Retirement Weekly article reprint
January 2017

How to Avoid Common Estate Planning Missteps

By Jeff Coplan

Have you planned to leave money to heirs or charities that are important to you? Are you planning to leave your distributions on a percentage basis? Will you designate specific dollar figures?

As our clients get to the stage of life where they are ready to engage in serious financial planning and to look ahead to their future, they commonly take the first step: update or write an estate plan. Their attorney prepares a will or a revocable living trust or other trust vehicle to document their wishes for estate distribution, and when appropriate, to streamline or avoid the probate and distribution process.

Common designations for distribution include a share to adult children, a share to grandchildren, and a share to a charitable organization, whether that be the individual's church or favorite charities.

Most often, distributions are made on a percentage basis. Sometimes clients plan to give a specific dollar figure to one or more of the beneficiaries.

No ''money pot'

A common assumption is that, upon the death of a client, there will be a large pot of money to be divided among the various beneficiary designees. Unfortunately, in practice, this is rarely the case.

Consider a scenario where a client, whose husband is no longer living, wants to:

- give 35% of her assets to each of her two adult children
- give 10% to each of her two grandchildren
- allocate the remaining 10% to a charity she supported through her lifetime.

Outside of these percentage designations, she would like to give $10,000 to a niece with whom she always had a special relationship.

Her assets may be a non-qualified investment account, a Traditional IRA, a Roth IRA, a permanent life insurance policy, and a variable annuity with tax deferred gains.

Tax structure affects distributions

When an estate plan is written, the attorney will often instruct the client to update beneficiary designations for each of the account assets. Unfortunately, if the attorney doesn't delve into the specific assets or doesn't consider the tax structure of assets (and how it should be incorporated into a properly drafted estate plan), the default will be the percentage distribution method.

What is wrong with that? You can lose significant dollars to taxes, strictly because of the lack of attention to the beneficiary designation structure.

What strategy works best?

To continue with the above scenario, assume the total assets of the client are approximately $1 million at death. This includes a $90,000 life insurance death benefit, $210,000 in Roth IRAs, $100,000 in a tax deferred annuity, $200,000 in a Traditional IRA, and a $400,000 non-qualified investment account.

In order to most efficiently pass her assets to her desired heirs, she can match the value of the assets to her desired beneficiaries.

- The $100,000 annuity is one of the most difficult to navigate. Often, a variable annuity is left to grow in value over time, with all of the earnings growing on a tax deferred basis. At death, this means the gains are typically taxed to the beneficiaries, with little control over how or when they pay that tax. This makes this asset a logical asset to give to the church, since the church is a non-profit entity and not subject to taxes when received as a distribution at death.

- The $200,000 traditional IRA is the next "least tax-efficient asset" as we prioritize them. Named beneficiaries of a Traditional IRA have a required minimum distribution they must fulfill, which is based on their life expectancy. Of all of the beneficiaries being considered, the grandchildren will have the longest life expectancy. Additionally, grandchildren are most likely to be in a low income tax status, especially in their younger years. This means they could likely withdraw some, if not all, of the IRA at a very low tax rate when compared to their parents. The Traditional IRA would logically be left to the grandchildren.

- The non-qualified investment account is next most tax-efficient. As long as the estate is under the current exemption of $5.49 million for 2017, there is no tax due at death. (The only exception to this may be state level estate taxes, which can be taxed to estates as low as $675,000 in some states). This means the $400,000 of assets in the brokerage account would be passed tax free. The client can add a Transfer on Death (ToD) designation to the account, which bypasses the estate probate process, and there is no tax due. The adult children are likely the highest income earners, so the non-qualified account would be left to the adult children.

- The most tax efficient asset of all of them in this example is the Roth IRA and the life insurance. There is no tax due on death for any of the beneficiaries, and the only requirement for a Roth IRA withdrawal to a beneficiary is a required minimum distribution based on their life expectancy. Because of this tax free beneficiary treatment, the Roth IRAs and life insurance will likely be best left to the adult children.

The special $10,000 designation to the niece? That would be most easily handled by setting aside $10,000 of the Roth IRA into a separate account. She would then name the niece as 100% beneficiary of that account only. A client can make transfers between Roth IRAs easily, with no negative consequences. Each year, as the client reviews her holdings, should the account value drop below $10,000, additional funds could be transferred from the other Roth IRA account. Should the account value grow to more than $10,000, the excess could easily be transferred back to the Roth IRA account intended for her adult kids.

What will you save?

Consider how the above assets would be taxed were the client to name the original 35/35/10/10/10 designation to each of the accounts.

The adult kids would be paying tax on the gain portion of the annuity at up to 39.6%, depending on their income and tax rate. Additionally the kids would have required distributions based on a much shorter life expectancy than their kids on the Traditional IRAs, causing them to be taxed sooner and at a higher rate. Last, the tax free nature of the Roth IRAs and life insurance will have gone to "waste" if given to the charity, as that charity wouldn't have paid tax anyway.

In addition to the tax savings in the examples above, note that each of these distributions were able to be executed via a named beneficiary designation. This means the estate planning document would be completely unnecessary, because there is no estate left to distribute. (Beneficiary designations are executed first, and only assets without a named beneficiary are subject to the estate distribution or probate process).

Best practices for you

First, evaluate your estate plan. Is it current? Are your wishes still as they were when the plan was written?

If not, have your estate plan updated. This may mean a simple amendment to the existing document, or if there are enough changes, an attorney may recommend replacing the existing plan.

Next, have your financial advisor, tax advisor, or estate planning attorney explain how each of your assets would be taxed should you pass them through either their beneficiary designations or current estate plan.

After you are clear on how your assets will be taxed to your beneficiaries, consider ways you can realign the beneficiary designations to match your wishes in your estate plan. If you want an expedited distribution to your heirs, do all you can to bypass your estate plan, which would be used strictly as a backup plan to any missing beneficiary designations.

About the author: Jeff Coplan is a CERTIFIED FINANCIAL PLANNER™ professional and financial advisor at Integrity Wealth, which he founded in 2006. Jeff is an Accredited Asset Management SpecialistSM and is Series 7, 9, 10, and 63 licensed. Integrity Wealth, 14850 Scenic Heights Road, Suite 110, Eden Prairie, MN 55344, 952-937-5003