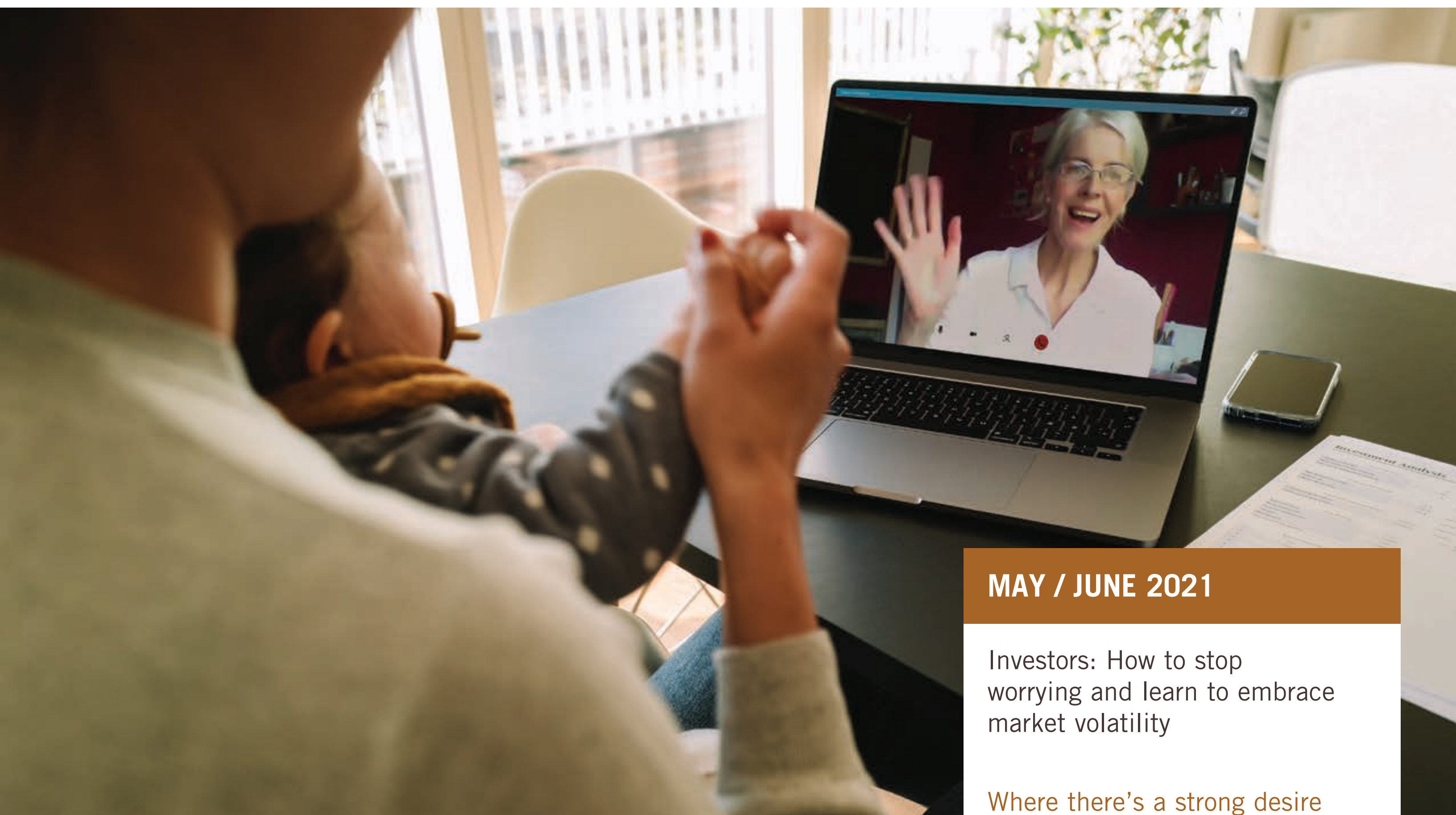
WEALTH MANAGEMENT **ADVISOR**



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POWER YOUR ESTATE PLAN WITH A WEALTH REPLACEMENT TRUST

Power your estate plan with a wealth replacement trust

For many people, charitable giving is an important component of their estate planning. But although sharing your wealth with the organizations you care about can be highly rewarding, you may be hesitant to reduce the amount you'll leave for children and grandchildren.

