Common Estate Planning Mistakes People Make & How You Can Avoid Them

15 Mistakes That Can Cost Your Family a Lot!

Common Estate Planning Mistakes People Make & How You Can Avoid Them

15 Mistakes That Can Cost Your Family a Lot!

Harvey L. Cox, J.D.

2020 Edition

Common Estate Planning Mistakes People Make and How You Can Avoid Them

Disclaimer

The author gives no warranties and makes no guarantees to any purchaser or end-user of this book. The book is for informational and educational purposes only. This book must not be considered legal advice. It is not a substitute for advice from an attorney. The sole intention of this book is to provide information about estate planning laws in Texas.

Reading this publication or reviewing Mr. Cox's website or other information does not establish an attorney-client relationship between the reader and Harvey L. Cox.

The author shall not be liable for any errors or omissions in the content or reliance on the content, nor shall the author be liable for any damages or costs from the use of or reliance on the information contained in this book.

About the Author

Harvey L. Cox is a licensed attorney and certified mediator in the State of Texas. He has been practicing law since 1990. He limits his practice to estate planning and asset protection planning.

Harvey also teaches Business Law at McLennan Community College. He lives in Waco, Texas, with his wife, Rebecca. They have three sons.

You can contact Harvey through his website at http://harveylcox.com or by calling 254-233-7300.

Table of Contents

Mistake #1

Not Preparing an Estate Plan

If you don't have an estate plan, Texas law has one for you. The state's plan determines who gets your property based on their relationship to you and the type of property you own.

<u>Example:</u> Bill and Julia have been married for twenty years. Together they have a son and a daughter. Bill also has two children from a prior relationship. Bill and Julia have approximately one million dollars in community assets. They each want their community property to go to the other upon the death of the first. They believe Texas law automatically gives the community property share of each of them to the other at death without them having to do anything. Because of this belief, Bill and Julia never get around to creating an estate plan.

Bill dies without even a simple will. What happens to Bill's half of the community property he owns with Julia? Does it automatically go to Julia as he expected it would under Texas law? It doesn't. Bill's half of the community property he owns with Julia goes to all four of his children in equal shares.

Each of his children gets one-fourth of his one-half of the community property ($125,000 for each child). Julia keeps her one-half of the community estate ($500,000) but gets none of Bill's community half ($500,000).

Bill and Julia's failure to create an estate plan results in a division of their assets in a way they didn't want. They could have easily changed this result by having an estate plan that includes, at a minimum, a simple will or, for better protection, a Family Trust.

Mistake #2

Not Understanding How Your Assets Pass at Your Death

Contrary to popular opinion, your will doesn't necessarily control how your assets pass at your death. You may hold most of your wealth in assets that pass outside of your will. For example, if you have a retirement plan, life insurance or IRAs, those assets aren't usually subject to probate. Your will does not affect how those assets are distributed at your death because they aren't subject to the probate process. If you have a retirement plan, IRA, or life insurance, they pass to the beneficiaries you name on a beneficiary designation form with the issuer of those particular assets.

<u>Example:</u> Ben is single. He names his brother Larry as the sole beneficiary in his will. He also names Larry as the beneficiary of his retirement plan and his life insurance. A few years later, Ben marries Glenda. After marrying Glenda, Ben changes his will to leave everything to her. However, Ben doesn't change the beneficiary designations on his retirement account and his life insurance. Tragically, Ben dies in an auto accident a year after marrying Glenda. Ben's retirement

account and life insurance make up the bulk of his estate. Those accounts pass to his brother Larry, not his widow, because Ben failed to change the beneficiary designations after his marriage.

Example: Phil and Donna have been married for six years. They have two children, a son, Darren, who is five years old and a daughter, Sabrina, who is three years old. Phil and Donna buy $500,000 of life insurance for themselves. Phil names Donna as his primary beneficiary and his children, Darren and Sabrina, as secondary beneficiaries. Donna names Phil as her primary beneficiary and her children, Darren and Sabrina, as secondary beneficiaries.

Two years later, Phil and Donna have another daughter, Samantha. Three years after Samantha's birth, Phil and Donna died in a car accident. Because they named only their first two children as their secondary beneficiaries, those two children, Darren and Sabrina, are the only two children to receive a payout from the life insurance policies. Their younger child, Samantha, is effectively disinherited for no reason other than a simple oversight by her parents.

