Danger of Outdated Estate Plan: 10 common pitfalls

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Your estate plan should regularly be reviewed to ensure it continues to meet your needs.

Do you remember when you last reviewed your estate plan? If the answer is when you first signed the stack of documents at your attorney's office, then you're not alone. Many of us complete an estate plan and then fail to revisit it for years (and some never do).

It is important, however, to review a plan every so often due to ever-changing tax laws and major life events, such as a birth, marriage, divorce, or death. At a minimum, an estate plan should be dusted off and revisited at least every three years, to help ensure alignment with current laws.

Below is a list of 10 common pitfalls of an outdated estate plan. If any of these apply to you, it may be prudent to meet with your estate planning team to review and, perhaps, update your plan.

Fiduciary follies: When the wrong executor or trustee is named

Do you know who your fiduciaries are? A fiduciary is someone who is appointed to take legal control over assets for the benefit of another person (the beneficiary). It is a fiduciary's legal responsibility to act in the beneficiary's best interest. Two types of fiduciaries often seen in estate plans are executors and trustees.

Executors are typically appointed in a will and are given control of assets during the probate process, until they are ultimately distributed to the named beneficiaries. Executors are responsible for collecting all the assets of the deceased, paying final debts, paying expenses, and filing any estate-tax returns.

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Trustees control the assets held within trusts, which may have been set up during a person's life, or at death under the terms of a will. While an executor's role is typically for a finite period, a trustee's role may continue either in perpetuity or until the trust is depleted or terminated.

A key role of the trustee is to make distributions to a beneficiary while following the terms of the trust agreement. Executors and trustees bear responsibility for investments, accounting's, and tax filings during their tenure.

Outdated estate plans often name fiduciaries or successor fiduciaries that may no longer be suited for the position. A fiduciary named years earlier may be too elderly, or even deceased. If a professional (e.g., attorney, CPA) is named, it is possible that he or she may no longer be practicing, or his or her professional relationship with the beneficiary may have since ended.

Even named corporations, which we generally assume to exist in perpetuity, may have merged with or been acquired by another entity. And children who may have been too young to serve when the documents were created could now be capable of taking on the role of fiduciary.

Although fiduciaries are bound by certain standards of law, it is most important to name individuals you trust. Other important considerations are the age, maturity, and level of financial knowledge of the fiduciary. It is quite possible that the individuals who had fit most of these qualifications may have changed over the years so that they no longer do.

Check to see who you have named as fiduciaries in your estate planning documents to determine whether you need to revisit these designations.

Your "little ones" aren't so little anymore

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When a child is young, a key estate planning decision parents often make is to determine a guardian. If your child is now an adult, however, a guardian may no longer be relevant, but new considerations arise: Is your child married? Is your child financially responsible? Are you leaving assets to your children in a trust? Have your children had children of their own?

Many trusts are designed to distribute assets to children at certain ages, e.g., one-third at age 25, one-half of the remaining assets at age 30, and the remaining balance at age 35. In this example, if a child is now age 27, he or she will have received one-third of the inherited amount outright and free of trust. This can present a host of problems for some families.

For example, if the amount is large enough, a child may lose the incentive to work. Further, if the child is married, an inheritance can easily be commingled with the spouse's assets, subjecting the distributed trust assets to equitable distribution upon a divorce. An inheritance free of trust will also be subject to any existing or future creditor claims.

Additionally, large sums might not be spent in the most prudent manner if they are free of restrictions. And, finally, any assets that ultimately pass outright to children will become part of that child's taxable estate. If the inheritance is large enough, this may result in estate taxes when the child dies that could have been avoided with better planning.

Furthermore, in many cases, outdated estate plans are simply not consistent with current wishes or circumstances. For example, it is possible that one child within a family has been financially successful while another has not. When an estate plan is initially created, an equal amount of inheritance among children may have been the goal, but that may have changed over time.

Also, in some cases, beneficiaries named on retirement accounts and life insurance policies may not be in line with the trusts created for children under a will or revocable trust. It is vital to revisit all the ways assets are being left to children, given their current age and maturity, to make sure the plan still matches the current intent.