One potential solution to this dilemma is to establish a wealth replacement trust (WRT). This type of trust leverages life insurance to replace the value of donated assets, thus allowing you to meet your charitable goals without shrinking your family's inheritance.

How it works

Typically, this strategy works by pairing a charitable remainder trust (CRT) with a WRT. The CRT is an effective vehicle for making a testamentary gift to charity while generating income and tax savings. Income from a CRT can be used to finance the purchase of life insurance. To do so, the funds are contributed to the WRT, which is an irrevocable life insurance trust (ILIT). The funds are then used to purchase a policy on your life (or the lives of you and your spouse) for the advantage of your beneficiaries.

When you die, or the second of you and your spouse dies, the CRT assets pass to the charity you've selected. At the same time, the insurance proceeds are paid to the WRT, which distributes the funds or otherwise uses them on behalf of the trust's beneficiaries.

CRT benefits

A CRT is an irrevocable trust that provides one or more charitable beneficiaries with a remainder interest. In a typical arrangement, you would contribute stock or other assets to the trust. Then, the trust would pay you (or you and your spouse) an income stream for life — usually a fixed percentage of the trust's value, recalculated annually. At the end of the trust's term, the remaining assets would be distributed to the charitable beneficiaries.

SHOULD YOU TRANSFER AN EXISTING POLICY?

It's possible to transfer an existing life insurance policy to a wealth replacement trust (WRT), but there are some risks involved:

- Under the "three-year rule," if you die within three years after the transfer, death benefits will be pulled back into your estate and potentially exposed to estate taxes.
- To effectively remove a policy you already own from your estate, simply transferring it to a WRT isn't sufficient.
- Be careful to relinquish all "incidents of ownership," such as the power to change beneficiaries or borrow against the policy's cash value.

To avoid potential mistakes, consider contributing cash to the WRT and have the trustee use the funds to purchase a policy on your life.

CRTs offer several cash flow benefits that can be used to buy life insurance. In addition to receiving periodic income payments, your contribution to the trust generates a charitable income tax deduction equal to the present value of the charitable beneficiaries' remainder interests. Even greater income tax savings may be available if you contribute appreciated property that would otherwise be subject to capital gains taxes if sold. As a tax-exempt entity, the CRT can sell capital assets tax-free and reinvest the proceeds in income-producing assets (you may be subject to income tax on some or all distributions).

Setting up a WRT

Although it's possible to replace wealth with a stand-alone life insurance policy, setting up a WRT to hold your policy can offer some important benefits. For one thing, if you own the policy, then the proceeds will be included in your taxable estate. This may reduce the policy's wealth replacement power. By contrast, if your policy is owned by a properly structured WRT, the death benefit bypasses your estate (although contributions to the trust to cover premium payments are subject to gift tax). Also, using a WRT allows you to place conditions on distributions to your beneficiaries.

Note that it's possible to transfer an existing life insurance policy to a WRT, but it can be risky. (See "Should you transfer an existing policy?" on page 2.) So unless you're uninsurable, you probably should make cash gifts to the WRT for the purchase of a new policy.

Case in point

The following hypothetical example illustrates the advantages of this strategy. Susan wishes to donate $2 million to her alma mater. But she's reluctant to deprive her children of those funds. She contributes $2 million to a CRT for the university's benefit, which invests the money in conservative income-producing investments.

Susan also establishes a WRT, naming her children as beneficiaries. She makes cash gifts each year to the trust (financed in large part by income from her CRT). The WRT's trustee uses these gifts to purchase a $2 million insurance policy on Susan's life. When she dies, the CRT distributes its assets to the university and the insurance company pays the death benefit to the WRT. This money, which replaces the charitable donation, can then be used by the trustee to benefit Susan's children.

Is it right for you?

