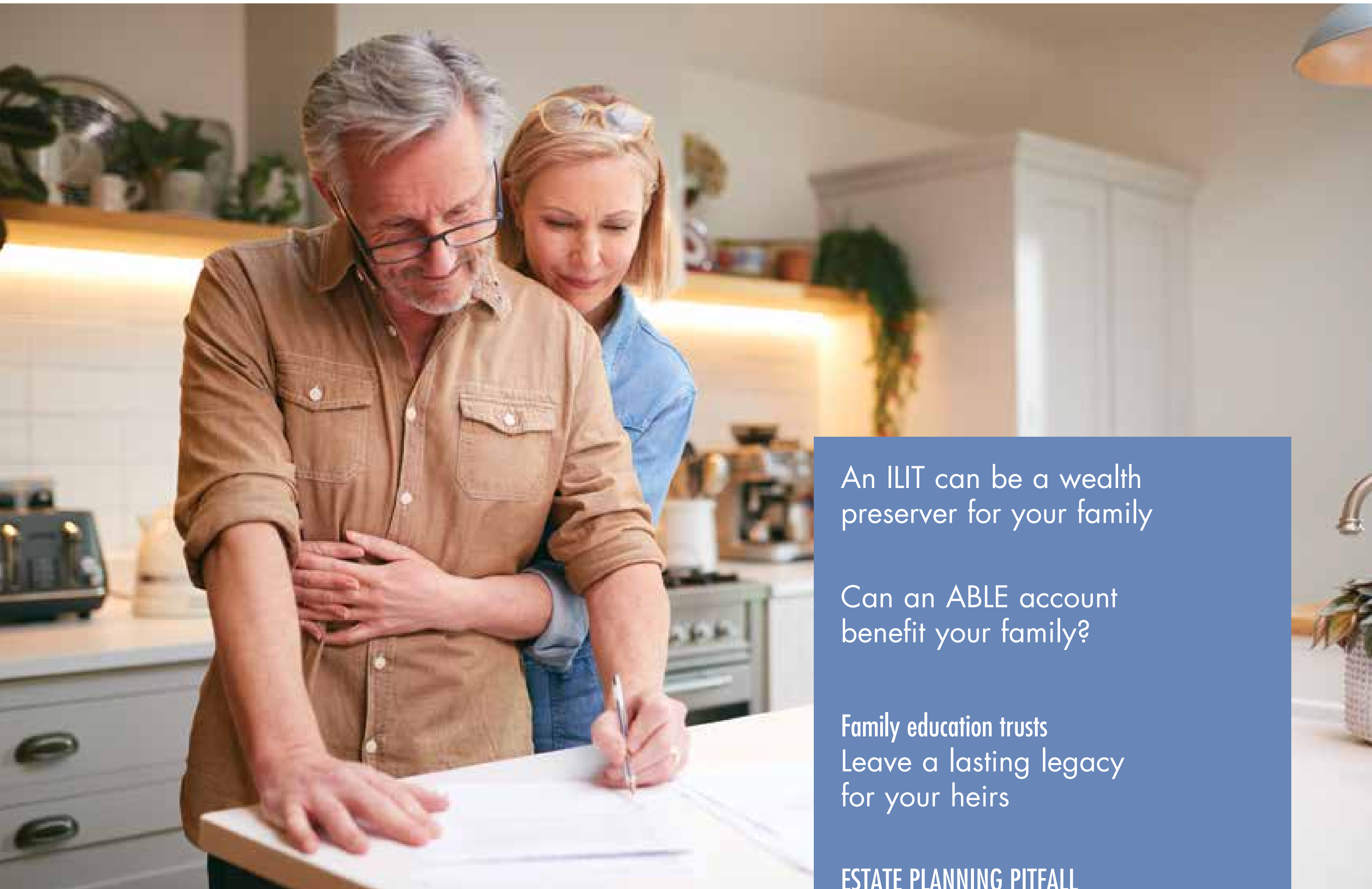
INSIGHT ON ESTATE PLANNING



An ILIT can be a wealth preserver for your family

Can an ABLE account benefit your family?

Family education trusts
Leave a lasting legacy for your heirs

ESTATE PLANNING PITFALL
You've amended your will yourself

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An ILIT can be a wealth preserver for your family

Life insurance is often an integral part of an estate plan. By acquiring life insurance coverage, you can provide liquidity when your family might need it the most, particularly if you're relatively young. The policy's proceeds can be used to help pay your mortgage, college tuition for your children or various other expenses.

Of course, you also must account for taxes. Generally, you can avoid dire federal estate tax consequences, based in part by using your gift and estate tax exemption. However, the exemption is scheduled to decrease after 2025, creating more complications. For many families, creating an irrevocable life insurance trust (ILIT) to hold your life insurance policy is a common solution.

