

No worries - Put your Estate Plan Under a Stress Test to Detect Abnormalities

A well-designed estate plan helps cement your legacy, but that doesn't mean it's written in stone. Changing family circumstances, evolving tax laws, fluctuating financial markets, health issues and other factors can impact the effectiveness of your plan over time. One strategy that can help identify potential weaknesses or vulnerabilities in your plan is to conduct periodic stress tests.

Stress test defined. Broadly speaking, a stress test is an assessment tool used to evaluate the performance of a system, plan, process or person under extreme, challenging or changing conditions. These conditions may be real or simulated. For example, a doctor may order a stress test to evaluate a patient's heart function during exercise. Or a bank may run simulations to see how adverse events or changes in interest rates or other market conditions would impact its financial performance. In either case, stress testing can reveal potential risks or dangerous conditions that need to be addressed.

In estate planning, stress testing involves examining your plan and asking a series of "what if" questions to evaluate how your plan would perform in various scenarios. If the results don't align with your estate planning goals, it may be necessary to modify your plan.

Potential findings. To stress test your estate plan, your estate planning advisor poses a variety of scenarios and constructs models to show how your plan would perform under those circumstances. Every plan is different, so the results of stress testing depend on your particular circumstances. Examples of potential findings include:

Unplanned results. Stress testing may reveal that, if you were to die tomorrow, the operation of your estate plan may result in unexpected — and undesirable — consequences. Perhaps significant assets would be distributed outright to your children, even though they're not yet prepared to manage the funds on their own. A solution may be to set aside those assets in trust for your kids' benefit.

What happens if you divorce? Does your ex-spouse still stand to receive a significant inheritance from your estate? Some estate plans automatically disinherit a spouse in the event of divorce, but if yours doesn't, an amendment may be needed.

Unexpected taxes. If the value of your estate exceeds federal or state exemption amounts, or if it will exceed those amounts if they're reduced in the future, a sizable chunk of your wealth may be lost to estate tax.

If estate tax is a concern, consider implementing tax-efficient strategies for removing assets from your taxable estate. Or set up an irrevocable life insurance trust (ILIT) to fund potential tax liabilities. (See "ILIT keeps insurance out of your estate" at X.)

Insufficient liquidity. Stress testing may reveal that much of your wealth is tied up in illiquid assets, such as closely held businesses or real estate. This may make it difficult to distribute these assets fairly among your heirs and to cover taxes and other expenses. Planning may be needed to create liquidity through life insurance or other strategies.

Improperly titled assets. Many estate plans employ revocable, or “living,” trusts to avoid probate and provide for the management of one’s assets in the event of incapacity. But these trusts are only effective to the extent that you fully “fund” them — that is, transfer title to assets to the trust. A stress test may identify assets that aren’t properly titled in the trust and, therefore, will be subject to probate and beyond the trust’s control in the event you’re incapacitated.

Missing beneficiaries or fiduciaries. This can happen, for example, if a beneficiary, executor, trustee or agent predeceases you and you haven’t named a backup. Failure to name contingent beneficiaries or fiduciaries can disrupt the operation of your estate plan or, worse, cause assets to be distributed to unintended recipients.

Inflexible trust language. If you were to die tomorrow, would your trust achieve your goals? For example, a “maintenance” standard would restrict distributions to your beneficiaries’ most basic living expenses. If you wish to provide more for them, consider establishing a higher standard or even giving the trustee full discretion to make distributions in accordance with your wishes.

Stress-free estate planning. To reduce the stress associated with estate planning, consider a stress test. By modeling how your plan would perform under various scenarios, stress testing allows you to make adjustments to ensure that it meets your goals. Contact your estate planning advisor for additional details.

Sidebar: An Irrevocable Life Insurance Trust keeps insurance out of your estate

Life insurance can be a powerful tool for creating liquidity to pay estate tax and other expenses. It can also provide an additional source of wealth to supplement your estate.

Many people are surprised to learn, however, that individually owned policies are subject to estate tax. One way to take advantage of life insurance without triggering additional taxes is to create an irrevocable life insurance trust (ILIT) to purchase and hold the policy. A properly designed ILIT ensures that life insurance proceeds bypass your taxable estate, maximizing the amount available to your family.

Note: It’s also possible to transfer an existing policy to an ILIT, but the insurance proceeds will be excluded from your taxable estate only if you live for at least three years after the transfer.