Properly designed, the combination of a CRT and WRT may allow you to make substantial charitable donations without reducing the size of your estate. To determine whether this strategy is right for you, you'll need to determine whether you qualify for the amount of life insurance you need — and what it will cost. You'll also need to analyze the projected numbers, including costs associated with preparing tax returns and trust documents. Talk to your tax and estate planning advisors about how to proceed. ■

Investors: How to stop worrying and learn to embrace market volatility

The year 2020 saw extraordinary fluctuations in stock prices, including precipitous declines when COVID-19 first began spreading in the United States, followed by record highs. Although volatility can be unsettling, it has always played a part in financial markets. So, it's important not only to accept volatility, but to embrace the opportunities it can offer.

Have a plan and stick with it

A tumultuous market can be stressful, and it may be tempting to reduce your exposure to equities when stocks are riding a particularly scary roller coaster. Even though reallocating the contents of your portfolio may help you avoid some downside, it's equally likely to cause you to miss out on stock surges. In the long run, this can damage performance even more than suffering stock slides.

Instead, learn to live with volatility by adopting a deliberate, long-term investment approach. There are no guarantees and it's always possible to lose your initial investment. But history has shown that a well-diversified portfolio, with the appropriate mix of stocks and bonds, tends to perform well over the long term. This is despite periodic — and sometimes severe — declines.

Not only should you resist the temptation to sell stocks when the market's unsettled, you might consider buying more of certain stocks when prices are low. This can help position you for future gains. Again, there's solid historical evidence that investing during periods of steep market declines results in stronger long-term performance.

Adopt dollar cost averaging

One way to adopt these strategies is to invest at regular intervals — regardless of what the market is doing — rather than invest only when you think the time is right. This systematic approach takes emotion out of the equation and helps you resist the urge to participate in market timing.

Dollar cost averaging is a systematic way to invest fixed amounts at regular intervals — for example, $1,000 per month in the same mutual fund or IRA portfolio. Contributing a portion of your paycheck to a 401(k) plan is another form of dollar cost averaging. As prices fluctuate, investing the same dollar amount each time means that you buy more shares when prices are low and fewer shares when prices are high, thus reducing your average cost-per-share and taking advantage of price swings. Note that dollar cost averaging doesn't guarantee profits or protect against losses. Before signing up, you should consider your ability to continue making purchases through all periods.

Rebalance regularly

You've probably carefully allocated your investment dollars among a mix of asset types based on your risk tolerance, investment objectives and personal circumstances. However, your asset mix may get out of balance over time as certain assets outperform or underperform others. For this reason, you need to monitor your portfolio's asset allocation and rebalance it when appropriate.

Just keep in mind that rebalancing doesn't guarantee profits or protect against losses. And rebalancing can have tax consequences if, for instance, you sell appreciated assets and reinvest the proceeds. But market downturns can create opportunities to rebalance your portfolio at a lower tax cost.

Keys to managing risk

One other thing is essential if you're going to ride out market storms: Maintain an emergency fund — particularly if you're retired or approaching retirement. You don't want to have to sell investments at a loss during a market downturn for living expenses. It's far better to tap an emergency fund while giving your investments time to recover.

Market downturns can create opportunities to rebalance your portfolio at a lower tax cost.

Indeed, the more time you have, the easier it can be to live with market volatility. Talk to your financial advisor about minimizing risk as you approach retirement or another goal. This may entail portfolio rebalancing and other strategies that make your holdings less vulnerable to the market's inevitable ups and downs. ■

Where there's a strong desire to retire, there's FIRE

What number do you think of when you hear "early retirement?" 60? Possibly 50?

How about 35 or 40? Some people that young are leaving the workforce for good thanks to a relatively new strategy called FIRE (for Financial Independence, Retire Early). No, we're not just talking about the founders of hot tech startups. FIRE is used by ordinary people who save aggressively by living a frugal lifestyle. Here's how you can follow FIRE — or just adopt some of its principles.

Setting a goal

FIRE strategies start with maximizing retirement savings. Adherents commonly set aside *at least* 10% of their gross income for retirement. Those who hope to retire in their 30s or 40s may save as much as 70% or 80% of their current income for retirement. Depending on your responsibilities for children and other family members, that may sound like a tall order. But there are several strategies anyone can follow to maximize savings and retire earlier than they originally anticipated.

