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## ESTATE PLANNING ALERT

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### COMMON PITFALLS IN ESTATE PLANNING PART I

#### All Wills Are Not Created Equally

If your Will is not properly structured, your estate could end up paying tens of thousands of dollars, hundreds of thousands of dollars, or even millions of dollars of unnecessary state and federal estate taxes.

##### Insurance Policies As Part of Your Estate

You may not realize that your taxable estate includes any life insurance policies that you own or control. The total value of any such policies raises your taxable estate dollar for dollar.

##### Estate Tax Exemptions and Estate Taxes

New Jersey's exemption from estate tax is only \$675,000 and New York's exemption from estate tax is only \$1 million. If you die with an estate in excess of your state's exemption (that does not pass to your spouse or to certain qualifying trusts for his or her benefit), these states will collect

estate taxes at rates of between 4% and 16%, respectively.

In addition, effective as of January 1, 2006, there is a \$2 million exemption from federal estate tax (the "applicable exclusion amount"). [It should be noted that the applicable exclusion amount is scheduled to rise to \$3.5 million in 2009.] *Once your estate exceeds \$2 million, the combined federal and state estate tax rates rise steeply, peaking above 50%.*

Consider the following examples:

If your Wills are not properly structured and you and your spouse pass away in close succession with a net worth of \$1.5 million, although no federal estate tax will be owed, on the surviving spouse's death, his or her estate will *unnecessarily* owe around \$65,000 in state estate tax. *Thus, if you are married with \$500,000 of assets and \$1*

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*million of life insurance, properly structuring your Wills can save \$65,000.*

On the upper end, if your Wills are not properly structured and you and your spouse pass away, as described above, with a \$4 million net worth, around \$920,000 of *completely unnecessary* federal estate tax will be owed and roughly \$280,400 of state estate tax will be owed. If the Wills were properly structured, no federal estate tax would have been owed and \$99,600 would have been due at both the first death and second death—so the failure to properly structure the Wills results in the *unnecessary* payment of \$920,000 of federal estate tax and an additional \$81,200 in state estate taxes. *Thus, for the married couple with \$2 million of assets and \$2 million of life insurance, over a million dollars of unnecessary state and federal estate taxes may be due if Wills are not properly structured.*

Let us explore why this happens.

### **The Marital Deduction**

As you may know, there is no estate tax on property passing between you and your spouse. As a result, often many Wills drafted prior to 2001's changes in the tax laws leave all property to a surviving spouse. Although these Wills result in no estate taxes being paid on the first spouse's death, as we have seen, they can prove very costly for your family on the surviving spouse's death.

Leaving all property to a surviving spouse wastes the deceased spouse's exclusion from federal estate tax, thereby resulting in unnecessary estate taxes being paid upon the surviving spouse's death.

### **Credit Shelter Trusts**

Simply including what is often referred to as a "credit shelter trust" in your Will, or drafting your Will to permit your surviving spouse to disclaim property into a credit shelter trust (or "disclaimer trust") for his or her own benefit (and often also for your children's benefit) safeguards the decedent spouse's applicable exclusion amount. This enables both your exemption and your spouse's exemption to pass estate tax free to the next generation, effectively doubling the amount of assets that pass to your children estate tax free.

Put simply, the surviving spouse can still have access to the property in the credit shelter trust, but upon said spouse's death, the property will not be included in his or her estate, and such property will pass estate tax-free to your descendants or to the other beneficiaries of the trust.

By giving your spouse the power to disclaim assets into a credit shelter trust, you preserve maximum flexibility in deciding whether to fully fund the credit shelter trust with the applicable exclusion amount, or whether to partially fund said trust with only the maximum state exemption from estate taxes (either \$1 million or \$675,000 in New York and New Jersey, respectively).

Of course, this same tax savings can be achieved by leaving the applicable exclusion amount directly to your descendants or other beneficiaries (who are not your spouse). This is generally advisable when your spouse will have sufficient assets to live on after your death.

### **The Necessity of Re-Titling Assets**

A common mistake is to set up credit shelter trusts in Wills but to fail to re-title assets in a manner that enables the credit shelter trusts to be funded upon death. Are your (and your spouse's) assets titled such that a credit shelter trust can be funded?

In order to achieve the maximum tax savings when the first spouse dies, you and your spouse should have sufficient assets in each of your own individual names to fund a credit shelter trust (\$2 million in each of your own names, if assets are sufficient to do so—or if assets are not sufficient to do so, the assets should be split such that each of you own one-half of them). This is because jointly owned property, retirement accounts (with designated beneficiaries) and insurance proceeds (that are not payable to your estate) cannot be used to fund a credit shelter trust since such assets pass outside of your Will.

Therefore, adjustments with respect to how you and your spouse own property may be appropriate in order to ensure that a credit shelter trust or a disclaimer trust can be funded upon your and your spouse's death (*e.g.* splitting of brokerage accounts or re-titling a home).

## **Periodically Update Estate Planning**

Also, many people fail to update estate planning documents to reflect life changing events such as a divorce, remarriage or birth of a child. Please make sure that your existing estate planning documents (including life insurance beneficiary designations and 401(k) and IRA beneficiary designations) still embody your present wishes.

## **Health Care Documents**

Lastly, as evidenced by the Terri Schiavo case, you should consider updating your health care documents to make sure that the documents adequately reflect your wishes and that you have designated a health care agent to make decisions on your behalf.

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The situations described above demonstrate first and foremost that in today's world of changing tax laws and evolving client wishes, sound estate planning is not a single event, rather it is a process that must be periodically updated.

As discussed above, you should take the opportunity to make sure that your Will (and other estate planning documents) are drafted in a tax-efficient manner and that your intentions are not frustrated by changes in the estate tax laws.

In future alerts I will address other simple actions that you can take (that are often not taken) to reduce the impact of estate taxes and to avoid unintended consequences for you and your family.

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**FOR MORE INFORMATION** on this Alert or other estate planning issues, please contact:

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