The problem illustrated with the estates of Ben, Phil, and Donna is entirely avoidable by reviewing beneficiary designations on life insurance policies and retirement plans. A study by the Life Insurance and Market Research Association

(LIMRA) found that more than 30% of all life insurance policies, annuities, and retirement plans are not updated to correct beneficiary designations after major life events such as the birth of additional children, death, divorce, or remarriage. I recommend, therefore, that you review beneficiary designations when significant life changes occur, such as marriages, divorces, the birth of children and grandchildren, to make sure your beneficiary designations continue to fit your family situation and your estate planning goals.

The example of Phil and Donna's estate also highlights the problem with naming children as beneficiaries. Mistake #14 discusses the issue of children beneficiaries.

Mistake #3

Planning Your Estate Around Specific Assets

I discourage clients from planning their estates around specific assets. In rare instances, there may be a compelling reason to do it, but in most cases, it can result in unintended consequences.

Example: John is a widower with three grown children. He wants to treat his children equally. In his will, John divides his assets equally to his children. Several years before he died, John made some changes that dramatically affected his estate. First, he transferred one-half of his home to his older son. Next, John added his daughter as the beneficiary of his savings account. Finally, he named his youngest son as the sole beneficiary on his life insurance policy. These changes in his home, savings account, and life insurance were substantially equal in value, so John thought he solved the problem of making sure his children were treated equally at his death.

Before John died, however, he sold his home and put the proceeds of the sale in the savings account. He also let his life insurance lapse. At John's death, the savings account passed to his daughter, who is the beneficiary of the account. But, there was no life insurance for the youngest son to collect and no home for the oldest to inherit. By trying to equalize the value to his children and planning around specific assets, John effectively disinherited two of his children. The problem with John's estate is easily avoidable with a Living Trust.

Mistake #4

Relying on Co-Ownership of Property to Avoid Probate

In Texas, co-owners of property can have a right of survivorship to the property they co-own. Co-ownership with the right of survivorship means that when one co-owner dies, the surviving co-owner becomes the sole owner of the property without the necessity of opening a probate estate. But, using this method of estate planning can cause unexpected tax and legal problems.

<u>Example:</u> You decide to make your son a co-owner of your property so that it will pass to him at your death without him having to hire a lawyer and file to probate your will. While the property will pass to your son outside of probate, you have created a few tax and legal issues that you didn't intend to happen.

First, you have created a tax issue by causing a reduction in your Federal Estate Tax Exemption because you are giving a lifetime gift (assuming half the property is valued at greater than $15,000 in the calendar year of the gift as of 2020).

Second, you have created a capital gains tax problem for your son. When you give half the property to your son during your lifetime, he takes your original basis in half of the property. When your son sells the property, he will owe significant capital gains tax on the half you gave him. If, however, you wait and give the property to your son at your death, he will get a full step-up in basis to the fair market value of the property on the date of your death. The full step-up in basis means your son will owe no capital gains tax if he sells the property shortly after your death.

Third, you have created a legal issue that could put your property at risk. By making your son a co-owner of your property, you are opening the door to any potential claims by your son's creditors. Your son's one-half interest in the property may be subject to claims to satisfy his debts.

There are numerous legal and tax implications when preparing an estate plan. It is easy to miss the particular nuances that could cost your family a lot of money if your estate plan isn't set up by someone skilled in the art of estate planning.

Mistake #5

Adding Your Children to the Deed of Your Home

This mistake is closely related to the previous one.

When you put your children on the deed to your home or any other asset, you become a co-owner of the property with them. The legal effect of co-ownership can bring unintended results.

The first unexpected result is creating an IRS tax liability issue for yourself. Putting your home in joint tenancy with your children is a taxable gift under IRS regulations. You will have to file a gift tax return for the year in which you added your children's names to your deed if the value of the interest transferred to each child is more than $15,000 (2020).

The second unintended result is that you may be inadvertently transferring the house to your child's ex-spouse or your child's creditors. If your child has a judgment against him, that judgment creditor may be able to file a lien against your child's interest in your property. If your child is going through a divorce, the ex-spouse may have a claim against your child's ownership interest in your home.

