INSIGHT ON ESTATE PLANNING

Will your will be contested?

Why contingent beneficiaries matter

Net gifts
A gift-giving technique that makes sense in certain situations

ESTATE PLANNING PITFALL
You haven't coordinated your estate plan with your spouse

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Seattle | Yakima

Stokes Lawrence | 1420 Fifth Avenue, Suite 3000 | Seattle, Washington 98101-2393 | 206.626.6000

Stokes Lawrence Velikanje Moore & Shore | 120 N. Naches Avenue | Yakima, Washington 98901-2757 | 509.853.3000

www.stokeslaw.com

Will your will be contested?

If your estate has to be probated, in a perfect world everything will go without a hitch and the assets are distributed to beneficiaries in a timely manner. Everyone is satisfied with their inheritance and family harmony is preserved.

Of course, the world isn't picture perfect. Your will may be challenged based on its validity, its terms or even your mental capacity at the time it was drafted. Although state law generally controls these matters, there are guidelines to follow. Keeping that in mind, let's examine who can contest a will and when and how you may be able to discourage discord.

Who can contest a will?

Your last will and testament, if properly executed, is a road map for an executor to follow. Notably, it includes a legally enforceable mandate as to the distribution of your assets to named beneficiaries. Some bequests are specific, while others may be covered by the residuary clause.

The contest to a will is made in probate court by an "interested party." To contest a will in any state, the person must have legal standing. This ability is restricted to beneficiaries named in the will, those named as beneficiaries in a prior will that have been cut out or that are receiving a reduced inheritance, and anyone else eligible under the state's intestacy laws. Typically, this means a spouse, child or other lineal descendant.

Beneficiaries can't contest a will until they've reached the age of majority in the state (age 18 in most states). However, a parent or guardian can initiate legal action on a younger beneficiary's behalf.

When can a will be contested?

There are several reasons for contesting a will:

Violation of state law. Each state has specific laws governing the wills of its residents. Generally, you must sign the will in the presence of at least two witnesses. All three people must be in the room watching each other

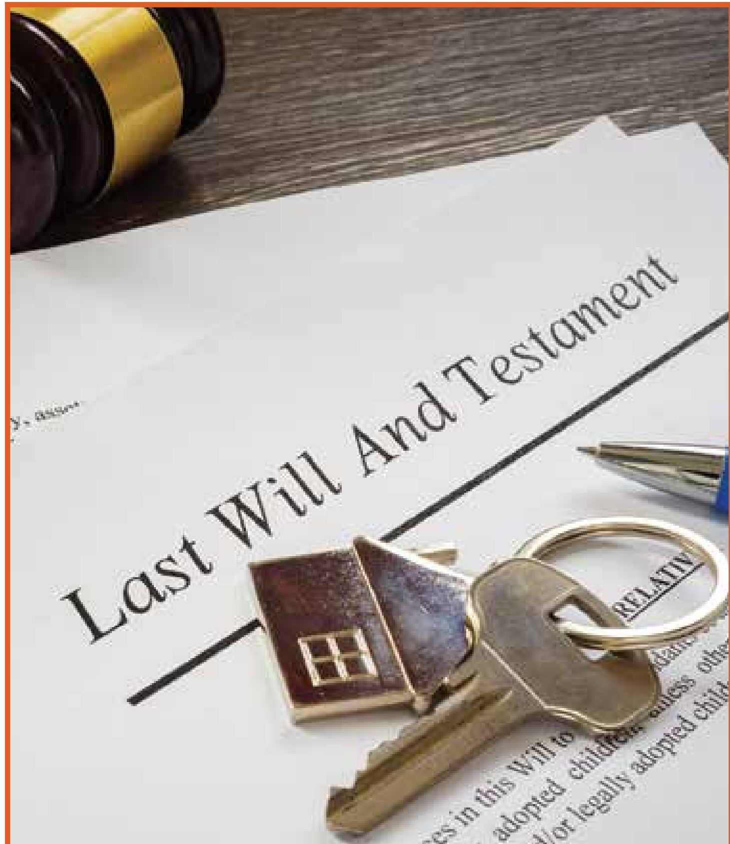
Protections outside of probate

Some types of property — such as retirement plan accounts and IRAs, life insurance proceeds, and property in a living trust — don't have to be probated. They generally pass directly to the named beneficiaries regardless of what the will says.

