Trust can be used by the surviving spouse during his or her lifetime and then pass to the insured's children free of Federal estate tax on the surviving spouse's death.

Since the ILIT is irrevocable, ensure that the trust is written with some flexibility.

1. Consider the use of a limited power of appointment.
2. Consider provisions dealing with the divorce of the insured.
3. Consider giving a third party, non-beneficiary a limited power of appointment to distribute the principal and terminate the trust.