The third unintended consequence will occur when you sell your home. When selling a home, you are allowed to exclude capital gains on the sale. The exclusion is $250,000 for individuals and up to $500,000 for married couples. But, since you now only own a fractional share of your home, you will only be able to use that capital gains exclusion on the portion that you own. Each child named on your deed may then have a significant long-term capital gains tax problem that you can avoid by keeping the house in your name, transferring it to a Revocable Living Trust.

Mistake #6

Adding Your Children to Your Bank Accounts

Adding your children to your bank accounts makes them co-owners of those accounts. If your children have creditors who have obtained a judgment against them, your accounts are now subject to a bank garnishment to collect the judgment. In other words, adding your children to your bank accounts makes your accounts subject to the claims of your children's creditors. Likewise, if your children owe the IRS, your accounts could be subject to an IRS lien or levy. Nationwide, parents have lost millions of dollars by making this catastrophic mistake.

If you need your children to help you manage your bank accounts, you should appoint them as your agent using a Durable Power of Attorney. The Durable Power of Attorney will give them the authority to manage your financial affairs without exposing your assets to their creditors. Another option is to transfer your assets to a Revocable Living Trust. You then list your children as your successor co-trustees, thereby giving them the ability to manage your assets without exposing those assets to their creditors.

Don't expose your bank accounts to the financial problems of your children. Before you even think about adding your children to your bank accounts, get legal counsel from an attorney with expertise in estate planning.

Mistake #7

Not Understanding the Tax Consequences of a Gift

Example: Janet is diagnosed with terminal cancer. She has three grown children. Janet heard that her children would likely spend thousands of dollars to probate her estate after her death. Since her only real asset is her family home, she is concerned that they will spend too much on probate to get the house in their names. Janet also heard that she can help her children avoid probate by deeding the home to them while she is still alive. Janet hires a lawyer to prepare a deed transferring her home to her children while she is still alive.

Janet is fortunate that none of her children were going through a divorce, dealing with tax liens, or dealing with lawsuits for unpaid debts before her death. If any of them had been dealing with those issues, Janet's home would have been subject to claims for those tax liens, lawsuits, or ex-spouses of the children.

But, after Janet had died, her children discovered why it is crucial to consider the tax consequences of a gift. When Janet's children sold her home after her death, they found that their basis (the cost for determining taxable gain) was Janet's cost of the house when she purchased it 30 years ago. That original price was $20,000. Janet's children were able to sell the home for $180,000. Since their basis in the house was only $20,000, the children had a taxable gain of $160,000. Using the top capital gains tax rate of 20%, the children owe $32,000 in capital gains tax.

If Janet had kept the property in her name or transferred it into a Living Trust, her children would have inherited the property with a step-up in the basis. The step-up in the basis means the children's basis for tax purposes would have been the fair market value of the property at the time of Janet's death. Assuming the fair market value is the $180,000 for which they sold the home after Janet's death, there would have been no capital gains tax due on the sale. Janet's gift to her children in an attempt to avoid the cost of probate costs her children $32,000. That is much more than probate would have cost her family.

Mistake #8

Using Beneficiary Designations as Your Only Plan

An effortless and straightforward way to plan for the passing of your estate is to use beneficiary designations. The problem is that beneficiary designations don't handle contingencies very well.

Example: You have a son and a daughter. You name them both as beneficiaries of your life insurance policy. Your daughter predeceases you. What happens to the proceeds of your life insurance upon your death? Do you think the insurance company will pay all of the policy to your son? Or, will the insurance company understand that you want your predeceased daughter's share to go to her children?

Most people think the insurance company will pay your predeceased daughter's share to her children. But that isn't what happens. The insurance company pays the entire amount of the policy to your surviving son. If you read the fine print on your beneficiary forms, most of them tell you that the insurance company will only pay surviving beneficiaries. The standard clause with such a notice says something like, “We will pay to the surviving named beneficiaries unless otherwise indicated in this document.”

You can avoid this problem by setting up a trust and naming the trust as the beneficiary of your life insurance. The trustee you name to manage the trust can control precisely how the proceeds of your life insurance are distributed, including any contingencies like the one in the example.

Mistake #9

Failing to Prepare an Estate Plan During a Divorce

When you divorce in Texas, your ex-spouse is automatically disinherited from your will. Texas law views your ex-spouse as predeceasing you for purposes of probating your will. But, what happens if you die while your divorce is pending? Before the judge signs that final divorce decree, your soon-to-be-ex-spouse is still your spouse and will still inherit under the terms of your will. While your divorce is pending before the court, therefore, you need to change your will. I advise clients to change their estate plans as soon as one spouse files the divorce.