However, there are certain exceptions. For example, surviving spouses may receive some protection from prevailing laws if they're excluded from retirement accounts, absent a valid waiver. Also, federal laws may protect the rights of an ex-spouse if the testator neglects to change beneficiary designations.

Successful challenges to these beneficiary designations are rare. Nevertheless, to be on the safe side, update your beneficiary choices after major life events, such as marriage, birth of a child or death of a family member.

sign the document. Depending on state law, other technicalities may have to be observed. Don't assume that the will is legally binding just because it was signed in your attorney's office.



Lack of competency. Did the testator (the person who made the will) have the capacity to understand the terms of the signed will? This is another aspect that's governed by state law. It's typically difficult to prove to the court that a testator lacked the requisite mental competency. For example, in some states a person may have dementia and still be treated as having capacity to sign a valid will. Evidence provided by physicians may be critical.

Undue influence. As people get older, they may be more susceptible to being influenced by others, sometimes resulting in revisions or even a complete re-write of a will. The main issue is whether enough pressure was exerted on the testator to cause a loss of free will. For example, this may occur when the influencer isolates the testator from other family members and friends. Note that mere threats, nagging and verbal abuse usually aren't sufficient to uphold a challenge. As with a lack of capacity, this charge generally is difficult to prove under state law.

Fraud. Someone contesting a will may claim that the testator was duped into signing it. Let's say that the testator signs a different document, such as a living will relating to end-of-life decisions and thinks that it's a last will and testament. Or maybe the testator is misinformed about the terms. This type of challenge often relates to mental competency. The testimony of witnesses can be significant in these cases.

A subsequent will. Did the executor probate the latest version of the will? A subsequent will revokes other versions. It's only the last one that counts as long as it meets state requirements. Frequently, a testator modifies or rewrites a will without notifying all the interested parties, leading to a challenge in court. Note that minor modifications included in a codicil don't revoke a prior will but may still muddy the waters.

Practical approach

Be proactive about protecting your estate from will contests. Start by observing all the legal technicalities in your state. Discuss the terms of your will and the reasons for your decisions with your loved ones so they won't be caught by surprise. Use this opportunity to express what they mean to you beyond your worldly possessions. Also, consider the benefits of transferring assets to a living trust. Finally, bring your attorney into the loop. With proper guidance, you can increase the chances of avoiding future conflicts. •

Why contingent beneficiaries matter

Your will is the foundation of your estate plan. Notably, it provides for the disposition of your worldly possessions, including your house, investments and other property. These go to the beneficiaries named in your will. In addition, this foundation is usually supported by documents for trusts, retirement plan accounts and life insurance policies. They also have designated beneficiaries.

But the process may be a little more complicated than it first seems. Of course, you must list the primary beneficiaries in these documents, but it's also imperative to include "contingent" beneficiaries for peace of mind. In fact, some would argue that naming contingent beneficiaries is just as important as the primary selections.

Naming backups

A contingent beneficiary in a will or other legal document is the backup to the primary beneficiary. In other words, in the event the primary beneficiary predeceases you, can't be found or turns down the inheritance, the contingent beneficiary is entitled to the assets.

For example, let's say you select your brother as the primary beneficiary of your vacation home, while you name your sister as the contingent beneficiary. When you pass away your brother inherits the cottage. Conversely, if your brother is no longer alive, it automatically goes to your sister.

Generally, contingent beneficiaries should be named in every applicable situation. They act as a safety net in case the primary beneficiary can't take the distribution.

Avoiding complications

But what happens if you forgo naming contingent beneficiaries? If the primary beneficiary inherits the asset, nothing. However, if the primary beneficiary can't receive the asset, the process can become complicated.

