SPECIAL REPORT

Your 20-Minute Estate Plan

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Your 20-Minute Estate Plan: Building a Lasting Legacy
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More than Money

A little more than a decade ago this discussion would have begun with taxes. Non- tax factors in estate planning would have been discussed only after taxes. It’s different now. We’ll discuss tax reduction later. **That’s because estate planning is about more than taxes, and even people without a potential estate tax burden need full estate plans**. The focus of estate or inheritance planning is on wealth. But there are more elements to a good plan than tax reduction.

Your plan should contain a durable power of attorney or revocable trust to ensure your assets are managed in case you are disabled. There should be a health care proxy or power of attorney so that it is clear who will make health care decisions on your behalf. You also should consider a living will or other instructions regarding your medical care. You need to ensure that your estate has enough cash and liquid assets to pay taxes, debts, specific bequests, and other obligations. Otherwise, assets will have to be sold in a hurry to meet obligations.

That's inheritance planning in a nutshell, and we’ll flesh it out in the coming pages: the 20 Minute Estate Plan. You’ll have an organized way of making your estate planning decisions and putting together a comprehensive plan that meets your goals. You’ll also know enough so that you can discuss the issues with an estate planner, and that will save you both time and money. Each month in Retirement Watch we discuss more about estate planning. We stay up to date on the latest changes and strategies and learn how to adapt to the coming fluctuations in the law.

Estate Planning Basics

What is estate planning? It's not avoiding taxes or probate. Estate planning is deciding how your wealth should be transferred to the next generation (or other heirs of your choice), then determining which legal tools to use to meet those goals. Only after establishing how you would like the assets distributed do you consider ways to reduce taxes, avoid probate, and other goals. Lawyers and others like to call the process estate planning, but it really is best to think of it as inheritance planning. That puts the true purpose of the process in the forefront.

To begin the inheritance planning process, you need to take these steps:

Make a list of all your assets and liabilities. You can't prepare an effective inheritance plan without this information. And a professional, no matter how skilled, can't do anything without this starting point. Don't forget frequently overlooked assets such as pension plans, life insurance policies, trusts of which you are a beneficiary, and inheritances you are likely to receive. Your heirs will inherit only your net assets, so you'll need to compile a list of all your debts, including whether or not the debts are secured by certain property.

Decide how you would like the assets distributed in the future. The traditional goal is for major assets to be inherited first by the spouse if he or she still is alive, then by the children, usually in equal shares. Smaller amounts or specific items might be designated for special friends or other relatives. Of course, you don't need to follow the traditional route. You might want to favor one child over others, or you might want the bulk of your assets to go directly to your children instead of your spouse. Many people decide to give a portion of their estates to charity. The only real limits placed on your choices are that a spouse cannot be completely disinherited (unless there is a valid prenuptial or postnuptial agreement) and children can be completely disinherited if the intention is made clear in the will.

As part of this step, you'll have to consider secondary goals. For example, would you like your spouse to inherit everything but only so that the property could not subsequently be inherited by a second spouse or family instead of by your children? Would you like to leave property to your children and grandchildren but with strings attached so that they don't waste the property or have to reach certain goals before getting the property? There are ways of accomplishing both your main and secondary goals, as long as you make the goals clear.

How much do you want to give now, and how much later? It's easier to reduce taxes and other costs if you are willing to part with some of your wealth now. Some people want to do that, others don't want to or can't afford to.

Work with one or more estate planning professionals to develop an estate plan that achieves your goals and also takes into account estate taxes, probate, and other concerns. An average middle class individual might need to work only with an estate planning attorney. Other individuals might need to add a life insurance agent, business appraiser, trustees, and other professionals.

Implement the estate plan after you fully understand it. Many people have great estate plans designed by skilled professionals, then they fail to fully implement the plans. They don't set up trusts recommended by their planners or fail to transfer assets to the trusts. Maybe life insurance is not purchased as planned, annual gifts to children are not made, or each spouse does not have title to enough assets to take advantage of the lifetime exemption equivalent. Don't let any of that happen to you.

Let your heirs know what you have decided and how things are set up. You can meet with them directly. You also should put together a letter of instructions that gives basic information such as where your will is kept, who your financial advisers are, and summarizing your assets and liabilities. This document should be updated at least annually and be accompanied by recent tax returns and an outline of your estate plan, at the minimum.

As you can see, from your point of view an inheritance plan really involves people more than law, life insurance, trusts, and other legal tools. Your focus should be on how you want to provide for people both now and after you are gone, and also how you want people to remember you. Then you should communicate your decisions to the people involved.

Eight Key Estate Planning Questions

Estate planning is not only about reducing estate taxes. That always was the case, but few people realized the importance of the non-tax factors until recently, and many still don't.

Every estate plan, regardless of the estate's size, needs to address certain issues. Ignore these issues, and your heirs will be worse off than they need to be. Tax issues, if there are any, should be considered only after the following issues are confronted.