Another critical thing to keep in mind during a divorce is that a divorce decree does not affect beneficiary designations for life insurance, bank accounts, or retirement plans. If your ex-spouse is a named beneficiary on your life insurance, that ex-spouse will still be your beneficiary after the divorce is final. You must change your beneficiary designations to keep this from happening. A divorce decree doesn't automatically change beneficiary designations. Changing beneficiary designations is your responsibility.

Mistake #10

Failing to Consider the Income Tax Consequences of Distributing Your Assets

Example: Mary's estate consists of two significant assets, a life insurance policy and a traditional IRA. Both assets are equal in value. In an attempt to simplify and equally distribute her assets, Mary names her son as the beneficiary of her life insurance and her daughter as the beneficiary of her IRA.

What is the problem with Mary's plan?

The problem is how the plan ultimately distributes the assets to Mary's children. The proceeds of life insurance are income tax-free. Mary's son gets the full value of her life insurance.

The proceeds of Mary's IRA, however, are subject to income tax. Mary's daughter will lose about one-third of the value of the IRA to income taxes.

Mary's attempt to divide her primary assets equally to her two children doesn't work.

This example illustrates why I discourage clients from leaving specific assets to specific persons. A better option is to name all children as beneficiaries with equal interest. The best solution, however, is to transfer all assets to a Living Trust. The trust then divides assets equally to the children and specifies what to do with assets should a child predecease you.

Mistake #11

Failing to Recognize That Wills Can be Easily Changed

Example: John and Diane have been married for over 30 years. They have no children together, but each of them has two children from prior marriages. In their wills, they provide for each other first and then leave the assets equally to all four children. What they don't consider when drafting their wills is that the survivor of the two of them can always change the will to leave everything to only that survivor's children.

In this situation, a trust can help protect children from a prior marriage. One option is for John and Diane to establish separate trusts. They can, of course, do a mutual trust being careful to list their separate assets on a separate property schedule. John and Diane can also include special provisions for sub-trust funding on the death of the first spouse.

Second marriage estate planning can be complicated, but it is doable.

Mistake #12

Poor Drafting

Most of the poor writing I see occurs when people attempt to write their wills using forms found on the internet, including LegalZoom and Rocket Lawyer. You should stay away from forms. Proper estate planning isn't as simple as a few fill-in-the-blank forms. You must know the legal effect of the wording that goes into your estate plan. You need a lawyer to make sure the wording in your estate plan correctly accomplishes what you want to achieve.

Let me illustrate some of the wrong wording I have seen in many "do-it-yourself" wills.

<u>Example:</u> Pete has three children, two sons, and a daughter. He prepares a will from a form he found on the internet. In his will, Pete left his estate to "my surviving children." That sounds good. But, is that what Pete meant to say?

If Pete's daughter predeceases him, does he want his estate divided only between his surviving two sons? That is the result he gets with the wording of his will. Do you think maybe he would rather have the share his daughter would have received had she survived him pass to her children, i.e., his grandchildren? In my experience, most people want the share of a predeceased child to pass to grandchildren. It is likely Pete wants his grandchildren to get their mother's share. Pete's will, however, doesn't accomplish that goal.

Example: Sara has two children, a son and a daughter. She finds a will form on the internet and uses it to write her will. At the time she writes the will, Sara has no grandchildren. Using the internet form, Sara leaves her estate equally "to her descendants." When Sara dies, her son has four children and her daughter has no children. The question at the probate of Sara's will is, "who are her descendants?"

The general rule in Texas is that if you can't go down the family tree, you go out on its branches. Applying this general rule, Sara's descendants include her son, her daughter, and her four grandchildren. Each of them will get one-sixth of Sara's estate. Do you think this is what Sara intended? It is possible. But, more probably, she would have wanted her estate divided equally between her son and her daughter. A properly drafted will or Family Living Trust avoids this type of confusion.

Mistake #13

Thinking That All Estate Plans are the Same

I have seen a lot of poorly drafted estate plans. Inexperienced attorneys wrote some of those plans. Financial planners and CPAs even wrote some of them. With the proliferation of wrong information on the internet, I have seen more than a few poorly written do-it-yourself estate plans from forms found on the web. It isn't a good idea to find forms on the internet and then complete them by just typing your name in blank spaces. And, just because you pay for a form on the web doesn't mean you're getting something that fits your needs.