Without a contingent beneficiary, the asset is returned to the estate, where it can be subject to lengthy and costly probate proceedings. Then, the distribution is made according to prevailing state laws even if they run contrary to your wishes. This could result in conflicts among family members and bitterly contested legal actions. Furthermore, a death benefit from a life insurance policy could be paid to the estate, possibly creating estate tax exposure.

Worst of all, you can easily avoid this common estate planning mistake. While there's time, choose contingent beneficiaries. Who should you name as a contingent beneficiary? The choice is purely personal, but there are common themes to observe.

For instance, if the primary beneficiary is your spouse, you can name your children as the contingent beneficiaries. You can bequeath other assets to other family members, friends or charities.

Keep in mind that if a family member listed as a contingent beneficiary is a minor when you die, the court will appoint a legal guardian to manage the assets until the child reaches the age of majority (age 18 in most states). Also note that you can't legally name a pet as a

contingent beneficiary despite your fondness for your animal companion.

Understanding beneficiary forms

The rules for trusts generally mirror those for wills. But know that the beneficiary forms for retirement plan accounts, life insurance policies and annuities control the disposition of those assets, regardless of what your will says. Thus, be sure that you complete the contingent beneficiary assignments for the assets and modify or update them when needed.

Frequently, a retirement account, IRA or life insurance policy will list multiple contingent beneficiaries. Each beneficiary is designated a specific percentage of the money, so the percentage must add up to 100%. For example, you might name five grandchildren to each receive 20% of an IRA.

Otherwise, a contingent beneficiary receives assets in the same manner as is intended for the primary beneficiary. Thus, for example, if the primary beneficiary was set to receive $10,000 a year for 10 years, for a total of $100,000, the contingent beneficiary would receive the money over the same payment schedule.

How many contingent beneficiaries should you name? Again, the choice is a personal one, but it's usually a good idea to have more than one, especially if you have a relatively long life expectancy. In some cases, such as for a life insurance policy, there may be a limit on the number of contingent beneficiaries allowed.

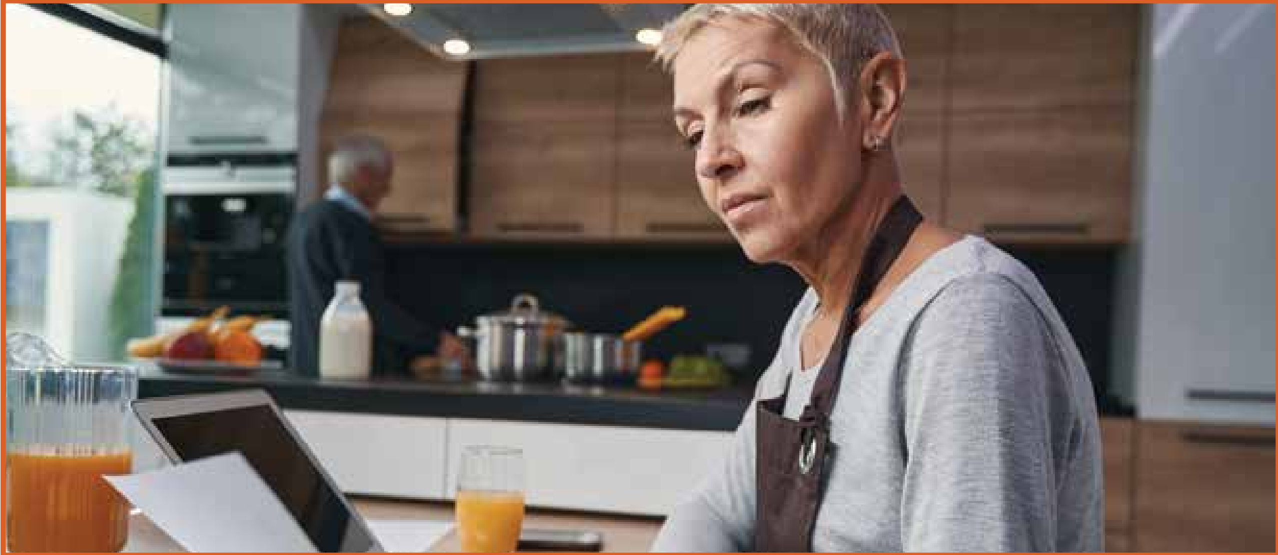
Choose carefully

When choosing contingent beneficiaries, don't make these decisions in a vacuum. Consider this to be a critical part of your overall estate plan. For help coordinating these important choices, contact your estate planning advisor. •