Lastly, when children are minors, they do not typically need health care powers of attorney, living wills, or advance health care directives, since their parents or guardians are legally responsible for them. But once they become adults, they should consider having these important documents in their own right. Parents (or others) can then be named as agents, to be able to see their children's medical information and make health care decisions for them, should the need arise.

Periodically review the ways that assets will be left to your children, and encourage them to have the appropriate estate planning documents in place as they get older and their circumstances change.

Privacy please: HIPAA rights and when they should be waived

The Health Insurance Portability and Accountability Act (HIPAA) was passed in 1996, in part to establish national standards for protecting the confidentiality of every individual's medical records and other personal health information. As a general rule, health care powers of attorney, living wills, and advance health care directives should contain provisions waiving an individual's HIPAA rights with respect to his or her health care representatives.

These stipulations allow physicians and other health care professionals to share a patient's medical information with his or her representatives, empowering them to make informed health care decisions. Without these HIPAA authorizations in health care documents, doctors may be unwilling to share medical information, which may impede decision making regarding a patient's care and any end-of-life wishes. As mentioned previously, these concerns would also apply to adult children who may have just graduated from high school or are attending college.

Take stock of your family's health care powers of attorney, living wills, and advanced health care directives, to ensure that health care representatives can make informed decisions regarding your family's care.

More money, more complexity: Wealth accumulation can create estate tax issues

Financial security is a goal for us all, but with wealth comes complexity. An increase in wealth not only typically causes an increase in annual income taxes, but it may also beget estate and gift taxes. Current federal law allows each citizen to transfer a certain amount of assets free of federal estate and gift taxes, named the "applicable exclusion amount."

In 2016, every citizen may, at death, transfer assets valued in the aggregate of $5.45 million ($10.9 million for married couples), free from federal estate tax. For gifts made during one's lifetime, the applicable exclusion amount is the same. Therefore, every person is allowed to transfer a total of $5.45 million during his or her life or at death, without any federal estate and gift tax. (This does not include the annual gift exclusion, which applies as long as each annual gift to each recipient is less than $14,000.)

Therefore, generally only estates worth more than these amounts at the time of death will be subject to federal estate taxes. But this wasn't always so. From 2001 to 2009, the applicable exclusion rose steadily, from $675,000 to $3.5 million. 2010 was a unique year, in that there was no estate tax, but it was brought back in 2011 and then made permanent (absent further legislation) by the American Tax Relief Act of 2012 at an exclusion amount of $5 million, indexed for inflation (now $5.45 million).

Outdated estate documents may include planning that was appropriate for estates at much lower exemption values. Many documents have formulas that force a trust to be funded up to this applicable exclusion amount, which may now be too large or unnecessary altogether, given an individual's or family's asset level.

Take the time to review the formulas in your estate documents with your attorney and tax professional to determine whether the planning you have in place is still appropriate.

Getting out of Dodge: Changes in state residency

Where were you living when you drafted your most recent estate plan? Each state has its own estate and income tax laws, and it is important to plan appropriately. Furthermore, some states are common law property states and others are community property states. There are significant differences between them when it comes to transferring assets, and a document drafted in a common law property state might not be appropriate in a community property state.

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Prior to 2001, many states imposed a state estate tax equal to the amount of the credit the Internal Revenue Code allowed an estate to take against federal estate tax, which was commonly known as the “pick-up tax.” Therefore, an estate paid the same total estate tax regardless of an individual’s residency; the difference was in how it was proportioned between federal and state estate taxes.

This changed with the 2001 tax legislation that phased out the state estate-tax credit. The result was that some states stood to lose substantial revenue because their state’s death tax was linked to the federal estate tax calculation. In response, a number of states enacted their own legislation to retain the state estate tax they would have otherwise lost. As a result, depending on state of residence, heirs could pay more in total estate taxes because of those imposed at the state level.

There are 15 states (and the District of Columbia) that currently have an estate tax and six states that have an inheritance tax, two of which have an estate tax as well (New Jersey and Maryland). Additionally, each state has different exemption amounts, so it is vital to evaluate your current wealth and estate planning needs with your attorney, in light of both the federal and your state’s exemption amounts in mind.