What is the estate? Estate planning is getting assets to one's objects of affection in the most efficient and lowest cost-way possible, and in the most appropriate ownership form. The first step is to develop a complete, clear description of your assets and liabilities. The estate also cannot be administered efficiently unless the executor or administrator knows what is in the estate. Frequently, it costs too much and takes too much time to administer an estate because the administrator is searching for details about the estate.

Prepare a statement of your assets and liabilities. List all your assets, including intangible assets, such as trusts of which you are a beneficiary and life insurance. Describe the property clearly, estimate its value, and state where your records on it are kept. Update the list at least annually. Be sure your estate administrator knows where to find the list.

Who is in charge? An estate needs an administrator or executor. The name depends on the state, but the job essentially is the same. This person is legally responsible for getting the estate through the probate process, paying debts, selling assets as needed, and distributing the property as directed by the will.

Traditionally your estate planning lawyer is named the executor. But in most states that entitles the executor to a percentage of the estate, regardless of the amount of work involved. To keep costs low, the best choice often is a responsible family member or friend of the family who will waive any fee or work for a reasonable fee. An attorney can be hired by the hour to handle the difficult or technical work. This is an important appointment and should be carefully considered.

Who should share in the estate? Usually, it is an easy choice to give the bulk of the estate to the surviving spouse and then to the children and perhaps grandchildren. But that isn't always the case.

Sometimes serious thought is given to leaving a child out of the estate. Many families have a child whose behavior concerns the others. In most states a child can be disinherited completely. First, consider two other options. One option is to leave the property in a trust. Another family member or friend can distribute income and principal according to the trust guidelines. We have discussed such trusts in past visits. Another option is to leave the individual less than a full share of the estate. Provide in the will that this individual loses even that amount if he or she challenges the will and loses. The trick is to find an amount the individual won't want to risk losing.

Blended families also present dilemmas. One example: Should stepchildren be included in your will? Are they already provided for by their biological parents or do you not want to include them in your estate? Some people consider putting special friends or charities in the will. In that case it is key to let other natural heirs know about the choice. They should not be surprised by the will, so they will not misunderstand the reasons for your actions.

Should shares be equal? It is natural to leave children equal shares of the estate. Some parents want to leave less to children who have had more financial success than other children on the theory that they do not need the money. Unfortunately, if this intention is not clearly explained ahead of time, they often view it as being punished for success or an indication that the parents had more affection for the others. An option is to equally split about 80% of the estate and put the rest in a reserve trust. Let the trustee distribute that money according to needs or other standards you set. Another issue is whether higher lifetime gifts or other help for one offspring should be offset by the inheritance.

Leaving equal shares can be difficult when a family business is involved. There often are conflicts between the children who are running the business and those who aren't. One solution is to provide life insurance benefits for those children not running the business or that enables those in the business to buy out the others. Another option is to give the children not in the business equal shares of equity and income but no voting interest.

How much to give now? The old estate tax put a premium on using lifetime gifts to reduce an estate. Now, fewer estates need lifetime gifts to keep the estate tax bill low.

Lifetime gifts still can be valuable. Loved ones won't have to wait to use your wealth to improve their lives, and you get to see the results. Some people use lifetime gifts to see how loved ones will use the money. This can help determine if the estate will be given outright or in a trust.

The traditional approach is to leave the bulk of the estate to your spouse with the children inheriting later. But the children might have needs in the meantime, such as wedding expenses or the down payment on a home. You might want to provide the children cash for such expenses if that can be done without depriving your spouse.

Lifetime gifts take many forms other than straight gifts of cash or property. You can pay tuition bills, contribute the down payment on a home, help start a business, or pay medical expenses. A popular gift is to pay for all or part of a family vacation. When making lifetime gifts, be sure to retain enough to maintain your standard of living, including possible emergencies. You need to assume that at least one spouse will live well into his or her eighties.

Should there be controls or incentives? When an heir is too young or otherwise unable to handle wealth responsibly, it is appropriate to give the property through a trust or with other restrictions. You need to decide which gifts and bequests should be made in this way, what the restrictions should be, and when, if ever, they should be lifted. If some heirs will receive unrestricted bequests while others do not, you should explain this in advance.

In the last decade or so, incentive giving became more popular. Generally, property is left in trust and doled out to heirs as they meet certain goals. Distributions might occur upon graduating from college or staying employed for a minimum time. Some people believe incentive trusts resolve the dilemma of how to give while ensuring children become responsible citizens.

Others, however, believe incentive trusts are too controlling or inflexible. If you use this tool, be sure the effect is not to channel children into activities they don't really like or that are unsuitable for them. In addition, be aware that at some point the children likely will resent and feel stifled by the restrictions. An incentive trust should not be set up to last forever.

What about special assets? You might have a collection, personal mementoes, or other assets that mean a lot to you but not as much to your loved ones. Or the loved ones might not have the time or expertise to continue caring for the property or even to ensure receiving maximum value from selling the asset.