Net gifts

A gift-giving technique that makes sense in certain situations

Lifetime giving is a smart strategy to reduce your taxable estate. However, if you've exhausted your $12.06 million federal gift and estate tax exemption, your gifts may be fully taxable at the 40% rate. In this case, consider making "net gifts." This technique requires your recipient to agree to pay the gift tax as a condition of receiving the gift, thus reducing the gift's value for gift tax purposes.



Benefits of a net gift

The easiest way to demonstrate the benefits of a net gift is through an example. Suppose you wish to make a $1 million gift to your adult son. For purposes of this example, also assume that you've already exhausted your federal gift and estate tax exemption amount, so the gift is fully taxable. At the current 40% marginal rate, the tax on your $1 million gift would be $400,000. However, if your son agrees to pay the gift tax as a condition of receiving the gift, then the value of the gift would be reduced by the amount of tax, which in turn would reduce the amount of gift tax owed.

Rather than get caught up in an endless loop of calculating the tax, reducing the gift's value, recalculating the tax, and so on, there's a simple formula for determining your son's tax liability: Gift tax = tentative tax/(1 + tax rate). In our example, the tentative tax is $400,000 (the tax that would have been owed on an outright gift), so the gift tax on the net gift would be $400,000/1.4 = $285,714. You can confirm that the math works by assuming that you give your son $1 million and that he agrees to pay $285,714 in gift tax. That tax liability reduces the gift to $1 million - $285,714 = $714,287, resulting in a tax liability of .40 x $714,287 = $285,714.

By using a net gift technique, you reduce the effective tax rate on the $1 million transfer from 40% to only 28.57%. Note that if the gift is in the form of appreciated assets rather than cash, the recipient's payment of the tax liability can result in capital gains taxes for the donor.

Double down with a net, net gift

It may be possible to reduce the effective gift tax rate even further by using a net, net gift. Using this technique, in addition to assuming liability for gift taxes, the recipient also agrees to pay any estate tax liability that might arise by virtue of the so-called "three-year rule." Under that rule, gifts made within three years of death are pulled back into the donor's estate and subject to estate taxes.

It may be possible to reduce the effective gift tax rate even further by using a net, net gift.

Another option

Going back to our example, suppose you'd like to take advantage of the net gift technique, but you'd like your son to enjoy the benefits of the full $1 million gift. It's possible for you

to finance the net gift by lending your son the $285,714 he needs to cover the gift tax liability. To ensure that the loan is respected by the IRS, and not challenged as an additional gift, it's important to charge interest at the applicable federal rate (AFR) or higher and to execute a written promissory note.

Meet with your estate planning advisor

Making net gifts may make sense if you've used up your gift and estate tax exemption amount. But be aware that it's important to properly document the transactions to avoid IRS scrutiny. Your estate planning advisor can help your net gifts pass muster with the IRS. •

ESTATE PLANNING PITFALL

You haven't coordinated your estate plan with your spouse

Estate planning can be complicated enough when you don't have a spouse. But things can get even trickier for married couples. Although you and your spouse may have agreed on most major issues in the past — such as child rearing, where to live and other lifestyle choices — you shouldn't automatically assume that you'll both be on the same page when it comes to making critical estate planning decisions.

Even worse, one spouse may plunge ahead without the knowledge or approval of the other, to the eventual detriment of the family. It's important for each spouse to clearly communicate their estate planning goals.

Start with the basic premise that state law generally governs estate matters. Therefore, state law determines if your property is community property, separate property or tenancy by the entirety. For instance, California is a community property state. That means that half of what you own is your spouse's property and vice versa. There's no circumventing this law when planning for a joint estate.

Next, consider your family's dynamics. Emotions can run high and tension may result when a family includes children from a prior marriage. If these issues aren't addressed beforehand, it could lead to legal squabbles.