In addition, for many married couples in a state that imposes a state estate tax, this may have the effect of requiring payment of state estate tax after the first death, when none had been anticipated.

Prior to 2001, because the “pick-up tax” was imposed only on estates that had to pay federal estate tax, estates below a certain threshold did not have to worry about such a tax. The threshold was the amount of the federal applicable exclusion amount. That is no longer the case.

The practical effect of the difference between a state's exemption and the federal applicable exclusion amount is that certain estates will now be subject to a state estate tax, despite the fact that the estate is exempt from federal estate tax. In some situations, establishing a trust as part of an estate plan can help counter state estate tax implications.

Review your estate plan with your financial advisor, attorney and/or tax professional, with an eye toward reducing federal and state estate taxes and make sure to re-evaluate and potentially update your plan if you move out of state.

Potent portability: Unused portion of exclusion amount may now be transferred to second spouse

In 2011, Congress passed a law enabling "portability," a shift that has had a significant impact on estate planning. Portability rules allow a surviving spouse to take advantage of any unused portion of his or her spouse's applicable exclusion amount, provided that a federal estate tax return is filed to preserve the deceased spouse's unused applicable exclusion amount within nine months (15 months if an extension is granted).

Prior to portability, many estate plans included credit shelter trusts (CSTs). CSTs are sometimes referred to as bypass, family, or exemption trusts and are typically funded with assets having a value equal to the applicable exclusion amount ($5.45 million in 2016) of the first spouse to die. Assets placed in a CST can be excluded from the estate of the surviving spouse if the applicable exclusion amount of the first spouse to die is properly allocated to it.

Prior to 2011, couples were required to use a CST to preserve the exclusion of the first spouse to die. With portability, this is no longer required. Although there may still be other reasons to use a CST, you might consider reviewing your estate planning documents with your attorney to determine whether allowing more flexibility in the funding of a CST, or the use of portability, is appropriate in your current situation.

As an alternative, for many people, disclaimer trust provisions allowing for this flexibility may be more suitable, considering the allowance of portability. Disclaimer trusts differ from CSTs in that they are optional, and are activated only after the first spouse's death at the election of the surviving spouse, depending on his or her current situation.

There is flexibility in this type of planning because if there is no tax reason to use credit shelter planning, the spouse can simply receive all or a portion of the assets outright. This allows tax-planning flexibility without creating unnecessary complication. In addition, disclaimer trusts may be a good way to help reduce state estate taxes (if your state imposes one) and may help address uncertainty over the size of the marital estate, or concerns that the exclusion amount may decline in the future.

Although recent law allows the portability of the deceased spouse's applicable exclusion amount, there is no portability of the deceased spouse's generation-skipping tax exemption amount. A generation-skipping transfer (GST) is the transfer of property, directly or in trust, to an individual who is two or more generations below the transferor. The IRS taxes these transfers at a rate of 40%.

However, the IRS does give an exemption amount for the first $5.45 million (similar to the applicable exclusion amount). If you wish to use GST planning for your children so that your assets can benefit them during their lifetimes and then pass to your grandchildren without incurring estate tax at that time, you must preserve the GST exemption.

Given changes to portability, it makes sense to review your estate plan with your attorney and tax professional to ensure it is still structured in the most efficient way.

Don't stop giving: Fulfilling philanthropic goals

For many, with success comes a desire to give back to the community or to causes that they feel most passionate about. Individuals may contribute their time (volunteer work), talents (pro bono activities), or treasure (money or other assets). Many donate to religious organizations or to charities that support cancer research or that provide benefits to military veterans.

Generally, people donate to charity because they care about these organizations, but they may also be seeking charitable deductions for income tax purposes. The bottom line is that philanthropy is positive for society, for the charity, and for donors' families.

Many of us, however, forget to include our important charitable causes in our estate plans, so our intentions are often not carried on after our deaths. Just like when we give to charity during our lives, there are many of the same benefits available when charitable giving is included in our wills.

