The Seven Biggest Mistakes in Estate Planning

Estate planning expert Thomas Handler says most mistakes can be avoided with advanced planning and knowledgeable guidance.

BY DAVID ADLER

Wealthy individuals—and their financial advisors—face unprecedented challenges in estate planning. Not only is the United States moving inexorably toward higher overall tax rates but also there is great uncertainty about how pending tax changes will be implemented. Financial planners are concerned about inconsistency in interpretation and enforcement.

As a result of these trends and overall economic instability, financial advisors wisely are focusing on estate planning more than ever before. But are they going about it the right way?

Sadly, there are a handful of recurrent—and potentially devastating—mistakes that many advisors make when it comes to estate planning. Avoiding these key planning mistakes can have a significant effect on estate preservation.

Just ask Thomas Handler,* managing partner of Handler Thayer, L.L.P. in Chicago, and an internationally recognized wealth-planning attorney. Handler recently spoke to a group of independent advisors at a two-day RIA Forum hosted by Lord, Abbett & Co. in Jersey City, New Jersey. Handler shared a useful perspective on estate planning today, including some common critical errors he has observed and suggestions on how to avoid them.

Underlying Handler's presentation was the recurrent theme that preserving capital across generations is extremely difficult. It requires a team of experts and constant attention to detail to ensure that the grandchildren of the family magnate don't have to sell the family jewels to keep the lights on.

Handler refers to a real estate family worth more than $500 million dollars who were caught in the recent liquidity crisis. Though the family had almost $250 million in liquid assets, this wasn't enough to fund their holdings as banks called loans and withdrew lines of credit. The family members personally went bankrupt. "It shows just how important liquidity risk is," Handler says.

Here are seven of the biggest mistakes to watch out for:

1. Choosing the wrong controlling document: wills versus trusts.

The most fundamental decision in estate planning is the choice of the controlling document that serves as the foundation of the plan—either a trust or a will. "The biggest mistake people tend to make is the wrong choice for their situation," says Handler. Higher-income people, who are older and/or in poor health, and who have sophisticated financial affairs, are more likely to benefit from living trusts. In practice, however, they tend to use wills. The mistake goes both ways: younger people, with less wealth and relatively uncomplicated affairs, often favor trusts when they should be using wills.

"People end up using a trust as their controlling document when they should use a will, and people who should use wills use a trust instead," Handler says. Advisors may not fully appreciate what factors determine the proper controlling document for each individual.

Moreover, as the paperwork needed to create trusts has become available on a mass-market basis, Handler has observed lawyers inappropriately recommending trusts to clients. "I've seen a factory worker who is just getting by financially tied up in an expensive trust that cost thousands of dollars to create and which was completely unnecessary, just because his lawyer put him there," he says.

One rule of thumb suggested by Handler: If the estate is less than $1 million, lean toward a will rather than a trust.

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2. Not integrating a plan.

A plan needs to be coordinated. The owner of a 401(k) must have a beneficiary designation and possibly a contingent beneficiary; the same is also true for an IRA. The titles for all the assets must be coordinated. A more basic problem is making sure that trusts are funded and that assets are correctly transferred. Handler points out that setting up a life insurance trust to pay estate taxes does no good if the trust itself isn't funded. "The number of trusts I've encountered with no assets is huge," he says. If a trust isn't funded, assets go through probate, resulting in more trips to court, and higher costs.

The underlying problem isn't a lack of resources but a lack of attention, Handler says. "Some law firms say this is how to fund the trust but leave it up to the client to follow through. In practice, they don't." Handler says. Legal and financial advisors need to make sure their clients follow through with all appropriate paperwork. "Clients must be somewhat engaged to make the plan work," he adds.

3. Not creating a minor's portion of an estate plan.

The portion of an estate plan pertaining to minors can include child emergency-medical authorizations, childcare authorizations, and a childcare guide. "We believe less than 5% of law firms around the country include this work," Handler says.

But thinking about it when you actually need it can be too late. Handler tells of clients whose baby was in the care of a sophisticated live-in nanny while the parents were skiing in Vail. The older children closed the door on the baby's finger, severing it. The nanny iced the finger, and rushed with the baby to the emergency room, where doctors refused to reattach the finger without authorization. The child's uncle, a donor to the hospital, arrived and insisted the hospital operate, but the ER team still refused to proceed.