Give careful thought to such assets. Some people find it best to sell the asset themselves. Others line up a charity or someone else who eventually will buy or receive the asset. Personal mementoes and effects, even when they have no real financial value, often cause the worst estate disputes. Be sure to establish a plan for how such assets will be distributed among your heirs. We have discussed alternatives in past visits, and these are available on the web site Archive.

Is it good enough? Some people never finish a will or estate plan, because they do not find the perfect answers to these questions. It is better to complete an estate plan in stages than to not have nothing in place while you wait for the ideal solution.

How to Leave a Legacy

Estate planning is the process of building a legacy. When people think estate planning is about money, property, and death, they tend to ignore the process. When they realize it is about values and other elements of building and living a legacy, they are more interested in making a plan.

This was made clear in a survey done for Allianz Group. The survey asked Baby Boomers and their parents questions about inheritance and related issues. It found that the non-financial aspects of planning are at least as important to both groups as are the assets and finances.

What are those nonfinancial issues that need to be considered?

Values and life lessons are a key part of leaving a legacy. In fact, most Boomers in the survey said that this was the most important part of a legacy. (Yet, about 40% of the parents believed that leaving financial assets is important, even an obligation.) Both the Boomers and their parents believed that conveying this information occurs throughout life, not just in an estate plan.

This part of legacy building is enhanced by also leaving some kind of values statement. Sometimes this is called an ethical will, a document in which the writer expresses hopes and values and imparts words of wisdom to loved ones. This can be part of the letter of instructions we discussed last month or it can be a separate document.

Instructions and wishes also are important as we discussed last month. While it is important to leave this information in writing, it also is key to discuss it in advance with the affected people. That provides an opportunity to answer questions, respond to objections, and perhaps change the instructions. It also gives people an opportunity to get used to your plan.

Personal possessions are a prime cause of estate disputes, though few people believe that when preparing their estate plans. Items of seemingly little financial value seem to have a strong emotional value to someone, or are an excuse to air unrelated, simmering grievances.

A good estate plan provides a way to disperse the personal items without triggering a dispute. Ideally, the disposition of the personal items is made clear in advance. The decision can be made jointly by everyone affected, or the parent can decide and let people know the decision.

Communication is vital to an effective disposition of personal property. The older generation needs to communicate with the younger generation its thoughts about the property and also needs to learn which items of personal property are of intangible value to which members of the younger generation.

The financial assets are the final key to the plan. The parents need to decide how these will be divided and let the children know the general scheme.

One interesting aspect of the survey is that both Baby Boomers and their parents in general agreed that inheritances should not necessarily be equal. A majority of both groups believed in some kind of performance-based allocation, especially for a child who took care of the parent. Parents were more likely to believe that less wealth should be left to the more financially secure children or to those who share fewer of the parents' value or who are less financially responsible.

Indeed, over a third of the seniors believe that inheritance decisions are an important source of power and control. The decisions allow the estate owner to base inheritances on the achievement of certain goals, milestones, or other behavior. Whatever parents decide about dividing the estate, they should convey the general scheme to their children. Otherwise, an unequal division, especially disinheritance, will trigger a dispute over the estate.

The survey also found that Baby Boomers aren’t likely to know the extent of their parents' wealth. This might provide difficulty for the Boomers when the inheritance comes through. Some will end up with less than they anticipated. Most likely there are a number of Boomers who are basing their saving and investing decisions on an estimate of the wealth they will inherit. If the inheritance falls short, these Boomers will be looking to retirement with less money than they anticipated. Some Boomers will inherit more than they expected and will be unprepared to manage the sum.

A successful plan considers all the aspects of estate planning, not just the division of the dollar amount. A good plan also involves soliciting ideas from the heirs over some issues, and communicating in advance the basic plan to all involved.

Popular Strategy Ruins Estate Plans

Many people naively undermine their estate plans, creating nightmares for their heirs and potential bonuses for the taxman. The situation is easy to cause, but also is easy to fix. The problem is that few people realize the importance of the wording of the legal title to their assets. Yet, this simple decision, often made without much thought when an asset is purchased or an account is opened, can negate all the good features of an estate plan.

Most married couples buy assets and open accounts jointly with right of survivorship. It seems fair, is convenient, and gives security to the spouse with lower income. But it can disrupt many of the goals of an estate plan. When a spouse passes away, full legal title to the property automatically goes to the surviving spouse. None of the jointly-titled assets go to any other beneficiaries named in the will. A jointly-titled asset also cannot be transferred to a trust through the will. The result can be both tax and non-tax problems.

There can be estate tax problems for the surviving spouse in large estates. He or she will have full title to all the assets and will have to do all the planning once both estate tax exemptions are used. The opportunity to increase the tax basis of assets also can be lost. When property was held jointly, the surviving spouse retains his or her original tax basis in half the asset. Only the half that is inherited from the first spouse has its basis increased to fair market value.

