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Famous People Who Failed to Properly Plan

It's almost impossible to overstate the importance of estate planning, regardless of the size of your estate or the stage of life you're in. A close second to the need to plan your estate is getting it done correctly, based on your individual circumstances.

You might think that those who are rich and famous would be way ahead of the curve when it comes to planning their estates properly, considering the resources and lawyers presumably available to them. Yet, there are plenty of celebrities and people of note who died with inadequate (or nonexistent) estate plans.

No estate plan

It's hard to imagine why some famous people left this world with no estate plan. A case in point involves former entertainer-turned-congressman Salvatore Phillip "Sonny" Bono. He died in a skiing accident in 1998, leaving no will or estate plan of any kind. His surviving wife had to petition the probate court to be appointed her deceased husband's administrator, seek court permission to continue various business ventures in which Sonny was involved, and settle multiple claims against the estate (including one from Sonny's more famous prior spouse, Cher). To make matters worse, a claim against the estate was brought by a purported extramarital child, which necessitated a DNA test from Sonny's body to determine whether he'd fathered the claimant (he did not).

Do-it-yourself disaster

We've all seen the ads for do-your-own legal documents, including wills and trusts. And the law does not require that you hire an attorney to prepare your will. But even the highest ranking jurist of his time should have relied on estate planning experts to prepare his estate plan. Instead, U.S. Supreme Court Chief Justice Warren E. Burger, who died in 1995, apparently typed his own will (consisting of only 176 words), which contained several typographical errors. More importantly, he neglected to address several issues that a well-drafted will would typically include. His family paid over $450,000 in taxes and had to seek the probate court's permission to complete administrative tasks like selling real estate.

The importance of updating your estate plan

Sure, formulating and executing an estate plan is important, but it shouldn't be an "out-of-sight, out-of-mind" endeavor. It's equally important to periodically review your documents to be sure they're up-to-date. The problems that can arise by failing to review and update your estate plan are evidenced by the estate of actor Heath Ledger. Although Ledger had prepared a will years before his death, there were several changes in his life that transpired after the will had been written, not the least of which was his relationship with actress Michelle Williams and the birth of their daughter, Matilda Rose. His will left everything to his parents and sister, and failed to provide for his "significant other" and their daughter. Apparently his family eventually agreed to provide for Matilda Rose, but not without some family disharmony.

Let someone know where the documents are kept

An updated estate plan only works if the people responsible for carrying out your wishes know where to find these important documents. Olympic medalist Florence Griffith Joyner died at the young age of 38, but her husband claimed he couldn't locate her will, leading to a dispute between Mr. Joyner and Flo Jo's mother, who claimed the right to live in the Joyner house for the rest of her life.

The will of baseball star Ted Williams instructed his executor to cremate his body and sprinkle the ashes at sea. However, one of William's daughters produced a note, allegedly signed by Ted and two of his children, agreeing that their bodies would be cryogenically stored. Before the will could be filed with the probate court, the body was taken to a cryogenic company, where its head was severed and placed in a container.

See disclaimer on final page

Stretch IRAs

The goal of a stretch IRA is to make sure your beneficiary can take distributions over the maximum period the RMD rules allow.

The term "stretch IRA" has become a popular way to refer to an IRA (either traditional or Roth) with provisions that make it easier to "stretch out" the time period that funds can stay in your IRA after your death, even over several generations. It's not a special IRA, and there's nothing dramatic about this "stretch" language. Any IRA can include stretch provisions, but not all do.

Why is "stretching" important?

Any earnings in an IRA grow tax deferred. Over time, this tax-deferred growth can help you accumulate significant retirement funds. If you're able to support yourself in retirement without the need to tap into your IRA, you may want to continue this tax-deferred growth for as long as possible. In fact, you may want your heirs to benefit--to the greatest extent possible--from this tax-deferred growth as well.

But funds can't stay in your IRA forever. Required minimum distribution (RMD) rules will apply after your death (for traditional IRAs, minimum distributions are also required during your lifetime after age 70½).

The goal of a stretch IRA is to make sure your beneficiary can take distributions over the maximum period the RMD rules allow. You'll want to check your IRA custodial or trust agreement carefully to make sure that it contains the following important stretch provisions.

Key stretch provision #1

The RMD rules let your beneficiary take distributions from an inherited IRA over a fixed period of time, based on your beneficiary's life expectancy. For example, if your beneficiary is age 20 in the year following your death, he or she can take payments over 63 additional years (special rules apply to spousal beneficiaries).

As you can see, this rule can keep your IRA funds growing tax deferred for a very long time. But even though the RMD rules allow your beneficiary to "stretch out" payments over his or her life expectancy, your particular IRA may not. For example, your IRA might require your beneficiary to take a lump-sum payment, or receive payments within 5 years after your death. If stretching payments out over time is important to you, make sure your IRA contract lets your beneficiary take payments over his or her life expectancy.