Start with an aggressive savings goal. Just keep in mind that it's one thing to set lofty goals, such as saving half of your income for retirement, and another to actually transfer that money to savings every month. To succeed, put your savings goals in writing, along with the procedures you'll follow.

For example, if you want to save 30% of current income for retirement, calculate how much money that is and write it down. Then determine benchmarks for how much money you should have saved by the time you reach certain ages so you can monitor your progress toward your long-term retirement goal.

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A good way to accomplish your goal is to arrange for automatic transfers into a retirement plan each pay period or month. Consider contributing a fixed percentage (rather than a fixed dollar amount) of your earnings into your employer's 401(k) plan. By doing so, with each raise or bonus, a portion will go to your retirement (assuming you're not at the maximum allowed). Also, don't pass up matches offered by your employer.

Finding the money

Many people are surprised to learn how much money they spend on nonessential items when they actually scrutinize their expenses. You might, for example, be able to disconnect your cable TV or downgrade your mobile phone package. Dramatically slash discretionary expenses, such as what you spend on entertainment tickets, restaurants and take-out coffee. Keep your vehicles well maintained so you can drive them for 10 years or longer and think long and hard about buying anything that isn't a "need."

You may also be able to boost income by, for instance, selling merchandise on sites such as Amazon and eBay or driving for a ride-sharing service. What about offering dog-walking services to neighbors?

It's important to recognize that expense-cutting and income-boosting activities probably won't get you to your goal if you're carrying excessive consumer debt. Strive to eliminate nonmortgage debt as soon as possible, starting with high-interest credit cards. Many FIRE devotees also put extra money toward their mortgage principal each month so that they can be mortgage-free by the time they retire.

Everyone can benefit

Obviously, not everyone can afford to retire before the typical retirement age of 65. But if you're young, out of school and employed, you might want to give it a shot. Everyone else can strengthen personal finances and advance their retirement goals by adopting FIRE principles. Talk to your financial advisor about building a retirement plan that makes sense given your personal circumstances. ■

Once-in-a-lifetime opportunity

Moving IRA funds to an HSA

Did you know that you can transfer funds directly from your IRA to a Health Savings Account (HSA) without taxes or penalties? According to the IRS, you're permitted to make one such "qualified HSA funding distribution" during your lifetime.

Ordinarily, if you have an IRA and an HSA, it's typically a good idea to contribute as much as possible to both to make the most of their tax benefits. But if you're hit with high medical expenses and have an insufficient balance in your HSA, transferring funds from your IRA may be a solution.

Help with health care costs

An HSA is a savings account that can be used to pay qualified medical expenses with pre-tax dollars. It's generally available to individuals with eligible high deductible health plans. Currently, the annual limit on tax-deductible contributions to an HSA is $3,600 for individuals with self-only coverage and $7,200 for individuals with family coverage. If you're 55 or older, the limits are $4,600 and $8,200, respectively. Those same limits apply to an IRA-to-HSA transfer, reduced by any contributions already made to the HSA during the year.

Here's an example illustrating the potential benefits of a qualified HSA funding distribution from an IRA: Joe is 58 years old, with a self-only, high deductible health plan. In 2021, he needs surgery for which he incurs $5,000 in out-of-pocket costs. Joe is strapped for cash and only has $500 left in his HSA, but he does have a $50,000 balance in his traditional IRA. Joe may move up to $4,600 from his IRA to his HSA tax- and penalty-free.

Other considerations

If you decide to transfer funds from your IRA to your HSA, keep in mind that:

- The distribution must be made directly by the IRA trustee to the HSA trustee,
- Funds transferred to the HSA aren't tax-deductible, but because the IRA distribution is excluded from your income, the effect is the same (at least for federal tax purposes), and
- A transfer counts toward your maximum HSA contribution for the year.

This is a once-in-a-lifetime opportunity. However, if you make a distribution during a month when you have self-only coverage, you can make another one in a later month in the *same* tax year if you change to family coverage.

These transfers are relatively straightforward. But if you're contemplating an IRA-to-HSA move, consult your financial advisor for specific advice. ■

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