On the other hand, if the first spouse to die had sole title to an asset, then the inheriting spouse could increase the basis to its current fair market value. There would be no capital gains taxes imposed on the appreciation during the first spouse's lifetime.

There also are potential non-tax problems. If the marriage is a second one, then joint title provides no protection for children of the first marriage. The surviving second spouse will get full ownership of the jointly-held assets. The children of the first marriage might end up with no assets from the estate.

Joint title offers some protection of assets from creditors, making joint title a fairly common asset protection strategy for those in high-risk professions, such as doctors. But the strategy could backfire. Suppose the surviving spouse is the one with the creditors. Then, on the death of the first spouse the creditors can lay claim to all the assets. The opportunity is lost to have the first spouse leave assets in trusts so that they are protected for the next generation.

A better strategy would have been to give the spouse without creditors full title to the assets, then in his or her will they would be transferred to a trust for the benefit of the other spouse, the children, or both.

Another potential problem with joint title of financial accounts is that either owner can empty the account at any time. This frequently happens when a divorce is contemplated. One of the spouses decides to take title to all the assets in the account. It also can happen if one spouse develops a problem such as substance abuse or gambling.

A related common estate planning strategy is for an older person to add an adult child to the account as joint owner with right of survivorship. These arrangements have several virtues. The assets avoid probate and are automatically transferred to the adult child. Also, the adult child is able to write checks and otherwise manage the finances should the older person become unable to.

Again, in these arrangements the joint owner can take the entire account whenever he or she wants. The child really needs to be trustworthy and sensible for this arrangement to work. Another shortcoming of the strategy is that the account is subject to claims of the child's creditors. The creditors are not a problem in many states when the joint owners are a married couple. But when the joint owners are not married, the rules are different. All or part of the account can be claimed by creditors of one joint owner. The rules vary from state to state.

Also, adding a child's name to an account or asset could trigger a gift tax liability or use up part of the lifetime gift tax credit. This is especially true if a child's name is added to the title for a valuable asset such as real estate.

Another titling mistake involves revocable living trusts. These generally are set up to avoid probate and also to provide for management of assets in case of incapacity. The problem is that many people do not transfer title of their assets to the trust. The living trust has no effect unless legal title to assets is shifted to the trust. The trust creator must change the titles on all financial accounts, real estate, automobiles, and other personal property. Many don’t do this.

One reason joint accounts and living trusts are widely used is that people believe these tools will save estate taxes. They will not. We already discussed the tax effects of joint title. With a living trust, all assets in the trust are included in the estate of the trust grantor when he or she dies.

Ensuring the optimum legal title for assets is an important part of an estate plan. Failure to properly title assets can result in assets going to the wrong person, inadvertent disinheritance of loved ones, higher estate taxes, unexpected gift taxes, theft, and loss of assets to creditors. Here are some guidelines to follow:

When there are children from a first marriage, assets that are intended for them should not be held in joint title with the current spouse. A financial power of attorney should be used to name the adult child or other person who will take charge of the finances when the parent is incapable. Joint title often is not a good substitute. Joint title should not be used with a spouse or adult child who is at risk to creditors, gambling problems or substance abuse.

Remember that beneficiary designations on IRAs, qualified pension plans, and other financial accounts supersede anything stated in a will. Whoever is named as beneficiary will inherit the assets. Highly appreciated assets probably are best titled in one person's name, so that whoever inherits can increase the tax basis to current fair market value.

Reducing the Tax Burden

Only after goals are established do you consider tax reduction, and after the 2017 changes only a very few people have to worry about federal estate taxes.

Once your nontax goals are clear, an estate planner usually can give you several options to accomplish those goals and compute the different tax effects of each option. Then you decide how to merge the tax plan with the personal plan to come up with one plan that comes closest to meeting your personal goals at the lowest possible tax cost.

The estate tax really is fairly simple. First, all the assets in which you have an ownership interest are compiled and valued. The total value of all the assets is known as the gross estate. From the gross estate, several deductions are allowed. Your debts are deducted, as are the administrative expenses incurred by the estate, such as lawyer's fees, probate costs, and similar expenses. Another deduction is the marital deduction. The final deduction is for charitable contributions.

After the deductions are taken, the remaining amount is your taxable estate. To this you add back lifetime gifts, and compute the tentative estate tax on that total. Then you subtract prior gift taxes paid, the unified estate and gift tax credit, and any state death tax credit (though the credit generally is repealed). The result is the estate tax payable. There also might be a generation skipping tax for gifts made directly to grandchildren.

From this computation, you can see that there are several basic ways to reduce estate taxes: Get assets out of the gross estate or reduce the value placed on assets. Maximize the use of deductions, such as the marital deduction and charitable contribution deduction. Use the lifetime estate and gift tax credit. Don't reduce taxes. Buy life insurance to pay the taxes or provide an inheritance.