Avoid "incidents of ownership"

Generally, the proceeds of a life insurance policy aren't included in your taxable estate if you don't own the policy and aren't subject to probate. For instance, if you're the insured person and someone else owns the policy and pays the premiums, the life insurance proceeds are exempt from estate tax.

However, life insurance proceeds will be included in your estate if you possess any "incidents of ownership." This goes beyond mere ownership of the policy. If you have the right to amend the policy — say, by changing the beneficiaries — or you can borrow against the cash value, it's treated as an incident of ownership.

The top estate tax rate is currently 40%. Fortunately, with your gift and estate tax exemption, you can shelter up to $11.7 million (for 2021) of the proceeds from federal

gift and estate tax. Be aware that without congressional action, after 2025, the exemption is scheduled to revert to $5 million (indexed for inflation). Also keep in mind that the Biden administration supports a reduction of the estate tax exemption to $3.5 million.

Furthermore, you may have to contend with estate or inheritance taxes at the state level. In any event, the estate tax treatment of life insurance policies is a prime consideration in estate planning, especially for wealthier individuals.

An ILIT to the rescue

A common method for avoiding these estate tax complications is to use an ILIT. This may be accomplished by setting up the trust as the owner of the life insurance policy when the coverage is purchased or by transferring an existing policy to the trust.

For starters, the trust must be "irrevocable," as the name states. In other words, you must relinquish any control over the ILIT, such as the right to revise beneficiaries or revoke the trust. Similarly, if you act as the trustee of the ILIT, this will be treated as an incident of ownership that invalidates the trust. You can, however, name another family member or a knowledgeable professional as the trustee.

Typically, you'll designate the ILIT as the primary beneficiary of the life insurance policy.

Upon your death, the proceeds are deposited into the ILIT and held for distributions to the trust's beneficiaries. In most cases, this will be your spouse, children, grandchildren or other family members.

Note that naming your surviving spouse as the sole beneficiary can be problematic. It may merely delay estate tax liability until the spouse dies (assuming he or she outlives you). But this can be addressed through estate tax planning measures designed for a surviving spouse.

The ILIT must be funded so the trust is able to pay the premiums on the policy. Choose a bank account to be used for this purpose.

Other ILIT considerations

There are several specific pitfalls to watch out for when transferring an insurance policy to an ILIT. Significantly, if you transfer an existing policy to the ILIT and die within three years of the transfer, the proceeds will be included in your taxable estate (see "Start the clock ticking" at right). One way to avoid this is to have the ILIT purchase the policy on your life and then fund the trust with enough money over time to pay the premiums.

The transfer of an existing policy is subject to federal gift tax. The gift may be sheltered from tax by the annual gift tax exclusion ($15,000 for 2021) and the gift and estate tax exemption. Alternatively, you can arrange for a "Crummey letter" that gives beneficiaries the right to access funds for a limited time.

Start the clock ticking

No matter what your intentions, if you die within three years of transferring ownership of a life insurance policy to an irrevocable life insurance trust (ILIT), the proceeds are included in your taxable estate. Period.

Therefore, if the ILIT strategy makes sense for your specific circumstances, there's no sense in waiting around, even if you're currently in good health. Set up the trust and transfer the policy as soon as possible. This will start the clock ticking on the three-year period. Note, too, that the three-year rule applies to other assets gifted to a trust.

Ensure your policy works as intended

A life insurance policy can protect your family's financial future. Using an ILIT can help ensure the policy works as you intend by shielding the proceeds from hefty estate taxes. Contact your estate planning advisor for more details. •

Can an ABLE account benefit your family?

A family with a disabled child faces difficult planning challenges. For many years, the most effective estate and financial planning tool for parents of a disabled child was a special needs trust (SNT). This trust type provides resources for the care of disabled children while preserving their eligibility for means-tested government benefits, such as Medicaid and Supplemental Security Income (SSI).

Another option available to families is the ABLE account. The Achieving a Better Life Experience (ABLE) Act was signed into law in 2014. It created Internal Revenue Code Section 529A, authorizing states to offer tax-advantaged savings accounts for the blind and severely disabled.

ABLE account details

Under the ABLE Act, you may contribute funds to a designated account that grows without current tax erosion, much in the same way that 529 plans operate. Furthermore, there's no tax on distributions paid for qualified expenses.

Currently, more than 40 states and the District of Columbia have established ABLE accounts for residents. If you live in one of the handful of states that doesn't permit ABLE accounts, you can create one in a state that allows nonresidents to participate. Fees paid to administer the account generally are minimal.

If the funds in an ABLE account are used to pay for qualified expenses, the payouts are exempt from income tax.