Key stretch provision #2

What happens if your beneficiary elects to take distributions over his or her life expectancy but dies a few years later, with funds still in the inherited IRA? This is where the IRA language becomes crucial.

If, as is commonly the case, the IRA language doesn't address what happens when your beneficiary dies, then the IRA balance is typically paid to your beneficiary's estate.

However, IRA providers are increasingly allowing an original beneficiary to name a successor beneficiary. In this case, when your original beneficiary dies, the successor beneficiary "steps into the shoes" of your original beneficiary and can continue to take RMDs over the original beneficiary's remaining distribution schedule.

When reviewing your IRA language, it's important to understand that a successor beneficiary is not the same as a contingent beneficiary. Most IRA providers allow you to name a contingent beneficiary. Your contingent beneficiary becomes entitled to your IRA proceeds only if your original beneficiary dies before you.

Stretch even further ...

If you name your spouse as beneficiary, your IRA can stretch even further. This is because your spouse can elect to treat your IRA as his or her own, or to transfer the IRA assets to his or her own IRA. Your spouse then becomes the owner of your IRA, rather than a beneficiary. As owner, your spouse won't have to start taking distributions from your traditional IRA until he or she reaches age 70½ (and no lifetime RMDs are required from your Roth IRA). Plus, your spouse can name a new beneficiary to continue receiving payments after he or she dies.

What if your IRA doesn't stretch?

If your IRA doesn't contain the appropriate stretch provisions, don't fret--you can always transfer your funds to an IRA that contains the desired language. In addition, upon your death, your beneficiary can transfer the IRA funds (in your name) directly to another IRA that has the appropriate stretch language.

A word of caution

While you might appreciate the value of tax-deferred growth, your beneficiary might prefer instant gratification. If so, there's little to prevent your beneficiary from simply taking a lump-sum distribution upon inheriting the IRA, rather than "stretching out" distributions over his or her life expectancy. It's possible, though, to name a trust as the beneficiary of your IRA to establish some control over how distributions will be taken after your death.

All in the Family: Transferring a Business to Your Children

With a grantor retained annuity trust (GRAT), you receive a fixed dollar amount that does not change even if the value of the trust property (corpus) increases or decreases. Some other types of trusts are a grantor retained unitrust (GRUT) and a rolling or cascading GRAT. A GRUT allows you to retain the right to receive a fixed percentage of the trust corpus (determined annually), while a rolling or cascading GRAT is a technique that involves creating a series of short-term GRATs (typically two or three years) with each successive GRAT being funded by the annuity payments from the previous ones. This technique can minimize the risk of the grantor dying during the GRAT term, and can also minimize interest rate risk.

You've spent years building a family business that's a source of pride and income for both you and your family, and now you may be thinking of handing over the reins to your children. If so, consider that transferring your business interest to your children may have income, gift, and estate tax consequences. Careful planning can help prevent the need to sell some (or all) of the business assets to pay those taxes.

Some common strategies for minimizing taxes are discussed briefly below. Remember, however, that none of these strategies are without drawbacks. Before you act, consult a tax professional as well as your estate planning attorney.

Gifting or bequeathing your interest outright

If you don't need continued income from the business and you don't want to retain some control, you can simply give the business to your children outright. For example, you can begin a systematic program of making annual gifts to your children in amounts that equal the annual gift tax exclusion ($14,000 per year per recipient in 2013). By transferring your interest in this manner, you may be able to transfer all or a significant portion of the business free from federal gift tax (although these transfers may still be subject to state gift tax). The disadvantage here is the amount of time that may be needed to transfer your entire interest.

If you can wait and transfer your business at your death, Section 6166 of the Internal Revenue Code allows any estate taxes incurred because of the inclusion of your family business in your estate to be deferred for 5 years (with interest-only payments for the first 4 years), and then paid in annual installments of interest and principal over a period of up to 10 years. This will allow your beneficiaries more time to raise sufficient funds to pay the taxes or obtain more favorable interest rates if they need to borrow the money. Be aware that the business must exceed 35% of your gross estate and other requirements must be met.

Selling your interest outright

If you need income from your business, you can sell your business interest (for full fair market value) to your children. This will avoid gift and estate taxes, but you may owe capital gains tax.

Using a buy-sell agreement

If you want to sell your business interest to your children but retain control over the business for a period of time, consider using a buy-sell agreement. This is a legal contract that states that the sale will happen when a specific event occurs, such as your retirement, disability, divorce, or death. When the triggering event occurs, the children will be obligated to buy your interest from you or your estate. The price and sale terms will have been predetermined by the contract. Remember, however, that you will be bound under a buy-sell agreement: you won't be able to sell or give your business to anyone except the buyers named in the agreement (unless they consent).