All the estate planning tools you hear about spring from those four strategies. Some tools can combine two or more of those strategies. Now let's take a look at the more common strategies so that you'll be able to discuss them with your estate planner.

Basic Tax Reduction Strategies

Once you have decided on the personal goals of your inheritance plan and have estimated the estate taxes that would be paid if no tax reduction measures were taken, it is time to consider tax reduction strategies. Many of you won’t have to worry about federal estate taxes and can skip this section. If you live in an estate with estate or inheritance taxes, you need to plan to avoid that. If your estate is nearing $10 million (indexed for inflation since 2011) and is likely to grow in value over the years, you should consider estate tax reduction. Your estate planner will ask you to consider some of these basic strategies:

Full use of the marital deduction. This involves leaving all the property to your spouse. The marital deduction will fully eliminate estate taxes. The problem with this strategy used to be that it simply deferred the taxes until your spouse's death. Then your spouse must decide how to reduce estate taxes without benefit of a marital deduction or your estate tax exemption equivalent. But since the individual lifetime estate tax exemption was made portable between spouses under the 2013 law, the estate tax exemption not used by one spouse can be used by the surviving spouse. So, leaving everything to your spouse creates problems only if the joint estate is worth more than $20 million.

Maximize the lifetime estate and gift tax credit. Everyone gets a lifetime estate tax exemption equivalent in the form of a tax credit. This exempts up to $11.4 million for estates of those who pass away in 2020 and increases for inflation each year. Previously to take full advantage of this credit each spouse had to have property in his or her name at least equal to the value of the credit. The estate tax exemption was a “use it or lose it” benefit. A spouse couldn’t take advantage of the unused credit or a spouse who predeceased him or her.

Now, we have portability of the estate tax credit. A surviving spouse receives the unused exemption of the first spouse to die, if the estate executor makes an election on the estate tax return. This portability makes it easier for a married couple to fully exempt $20 million (indexed for inflation) in assets without having to change title to the assets. Some people are saying portability means estate

plans no longer need to include credit shelter trusts (see below). That isn’t the case for most estates. There still are good tax and non-tax reasons for credit shelter trusts, even for estates that aren’t big enough to be hit with federal estate taxes.

Make lifetime gifts. You can give any person up to $15,000 worth of property in 2020 without incurring gift taxes, and you can make these annual gifts to as many people as you want. (The amount is indexed for inflation.) If spouses give jointly, the exempt amount is $30,000 annually. That means if you have three children and you and your spouse give jointly, you can get up to $90,000 out of your estate annually without incurring taxes or using part of your lifetime exemption. You can make direct gifts of the property or put it in a trust, and you can give away more if there are grandchildren. These gifts are in addition to the lifetime estate and gift tax exemption amount.

Make large lifetime gifts. The full $10 million lifetime estate and gift tax credit can be used against either estate taxes or gift taxes or a combination of the two. If you can afford to be without the property, it is better to use the credit now with large gifts than later through your estate. That's because estate and gift taxes are based on the value of property. If property is appreciating, your heirs get more tax-free wealth if you give it away now rather than giving it away later when the taxes will be computed on the appreciated value.

Use a credit shelter trust. This trust accomplishes several goals. It ensures that you take full advantage of the lifetime exemption equivalent if you haven't done so already. The trust also allows your spouse full use of the property and its income during his or her lifetime but ensures that any remaining property will go to your children (or other beneficiaries you designate) rather than to a potential second family or other objects of your spouse's affection. The credit shelter trust simply involves leaving property up to the exempt amount to a trust of which your spouse is beneficiary for as long as he or she is alive, then has your children as beneficiaries after your spouse's death.

Use irrevocable trusts. Property that is transferred to an irrevocable trust is excluded from your gross estate if you are not a beneficiary of the trust. You'll probably owe gift taxes when the trust is set up, but that should be cheaper than paying estate taxes down the road. Or you can put just enough into the trust each year to take advantage of the annual gift tax exemption. With an irrevocable trust, you can give gifts with strings attached. That protects heirs from themselves and also from being spoiled or otherwise damaged by an inheritance.

Use life insurance to pay taxes or provide an inheritance. Life insurance benefits are included in your estate only if you have any ownership interests in the policy. Life insurance can avoid being included in your gross estate if the policy is owned by either an irrevocable trust, a limited partnership, or another individual. With life insurance you might be able to leave your heirs more after- tax wealth than you could otherwise, especially if you and your spouse are covered by a joint life or survivorship policy.

Give to charity and heirs. There are various strategies, such as charitable remainder trusts and charitable lead trusts, that allow your estate to take advantage of the charitable contribution deduction while providing income or property to your heirs.

Family limited partnerships for businesses. Many business owners have found that family limited partnerships let them reduce gift and estate taxes, keep the business intact, and still retain control of the business during their lifetimes.