Bear in mind that an ABLE account may be used only to benefit an individual who experienced a disability prior to the age of 26 and who satisfies certain Social Security criteria. Therefore, it's not available to every disabled person.

Although an ABLE account can be managed by its beneficiary, these responsibilities typically are handled by the parents, a professional or another person acting under a power of attorney.

Funding ABLE accounts

An ABLE account's funds are invested through options authorized by the applicable state. Investment changes may be made twice a year, and only one ABLE account can be set up for a qualified individual.

Normally, an ABLE account is funded through a series of annual contributions. These contributions are tied to the annual gift tax exclusion, which is indexed for inflation. (The gift tax exclusion amount for 2021 is $15,000.) Plus, lifetime contributions are limited to the amounts imposed by the individual state for 529 plan accounts. These limits are generally at least $250,000 — and can exceed $500,000.

However, there are complications related to other programs. If a disabled individual meets SSI or Medicaid requirements and is receiving benefits from either, or both, he or she is still eligible for an ABLE account. An ABLE account's funds don't count toward the limits on personal assets for these public benefits.

If the assets in the ABLE account exceed $100,000, the beneficiary's SSI benefits will be suspended until the total drops below this threshold. However, Medicaid eligibility will not be affected by the account's amount.

Also, be aware that contributions to an ABLE account aren't tax deductible. A few individual states have carved out limited state income tax benefits for these accounts.

Distribution rules

If the funds in an ABLE account are used to pay for qualified expenses, the payouts are exempt from income tax. Qualified expenses must go toward maintaining or improving the health, independence or quality of life of the beneficiary. These include basic living costs and expenses for, among other things:

- Education,
- Food,
- Housing,

- Transportation,
- Employment training and support,
- Assistive technology,
- Personal support services,
- Health care expenses,
- Financial management, and
- Administrative services.

However, if withdrawals are made for nonqualified expenses, the portion of the distributions attributable to earnings is subject to tax at ordinary income rates, plus a 10% penalty tax is imposed on that portion. In states that have adopted special state income tax benefits, withdrawals might also result in penalties.

Other considerations

Although SNTs offer more flexibility, an ABLE account may be especially beneficial in certain situations. For example, with an ABLE account a disabled individual can set aside wages or Social Security benefits for a future purchase without violating the general rule that the recipient of SSI and Medicaid can't accumulate more than $2,000.

In addition, an ABLE account may be used if a small inheritance under $15,000 has been left to someone receiving SSI or Medicaid. It might also be used for an unexpected windfall like lottery winnings or a legal settlement. In fact, the ability to pay for housing without affecting SSI is one of the main reasons for using ABLE accounts.

Worth exploring

If you have a child or relative with a disability in existence before age 26, consider exploring the feasibility of an ABLE account. Contact your estate planning advisor for additional information. •

Family education trusts

Leave a lasting legacy for your heirs

Providing for the educational needs of your children, grandchildren and even future generations is an honorable estate planning objective. What are your options for achieving this goal? A 529 plan can be a highly effective tool for funding tuition and other educational expenses on a tax-advantaged basis. But after your death, there's no guarantee that subsequent plan owners will continue to use it to fulfill your original vision. An alternative strategy is to create a family education trust that invests in one or more 529 plans.

529 plan flexibility

529 plans are state-sponsored investment accounts that permit parents, grandparents or other family members to make substantial cash contributions (up to $400,000 or more, depending on the plan). Contributions are nondeductible, but the funds grow tax-free and earnings may be withdrawn tax-free for federal income tax purposes (plus state tax breaks in some cases) provided they're used for qualified education expenses.

Qualified expenses include tuition, fees, books, supplies, equipment, and some room and board at most accredited colleges and universities and certain vocational schools. In addition, 529 plans can be used to pay up to $10,000 per year per student for elementary and secondary school tuition. Note that there may be state tax implications with using plan funds for items unrelated to higher-education expenses.

Contributions to 529 plans are removed from your taxable estate and shielded from gift taxes by your lifetime gift and estate tax exemption (currently $11.7 million) or annual exclusions ($15,000 per recipient). If gift taxes are a concern, you can accelerate up to five years' worth of annual exclusions into a single year, allowing you to make nontaxable contributions up to $75,000 per beneficiary in year one rather than spreading them over five years.

529 plans offer the owner a great deal of flexibility. For example, depending on the plan's terms, owners have control over the timing of distributions, can change beneficiaries from one family member to another and can roll the funds over into another state's plan tax-free (limited to once a year). It's even possible to recover funds that won't be used for education expenses (subject to taxes and, in most cases, a 10% penalty).

In addition to the risk that a subsequent owner will use the funds for noneducational purposes, disadvantages of 529 plans include relatively limited investment choices and an inability to invest assets other than cash.