Everything from direct gifts to charities, to charitable trusts, to donor advised funds, or to family foundations should be discussed and considered with your estate planning team. There are various ways to help you achieve your charitable goals while ultimately potentially reducing your estate taxes and increasing the amount you pass on to heirs. Discuss your charitable intentions with your estate planning team to ensure that your philanthropic goals are included as part of your plan.

The lesser of two taxes: Income tax rates have increased relative to estate tax rates

Your prior estate planning may have emphasized federal estate tax savings because of the much lower applicable exclusion amount and traditionally higher federal estate tax rates. Changes in the federal tax law make it increasingly important to focus on the income tax consequences of estate planning in addition to the estate tax consequences.

For estates still subject to federal estate tax, the federal estate tax rate is 40%, much lower than in prior years, when the federal estate tax rate was as high as 55%. These rates must be compared to the top federal income tax rates of 39.6% on ordinary income and 20% on long-term capital gains and qualified dividends, plus a 3.8% Medicare net investment income tax.

Furthermore, trust income tax rates must be taken into consideration. Trusts are taxed at the highest federal income tax bracket at as low as $12,400 of income. Therefore, when transferring assets to a trust for estate planning purposes, consideration should be given to the potentially negative consequences of higher income taxes. Outdated estate plans may not provide the flexibility required to shift the income tax burden from the trust, to individuals in potentially lower tax brackets.

Revisit your estate planning documents and gifting strategies with your attorney and tax professional to determine whether they are still appropriate, considering the increased capital gains tax rate, reduced federal estate tax rate, and the increased applicable exclusion amount.

Make sure life insurance policies are not on life support

Does your existing life insurance policy still make sense, both from an estate planning and a financial planning perspective? Is the policy performing as expected? Is the policy still competitive with what is available in the marketplace today? Do you own your policy outright or should it be owned by a trust? Many people purchase life insurance and continue paying the premiums for many years, even though their financial picture has changed dramatically.

Carefully review and assess the health of your life insurance and its ownership during your periodic estate plan review to make sure it is consistent with your financial and estate planning goals.

Help me help you: Talking with the next generation

Do your loved ones know what you plan to leave to them when you die? Do they know whom to contact when something happens? Fewer surprises will make estate administration much easier when the time comes.

Consider drafting and regularly updating a letter of instruction to your children and fiduciaries. This letter should include an inventory of assets, and a list containing names, addresses, and phone numbers of your estate planning team. Easy access to this information may save your family from headaches down the road.

Furthermore, having a discussion regarding your assets, your intentions, and your reasoning (especially when creating trusts rather than leaving assets outright) will help build relationships and avoid family discord, and may even reduce the likelihood of litigation down the road.

Additionally, make sure to give your fiduciaries the appropriate power to handle your assets. A big change in recent years has been the administration of digital assets, such as email accounts, social media accounts, and song and picture libraries. Make sure your power of attorney and your will give your fiduciaries the appropriate access to these accounts.

Furthermore, make sure they have the proper information, including passwords, to access these digital entities. Have periodic conversations with loved ones regarding your plans, and ensure they have all the information they need to make estate administration easier and remove roadblocks when the time comes.

The bottom line

Many estate plans no longer meet their original intent due to inattention and a lack of routine updating. Death, birth, marriage, divorce, and having children reach adulthood are some of the many reasons estate plans become outdated.

Inevitable changes in laws and the tax code, not to mention changes to family and financial circumstances, further erode a plan’s effectiveness. Successful estate planning requires more than just having signed the initial documents: your plan should evolve as your circumstances do.

Why Hire David Ortiz?

I know that over my clients' lifetimes there will be economic, political, and market events that will create significant emotional hurdles. My mission is to assist them to clear these obstacles and prepare them for the future with a well-designed estate plan. An estate plan is a critical part of any ongoing financial planning process, regardless of your wealth. It is also about much more than just money. An estate plan will help carry out your long-term plan for your family and provide detailed instructions on how to handle assets that need to be split among multiple family members. It will also protect any desire you might have to support specific philanthropic endeavors.

Let's Talk: Click to Contact David Ortiz