More sophisticated strategies. People with more wealth than $10 million or with complicated assets such as family businesses should meet with an estate planner to discuss strategies such as family loans, intentionally defective grantor trusts, personal residence trusts, and others.

More Estate Planning Tips (Mostly About IRAs)

How to make your beneficiary designation form air-tight. Mistakes and oversights by IRA owners prevent their heirs from maximizing the after-tax benefits of the accounts. As we have discussed, the source of many problems is the IRA beneficiary form, a document to which most IRA owners devote only a minute or so. This form should be an important element of an estate plan, and some IRA owners should skip the standard forms offered by the IRA custodian and submit their own customized beneficiary forms.

Shrewd IRA owners will take the following steps: Be sure beneficiary designations and the designation form are key elements of your estate plan. Review the beneficiary designations regularly to determine if changes need to be made. Don't hesitate to have your estate planner draft a custom beneficiary form and submit it to the custodian. If the custodian will not accept the customized form, search for another custodian. Keep copies of the forms and be sure beneficiaries and the executor have access to them.

After making changes in a beneficiary form, ask the custodian to return the old form so that there will be no confusion in the custodian's records. Some advisors also recommend that you send two copies of the new form and have one copy stamped "received" with the date and returned to you.

These five simple steps practically guarantee your IRA custodian carries out your instructions to the "T". The "magic" word you should ALWAYS put on your beneficiary form. After making changes in a beneficiary form, ask the custodian to return the old form so that there will be no confusion in the custodian's records. Some advisors also recommend that you send two copies of the new form and have the custodian stamp one copy "received" with the date and returned to you. Two questions to ask your IRA custodian if you want to name a trust as your beneficiary.

If you are considering naming a trust as the IRA beneficiary, does the custodian allow this? The tax law allows it, but the rules are complicated. An experienced estate planner is needed to be sure the trust complies with IRS requirements. Some custodians don't want to bother with the details. Be sure to ask the custodian: Do you accept trusts as beneficiaries of IRAs? If so, what are your requirements? Many custodians want the trust agreement on file ahead of time, and some want their IRA experts to review it. Some want the agreement or an affirmation that the trust still is valid submitted each year.

The one beneficiary you can name who NEVER pays a single dime in distribution taxes. Unlike when other assets are inherited, beneficiaries of an IRA pay income taxes when they take distributions from the IRA. The beneficiary pays the same income taxes on distributions that the owner would have paid. These taxes cannot be avoided, and the fact of them might influence who is named beneficiary of the IRA or how much is left to different beneficiaries.

A non-IRA asset is more valuable to an heir than an IRA of equal value, because there will be income taxes on distributions from the IRA. The non-IRA asset can be sold and no capital gains taxes would be due on the appreciation that occurred during the owner's holding period.

The income taxes due on IRA distributions are a reason to consider making charitable gifts with the IRA rather than with other estate assets. The IRA will be included in the estate, but there will be an offsetting charitable contribution deduction, for no net tax. A charity that is named beneficiary of an IRA will not owe income taxes when it takes distributions. If there is an inclination to make charitable gifts through the estate, it often is better to make the gifts through an IRA and maximize the non-IRA assets left to other heirs. Special exception that lets you take an IRA distribution before 59½ for any reason with NO penalty.

IRA owners who take distributions from an IRA before age 59½ face two consequences. They owe income taxes on the distributions. In addition, they owe an early distribution penalty equal to 10% of the distributions. What many people do not realize is that the 10% early distribution penalty does not apply to beneficiaries of an IRA. In fact, beneficiaries are required to begin taking distributions from an inherited IRA. They owe income taxes but not the penalty, regardless of their age. Two entities you should NEVER name as your IRA beneficiaries.

The goal of most IRA owners is to allow their beneficiaries to continue benefiting from the tax deferral power of the IRA. They do not want beneficiaries to be forced to take distributions on an accelerated schedule and have to pay income taxes on the distributions. If that is your goal, be sure to name individuals as primary and contingent beneficiaries. There are two beneficiaries you definitely should not name. One is the estate. Name the estate as the beneficiary (or fail to name a beneficiary) and distributions will be required on an accelerated schedule. The tax deferral power of the IRA will be lost.

Likewise, a living trust should not be named as beneficiary. Owners of living trusts are told to put all of their assets into the trust. But only assets that will be subject to probate should be put in the trust. An IRA will avoid probate. If you name the living trust as beneficiary, the estate will be considered the beneficiary and accelerated distributions will be required.

Have a business you want to pass on? There is at least one strategy that will drastically reduce estate taxes, provide cash for the estate, and allow the owner to stay in control.

Business owners often put off estate planning, and as a result the business does not survive for the next generation. The key issues for many business owners are that to reduce estate taxes they have to give up some ownership or control today. There is at least one strategy, however, that will drastically reduce estate taxes, provide cash for the estate, and allow the owner to stay in control.