Don't forget about the tax implications. Currently, married couples can take advantage of generous tax law provisions that shelter most estates from tax. Incorporate estate tax minimization techniques into a coordinated plan.

Decide on distributions of assets to designated beneficiaries. You may intend, for example, for expensive jewelry to go to one child, but your spouse might have other ideas.

Indeed, clear communication is essential for married couples when developing their estate plans. Your estate planning advisor can help ensure that you and your spouse both have plans that work in harmony.

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Seattle | Yakima

Stokes Lawrence, P.S.
1420 5th Avenue, Suite 3000
Seattle, Washington 98101-2393
206.626.6000

Stokes Lawrence
Velikanje Moore & Shore
120 N. Naches Avenue
Yakima, Washington 98901-2757
509.853.3000

www.stokeslaw.com

Careful Estate Planning for Parents of Minor Children

Many parents of young children forego estate planning, whether it's because they are in good health and don't see the need, feel their wealth doesn't justify investing in a comprehensive estate plan or are simply overwhelmed with the day to day of parenting. For those with minor children especially, estate planning is vitally important as it ensures that their children will be cared for - financially, physically, and emotionally.

Guardian Selection

Perhaps the most important estate planning decision for parents of young children is who will serve as guardian if the parents become incapacitated or die? A guardian is given all of the responsibility and power of a parent, and makes critical decisions about the children's medical care, schooling, and general upbringing. Selecting a guardian may seem complicated, but with careful reflection, it can be simple. The following are some important considerations in selecting a guardian:

- Where does the potential guardian live? If there is a need for a guardian, the children have just experienced a tragic loss. Uprooting an older (e.g., teenage) child's life may be much more disruptive than for an infant or toddler. It's important to select a guardian who can provide stability for the child in this challenging time, and where the guardian lives should be taken into consideration.
- Will the potential guardian be physically and mentally able to care for the children until adulthood? Consider the age, health, and lifestyle of the potential guardian. Is the potential guardian able and willing to make the commitment necessary to raise the children?
- Is the potential guardian financially stable? Will the addition of children to the guardian's household cause an undue burden? How can funds be made available to ease this burden for the guardian?

Distribution of Assets

Many parents are disinclined to give their children unfettered access to wealth at age 18, and instead opt to delay full distribution of their estate. Typically, this is accomplished through a trust or a Uniform Transfers to Minors Act (UTMA) account.

At its core, a trust is a legal arrangement in which the donor appoints a trusted adult or institution, called the trustee, to manage the assets for the beneficiary's benefit until the trust's termination (which is tied to a triggering event, such as reaching a particular age or obtaining a post-secondary degree). During the trust term, distributions can be made for the beneficiary's health, education, and support, and additional distributions may be authorized for such things as buying a home or establishing a business. Compared to UTMA accounts, trusts offer additional flexibility, but come with additional administrative obligations and are therefore better suited to larger gifts.

For smaller gifts or for those individuals who are averse to the complexity of a trust, a UTMA account is an alternative arrangement that operates similarly to a trust, but with less flexibility. UTMA accounts are created by delivering property to a person or institution "as custodian for" the beneficiary. Distributions are allowed only for the beneficiary's health, education, and support, and state law dictates that a UTMA account terminate when the beneficiary reaches age 18, 21, or 25, depending on the form of the gift.

Coordinating Non-Probate Assets

There are certain assets, often of significant value, that pass to beneficiaries separate from a Will. These assets are known as "non-probate" assets and include life insurance, retirement accounts, and joint tenancy accounts. Non-probate assets pass to the named beneficiary or according to the account titling at the time of your death. For these assets, ensuring the beneficiary designations are consistent with the overall estate plan is critical. Otherwise, assets left directly to minor children will be available to them at age 18, bypassing the careful planning contained in a Will.

Creating an estate plan makes sense for everyone, no matter their situation. But for families with young children, it is absolutely essential. If you are interested in creating an estate plan, or updating your current estate plan, please contact a member of the Stokes Lawrence Estate Planning Group at (206) 626-6000 in Seattle or (509) 853-3000 in Yakima.