I recently reviewed a Revocable Living Trust created from a form purchased online. One of the most significant advantages of a Revocable Living Trust is that it allows your beneficiaries to avoid probate. But, the language in this particular Living Trust is so bad that it wouldn't even do that for the person who asked me to review it. The problem with the trust is that it contains the wording, "Upon my death, my trust shall be paid to my estate." That wording requires the beneficiaries to file for probate at the passing of the grantor because it moves assets out of the trust and into the probate estate at death, the exact opposite of what it should do.

My point is that you can't use a "one size fits all" form to create an effective estate plan. Assuming that all forms and all plans are the same is a costly error. If you have doubts about your current estate plan, have an experienced attorney review it.

Mistake #14

Leaving Property to a Minor Child or Grandchild

Let's suppose you name your twelve-year-old granddaughter as the beneficiary of your $500,000 life insurance policy. Do you think the insurance company is going to pay that $500,000 to her? They won't do it. They will only pay a court-appointed guardian for the child. Your heirs will have to hire an attorney and ask a court to appoint a guardian to receive the money. The process will cost your heirs a significant amount of time and money. Additionally, the guardian appointed to receive the funds for your granddaughter may not be the person you would want to receive and manage the money for her.

The problem of leaving property to a minor isn't limited to life insurance beneficiary designations. Let's suppose you have a will in which you state your property is to be equally divided between your son and your daughter. Your son has two children. He predeceases you. In your will, you provide for that contingency by stating that the share any child who predeceases you would have received is to go to that child's children, i.e., your grandchildren.

If your grandchildren are minors, the court will need to appoint a guardian to receive the money. The court will give preference to the children's surviving mother, who may be your ex-daughter-in-law. Would your ex-daughter-in-law be your choice to manage the funds for your grandchildren?

In the guardianships created in these situations, the money is held for the minor children until they reach the age of 18 years, at which time they receive the full amount. That is probably the worst age at which to give a significant inheritance to a child or grandchild. A better alternative is to have the estate turned over to a trust in which you name the trustee who manages the inheritance for the child or grandchild. The trust can provide for distributions to your beneficiaries for a college education and to help them get a good start in life. Full disbursement of the inheritance doesn't happen until your beneficiaries reach the age you designate in the trust.

I advise my clients to choose a trustee who isn't related to them or subordinate to them or their children. An independent trustee won't be unduly influenced by other family members to make unwise distributions from the trust, and a court can't force the trustee to make a distribution. As long as the inheritance is held in trust by an independent trustee in charge, the estate is protected from:

- Your child's bad spending habits
- Your child's future divorcing spouse
- Your child's creditors or lawsuits filed against them

With proper investment management, your child's inheritance can grow in the trust and provide long-term financial support.

Mistake #15

Failing to Fund a Living Trust

Don and Virginia heard that a Revocable Living Trust is an excellent tool for setting up their estate in a way that avoids the hassle of probate for their children. They hired an attorney to create a Revocable Living Trust for them. The attorney deeded their home to the trust and gave them instructions for transferring the remainder of their assets to the trust. Don and Virginia never got around to following those instructions, so their property never made it to the trust. Years later, they sold their home and purchased another one. The new house was deeded to them personally, not to their Living Trust. A few years later, Don and Virginia died within weeks of one another.

Rather than avoiding probate as they thought they were doing, Don and Virginia's entire estate is subject to probate. They defeated their primary estate planning goal of avoiding probate by failing to title their assets in the name of the trust.

The moral of this story is that creating a Living Trust does not affect your estate if you don't fund it with your assets.

For More Information

It is my goal to protect Senior Citizens throughout Texas from making the mistakes I discuss in this book by helping them avoid the expense, delay, and hassle of Probate and prevent the loss of their homes from Nursing Home claims.

As part of my Pro Bono Community Outreach Program, I would like to offer you a free, no-cost, no-obligation review of your will, trust, or other estate plan documents as well as a review of beneficiary designations on all of your life insurance policies, annuities, and retirement plans.

If you would like to receive my pro bono services, you may contact me or my Senior Legal Assistant, Gary Hill, at (254) 233-7300. We will review your current estate plan and make sure you have a plan that protects your assets for your future and the future of your family.