A strategy that probably is not used enough is the employee stock ownership plan (ESOP). The tax law provides a number of incentives to use an ESOP. In a typical ESOP, a small business owner creates the ESOP and a related trust. The company borrows money from a bank and in turn lends that money to the trust. The owner sells some or all of his stock to the trust. Over time, the company makes annual contributions to the trust, which are deductible. The trust uses the money to repay the loan from the company, which the company uses to repay the loan from the bank.

Special tax breaks allow the company to deduct both the interest and principal it pays on the loan. It also gets to deduct contributions made to the trust as well as dividends paid on stock owned by the trust. The owner also gets tax breaks. Gains from the sale of the stock are deferred if within a year the owner uses the proceeds to purchase securities issued by domestic companies and meets other restrictions. Taxes are due only as the owner sells those investments. The owner can sell whatever percentage of his stock he wants. In many ESOPs, the owner still retains a majority share of the company.

An ESOP is best for an owner whose children do not plan to run the company and do not want to own it. The ESOP gives a share to each employee and must meet nondiscrimination rules; the owner cannot pick and choose which employees get greater shares in the ownership distribution. When an employee leaves the company, he receives cash equal to the value of his ESOP account. Employees generally are allowed to vote on major corporate changes, such as mergers and acquisitions.

The ultimate "feud fighter". The most unexpected events can cause a will to be challenged. A carefully planned estate becomes a mess as legal fees lay waste to the family wealth and acrimony drives members apart. It doesn't have to happen. In most cases, a will contest and related lawsuits could have been avoided with a few preventive steps.

Most people believe a will is likely to be contested only if they leave significant assets to someone outside the immediate family, especially to a mistress, or to a second spouse instead of to children from the first marriage. Those acts are likely to trigger a battle, but those are not the only or even most common causes of disputed wills.

A no-contest clause is the old-fashioned way of blocking contests. Most estate planners recommend that no potential heir be left completely from the will. Instead, leave the unfavored heir an amount that will be meaningful to him or her. Then, include the no-contest clause, which states that anyone who challenges the will loses his or her inheritance if the contest fails. That way, the disgruntled heir has something to lose and cannot count on the modest inheritance to pay the legal fees. The heir has to risk losing both the legal fees and the inheritance.

The no-contest clause is very simple. It simply states that any beneficiary who challenges any term of the will is not to receive any bequest under the will if the contest is unsuccessful. How to audit-proof your estate tax return.

Planning an estate and implementing the plan don't end the job. To meet your goals, take another step and ensure that the estate will prevail in an audit. These steps aren’t essential for as many people now. But if your estate might be subject to federal or state taxes, then you’ll want to read this next section.

Few people realize that the audit rate on estate tax returns is far higher than the rate on income tax returns. The greater an estate's value, the more likely it is to be audited. An estate tax return can be 10 or 20 times more likely to be audited than an income tax return, depending on the individual's wealth.

An estate audit often addresses issues beyond the estate. It is not unusual for an estate tax auditor to conclude that prior income or gift tax returns need to be restated. Add penalties and interest, and the stakes in an estate audit can be quite high. Keep the potential for an audit in mind during the planning process. There are issues that make an aggressive estate tax audit more likely, and steps you can take to avoid adverse results from an audit.

Valuations. The top targets for the IRS are returns on which the value placed on property can be questioned. The estate and gift tax is based on the value of assets. The IRS increases tax revenue each time it successfully argues that the value of one or more items listed on the tax return is too low.

When a large portion of an estate's value is in real estate or a non-publicly traded business, the IRS takes notice. Art, antiques, and collectibles also can draw the IRS's interest. For all these items, there is no public market price. The value is subjective unless the property is sold to a willing, independent buyer. The IRS has appraisers to challenge the value placed by the taxpayer's appraiser. The auditor will examine how the value was determined by the estate and decide if the result should be challenged.

Gift challenges. An effective and frequently-used estate tax strategy is to make gifts of property. If property is out of the estate, it is not taxed. There might be gift taxes, or they might be avoided because of the annual and lifetime exemptions. In either case, the future appreciation is out of the estate. The IRS challenges gifts in two ways.

One challenge is to the value placed on the gift. Suppose a corporation owner each year gives his children stock with a value that does not exceed the annual gift tax exclusion. Over time he is getting the value of the business out of his estate without owing estate or gift taxes.

In this case, the IRS might challenge the value placed on the stock each year. It might argue that instead of giving $10,000 of stock to each child each year, he gave away

$20,000 of stock. The owner's estate and children would have to establish the value of the stock for each year a gift was made.

The second challenge is that a gift was not made. To make a legal gift, the owner might give away all beneficial interests in the property. Often, a wealthy individual will purport to give away property without legally giving up control. The IRS loves to see that. If the owner retains even partial control or some of the benefits of ownership, the IRS will say that the entire value of the property is included in the estate.

For example, an individual has his lawyer change the deed to a house or vacation house so his children are listed as the owners. But the owner continues to make full use of the property and pays all the bills. Perhaps the children aren't even told the title was transferred to them.