Handler became involved and eventually was able to reach the parents, who faxed in approvals. Only then did the hospital proceed. The finger was successfully reattached.

"The family got lucky," Handler says. But the larger lesson is the need to create a minor's portion of an estate plan: "This inexpensive little document, 'Emergency Medical Authorization for Minors,' should be a consideration in every plan," Handler says.

4. Believing life insurance isn't taxable in an estate.

It is. Life insurance might not be subject to income tax in many cases, but it is subject to estate tax. As a result of this misconception, taxpayers fail to include it when adding up assets for estate-planning purposes. Handler's recommendation is to remove the policy from the estate, typically via an irrevocable trust.

5. Underestimating the value of the estate.

Not including life insurance is just one error of many along these lines. "Almost everybody underestimates the value of their estate," Handler says. Take the contents of a house for example. Handler has had clients with multimillion-dollar houses who say the contents are worth very little. However, insurance companies, as a standard matter, generally value the contents at about half the value of the home itself. Depending on the owner, the contents may have significantly greater value. "People often don't factor this in, but the IRS does," says Handler.

Similarly, entrepreneurs tend to undervalue their businesses for estate-planning purposes. Owners may consider themselves to be a "key" man or woman, with the business having little value without them. However, cash flow or other valuation metrics may show otherwise.

Add in that people often forget to consider the value of their IRAs and life insurance for estate-planning purposes, and they could very well be facing a situation where they have a problem with the tax man. But, says Handler, "this problem can be solved by a trust or other sophisticated provisions."

6. Not integrating income tax and estate planning.

Income tax planning and estate tax planning are largely separate disciplines, with different specialists in each. Nonetheless, for truly comprehensive tax planning, they must be integrated. Income taxes can eat up assets. The good news is, "There are tremendous opportunities to save income taxes if estate planning is done well," Handler says. "Creating trusts and family partnerships can have tremendous income tax benefits."

"Not integrating income tax planning and estate planning is a very big deal," Handler says. He offers an example from the trenches: a billionaire family, under the advice of a team of trusts and estate lawyers from a major law firm, placed their assets into 30 separate trusts. "These were all good trusts, but the law firm didn't consider risk management, or asset protection, or income taxes," Handler says.

Handler explained to the family that their lawyers had leapfrogged these basic and critical elements. "The law firm skipped the foundations and just loaded up on trusts," he says. The siloed approach of the law firm cost the family dearly. They were spending an extra $10 million a year on income tax because the estate tax lawyers didn't have expertise in this area and failed to consult their tax partners.

More distressingly, because the trust lawyers didn't consider asset protection or risk management, the family had an excessively concentrated position in a failing public company. The family lost approximately $300 million as a result. Handler

was able to put in a costless collar, a hedging technique, which protected their assets going forward. Nonetheless, "the damage was done," Handler says. The billionaire family was able to weather the damage, but this case study shows how an integrated approach to estate and tax planning is called for.

One technique is to focus on asset location as much as asset allocation when it comes to investing. Asset location refers to the type of structure in which an asset is invested, such as a 401(k), a Roth IRA, a trust, etc. Optimizing taxes during the distribution period following retirement is a related idea. Though the specific sequence of withdrawals depends on each client's specific situation, of course, Handler has some general recommendations: "Withdraw highly taxed assets first," he says. "You don't want retirement assets double taxed in your estate, first by income taxes and then by estate taxes."

7. Not planning for your own medical emergency.

Estate planning is intrinsically hard, as it forces clients' to contemplate their own demise. Perhaps just as hard is planning for a medical emergency that results in cognitive impairment, and the need for someone else to make decisions. "People don't think about what would happen if they were in a coma," Handler says. Handler advocates getting, in advance, legal documents that designate surrogate decision makers who will be given the power to make health decisions (via a health proxy), as well as granted power of attorney in an emergency. The documents should also include a living will.

Planning for a medical emergency is not an abstraction for Handler. "I was in a coma as a result of a car accident. Four days of my life disappeared," he says. Handler, of course, survived. But the incident prompted him to plan ahead for unforeseen events such as his.

His own brush with death, coupled with the common mistakes he encounters on a regular basis, make him keenly aware that most mistakes can be avoided. "There are many, many tools you can use to solve these problems," he says. ■

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