Using a grantor retained annuity trust (GRAT)

A GRAT is a trust into which you transfer your business interest, and from which you receive income for a period of time. The value of the gift is determined using the IRS's current interest rate (published monthly by the IRS). The trust must terminate at a specified time (e.g., 10 years). You receive annuity payments during the term of the trust, and at the end, your children will receive the business. If the business has appreciated beyond the IRS's interest rate, the excess can pass tax free. Be aware, however, that if you die during the GRAT term, your entire business interest will be included in your gross estate for federal estate tax purposes. You will have failed to transfer your business interest and lost the tax advantages of the GRAT. Plus, you will have incurred the costs of creating and maintaining the GRAT for nothing. For these reasons, be sure to structure your GRAT carefully.

Creating a family limited partnership (FLP)

An FLP is a type of business entity. First, you establish a partnership with both general and limited partnership interests. Then, you transfer the business to this partnership. You retain the general partnership interest for yourself, allowing you to maintain control over the day-to-day operation of the business. Over time, you gift the limited partnership interests to your children, leveraging your lifetime gift tax exemption and the annual gift tax exclusion. You also save taxes because the value of the gifts may be eligible for valuation discounts, such as the minority interest and lack of marketability discounts.

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What rate of return should I expect from stocks?

That depends on many factors, including your time frame and the types of stocks involved. Many retirement planning calculators project a portfolio's future value based on historical returns. However, past performance is no guarantee of future results, and you should take any such assumptions with a grain of salt.

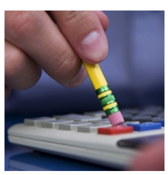
You may have heard that stocks have historically averaged a 10% return. However, be careful about relying too much on that number. First, the figure on which that statement is based--9.8%--reflects the compounded annual total return of the S&P 500 between 1926 and 2012. Is your time frame likely to be that long? Second, equities' performance in recent years hasn't been as robust. The last time the S&P's compounded annual 10-year total return was 9.8% or more was 2004; from 1999 to 2008 it was negative for the first time in decades, and from 2003 to 2012, it was 7.1%.*

Third, that 7.1% was the index's nominal return; it doesn't take into account inflation or taxes. As of April, the annual inflation rate was a little over 1%, according to the Bureau of Labor Statistics. That would cut that 7.1% to just over 6%. And a 1% inflation rate is very low; over the last 20 years, it has averaged roughly 2.4% a year, which would mean an inflation-adjusted return under 5%. That's less than half the often-quoted 10% average, not including any taxes owed.

What would that mean to a hypothetical $100,000 portfolio? Even if you managed to achieve a 9.8% nominal return compounded annually for 10 years, adjusting it for 2.4% inflation would mean a projected balance of almost $255,000 would actually be worth roughly $200,000 before taxes. That's a pretty substantial gap.

Returns for stocks other than the large caps of the S&P 500 can be different. Still, when planning for income or long-term goals, focusing on real returns could help keep your expectations realistic.

*Calculations based on total returns compounded annually through December 2012 on the S&P 500 Index, which is an unmanaged market-cap weighted index composed of the common stocks of 500 leading companies in leading U.S. industries. It is not available for direct investment.



What return are you really earning on your money?

If you're like most people, you probably want to know what return you might expect before you invest. But to translate a given rate of return into actual income or growth potential, you'll need to understand the difference between nominal return and real return, and how that difference can affect your ability to achieve financial goals.

Let's say you have a certificate of deposit (CD) that's about to expire. The yield on the new five-year CD you're considering is 1.5%. It's not great, you think, but it's better than the 0.85% offered by a five-year Treasury note.*

But that 1.5% is the CD's nominal rate of return; it doesn't account for inflation or taxes. If you're taxed at the 28% federal income tax rate, roughly 0.42% of that 1.5% will be gobbled up by federal taxes on the interest. Okay, you say, that still leaves an interest rate of 1.08%; at least you're earning something.

However, you've also got to consider the purchasing power of the interest that the CD pays. Even though inflation is relatively low today, it can still affect your purchasing power, especially over time. Consumer prices have gone up by roughly 1% over the past year.** Adjust your 1.08% after-tax return for inflation, and suddenly you're barely breaking even on your investment.

What's left after the impact of inflation and taxes is called your real return, because that's what you're really earning in actual purchasing power. If the nominal return on an investment is low enough, the real return can actually be negative, depending on your tax bracket and the inflation rate over time. Though this hypothetical example doesn't represent the performance of any actual investment, it illustrates the importance of understanding what you're really earning.

In some cases, the security an investment offers may be important enough that you're essentially willing to pay someone to keep your money safe. For example, Treasury yields have sometimes been negative when people worried more about protecting their principal than about their real return. However, you should understand the cost of such a decision.

*Source: Department of the Treasury Resource Center (www.treasury.gov) as of April 2013.

**Source: Bureau of Labor Statistics, Consumer Price Index as of April 2013.