Another common example: A business owner gives or "sells" the business to his children. But he retains a consulting contract or other arrangement that requires the business to pay him most of its income each year for life. The IRS will say that there was no gift or sale, because there was a side deal to pay the parent most of the income for life. Often, there is evidence that the parent continues to make most of the significant business decisions, indicating that he retained control.

Life insurance. If the insured retains any beneficial interest in a policy, the life insurance proceeds are included in his estate. To effectively give away a life insurance policy, not only must the gift be complete but the gift must be made more than three years before death. An auditor will closely examine life insurance arrangements. If there is a life insurance trust, the documents will be reviewed for any forbidden powers. For example, if the insured retains the right to change the beneficiary, the policy proceeds might be included in the estate. If a business owned life insurance, the arrangement will be examined to see if the insurance benefits can be included in the estate. Many estates overlook group term policies offered through the deceased's employer. The benefits should be included in the estate.

Missing property. The IRS expects that people who own assets of a certain value also will own certain other valuable assets. For example, if someone owns a million-dollar house, the IRS expects the furnishings to be worth a significant amount. If a lesser amount is listed on the tax return, the auditor will want proof that really is how the house was furnished. The auditor will get a copy of the homeowners' insurance to check the stated value of the contents. The auditor also will look for riders covering other valuable property, such as art, antiques, furs, collectibles, and jewelry.

Past income tax returns also might be examined. If property taxes for a boat are deducted, the boat better be listed on the estate tax return or proof of sale produced. If the auditor believes the personal assets are understated, he might even review the checkbook, credit card statements, and other records for evidence of purchases, repairs, or storage of valuable assets.

Here are some steps that will protect your estate and heirs from an adverse estate tax audit.

File gift tax returns. When a gift tax return is filed, the IRS normally has three years to challenge the return. If no return is filed, there is no statute of limitations. Don't file a return, and your heirs might be forced to defend the value placed on gifts made 20 years earlier.

After making gifts, file a gift tax return. File a return even if the gift qualifies for the annual gift tax exclusion, especially when the value of a gift can be questioned. You might not need to file a return for gifts of cash or publicly-traded property that are well-documented. But for business interests, real estate, collectibles, and similar assets, file a return to get the statute of limitations running.

Get quality appraisals. Be sure all your appraisals are done by someone who does qualified tax appraisals and is experienced with IRS appraisals. The appraisal document should have an extensive explanation of how the value was determined. The exact format and length will depend on the type of property valued. When hiring an appraiser, pretend you are an IRS auditor. Question the appraiser's training and experience in detail. Don't have any broker or realtor appraise the real estate.

Remember the three-year rule. Life insurance and business interests that were owned within three years of death generally are included in the estate. If you want the assets out of your estate, sever all ties from them.

Keep great records. The IRS's favorite estates are those in which the owner knew everything about every item of property, but all the information was in his head. When he dies, the IRS has a field day finding all the assets and including them in the estate. It is up to the estate to prove that the assets should be excluded. Keep personal financial statements and past income and gift tax returns. Let your executor know where the files are that show the history of each asset.

Biography

Bob Carlson is editor of the monthly newsletter and website, ***Retirement Watch.*** He has served on the Board of Trustees of the Fairfax County Employees' Retirement System since 1992 and been chairman since 1995. The system has more than $4 billion in assets. Carlson was a member of the Board of Trustees of the Virginia Retirement System, which oversaw $42 billion in assets, from 2001-2005. He was appointed to the Virginia Retirement System Deferred Compensation Plans Advisory Committee in 2011.

His latest book is the revised edition of “The New Rules of Retirement” (Wiley, 2016; first edition 2004). He also co-authored “Personal Finance after 50 for Dummies” (with Eric Tyson; Wiley, 2015) and wrote “Invest Like a Fox…Not Like a Hedgehog” (Wiley, 2007).

He has written numerous other books and reports, including “The New Rules of Estate Planning,” “Securing Your Lifetime Stream of Income,” “Tax Wise Money Strategies, Retirement Tax Guide,” “How to Slash Your Mutual Fund Taxes,” “Bob Carlson’s Estate Planning Files” and “199 Loopholes That Survived Tax Reform.” He also has been interviewed by or quoted in numerous publications, including *The Wall Street Journal, Reader's Digest, Barron's, AARP Bulletin, Money, Worth, Kiplinger’s Personal Finance,* the *Washington Post* and many others. He has appeared on national television and on a number of radio programs. He is past editor of *Tax Wise Money*.

Carlson also was a Commissioner on the Fairfax County Redevelopment and Housing Authority. Carlson is an attorney and passed the CPA Exam. He received his J.D. and an M.S. (Accounting) from the University of Virginia and received his B.S. (Financial Management) from Clemson University. He also is an instrument rated private pilot. He is listed in many editions of *Who's Who in America* and *Who's Who in the World*.