Transfer a 529 plan to a trust

Establishing a family education trust to hold one or more 529 plans provides several significant benefits:

- It permits you to maintain tax-advantaged education funds indefinitely (depending on applicable state law) to benefit future generations and it keeps the funds out of the hands of those who would use them for other purposes.
- It allows you to establish guidelines on which family members are eligible for educational assistance and direct how the funds will be used or distributed in the event they're no longer needed for educational purposes. You can also appoint trustees and successor trustees to oversee the trust.
- It can accept noncash contributions and hold a variety of investments and assets outside 529 plans. For example, the trustees might invest in hedge funds, private equity funds, life insurance or other alternative investments if they conclude that the increased returns would outweigh the tax cost.

A family education trust can also use funds held outside of 529 plans for purposes other than education, such as paying medical expenses or nonqualified living expenses.

Turn to the professionals

Leaving an education legacy for your loved ones and future heirs requires considerable planning but can be incredibly fulfilling for you and beneficial for your family. Turn to your estate planning advisor for guidance in creating a family education trust. •

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You've amended your will yourself

Let's assume you have a legally valid will but you've decided that it should be revised because of a change in your family's circumstances. Perhaps all you want to do is add a newborn grandchild to the list of beneficiaries or remove your adult child's spouse after a divorce. These are both common reasons to revise your will.

Resist the temptation to revise the will yourself. State laws control the validity of your will, and the laws in each state vary, so simply following an online template for revisions isn't certain to suffice.

In addition, the amended will generally must be witnessed and notarized. A notary isn't a replacement for an attorney who knows his or her way around applicable state laws. To ensure the validity of the will, rely on the appropriate professional.

Furthermore, in many states, a will that has provisions crossed out and changed in handwriting won't stand up to legal scrutiny. The same is true for a will with a typed paragraph attached to the original. If someone is then

"cut out" of the will or not added as promised, it could lead to challenges in court and possibly create discontent that causes a rift in the family.

Minor changes to a will can be made through a codicil or an addendum. However, it usually makes more sense to create a brand-new will, especially if changes are substantial or state law requires the same legal formalities for codicils and addendums as it does for a will.

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What You Need to Know About the Uniform Electronic Wills Act

With the world becoming more and more digital, it was only a matter of time before the estate planning industry followed suit. On April 26, 2021, Governor Jay Inslee signed Senate Bill 5132 into law. Among other things, SB 5132 adopted the Uniform Electronic Wills Act (the "Act") effective as of January 1, 2022. Washington joins a growing list of 13 states that allow Electronic Wills, a few of which have also adopted the Uniform Electronic Wills Act. While it remains unclear how popular Electronic Wills will become, it is clear that this represents a major change for estate planning in Washington. The following is a summary of the key points of the Act.

- The Act will apply to those who die on or after the effective date of the legislation (January 1, 2022).
- Just like a regular Will, certain formalities in execution must be observed. An Electronic Will must be in writing ("a record that is readable as text at the time of signing") and signed in the presence, or electronic presence, of two witnesses.
- Under the Act:
    - "Record" means "information that is inscribed on a tangible medium or that is stored in an electronic or other medium and is retrievable in perceivable form."
    - "Sign" means "with present intent to authenticate or adopt a record, to affix to, or logically associate with the record an electronic symbol, an electronic sound, or process."
    - "Electronic Presence" means "the relationship of two or more individuals in different locations communicating in real time to the same extent as if the individuals were physically present in the same location."
- After execution of an Electronic Will, the Will must be stored by a Qualified Custodian. With some exceptions, those eligible to serve as a Qualified Custodian include: Washington residents over the age of 18, certain trust companies, nonprofit corporations, and professional service corporations, as well as Will repositories in the county where the Decedent is domiciled. Heirs, beneficiaries and other parties interested in the Decedent's estate may not serve as a Qualified Custodian.
- It is imperative that custody of an Electronic Will be maintained by a Qualified Custodian with no interruption in custody or the Will will be treated as if it has been lost or destroyed. This presents a significant burden toward getting the Will admitted to probate.
- After execution of an Electronic Will, the Testator may thereafter choose to make a certified paper copy of the Will.

As with any new law, the Act will surely take on new life once it becomes effective. Definitions will be interpreted, provisions will be tested, and we'll begin to better understand how much of a change the Act will mean for estate planning in Washington. One thing is certain, if you plan to utilize the provisions of the Act in 2022 and beyond, it is imperative that you pay close attention to the Act's details to ensure that your Electronic Will is properly executed and maintained.

If you need help with your estate planning, we at Stokes Lawrence would be happy to assist. Please contact a member of the Stokes Lawrence Estate Planning Group at (509) 853-3000 in Yakima or (206) 626-6000 in Seattle.