John Hancock
LIFE INSURANCE

Sales Strategy

Estate Planning for Non-Citizens in the United States

SINGLE LIFE SPOUSAL ACCESS TRUST: A LIFE INSURANCE ALTERNATIVE

As large numbers of people from other countries settle in the United States (U.S.) the need for estate planning for non-citizens has been increasing. Non-citizens who reside in the U.S. are referred to as resident aliens (RAs). Non-citizens that are in the U.S., but permanently reside in a country outside the U.S. are referred to as non-resident aliens (NRAs). Generally, transfers of world-wide assets owned by RAs are taxed the same way as are transfers by U.S. citizens. In contrast, NRAs are generally only taxed on transfers of real or tangible personal property located within the United States.[1]

A non-citizen's residency (for gift and estate tax purposes) is primarily determined by the persons domicile. Domicile is based on a non-citizen's subjective intent to remain in the U.S. indefinitely.[2] The government may look at a number of factors to establish domicile including a non-citizen's permanent home, business interests, green card and real or tangible personal property located in U.S.

RAs can use the $5,000,000 gift exemption (scheduled to drop to $1,000,000 on January 1, 2013)[3] and the standard annual gift tax exclusion (currently $13,000) during their lives. Neither RAs nor NRAs qualify for the unlimited gift tax marital deduction that is available to U.S. citizens. However, annual gifts to a non-citizen spouse by a spouse who is a U.S. citizen, can qualify for a current annual exclusion of $139,000 in 2012.

RAs in the U.S. do have the benefit of the full applicable credit amount against U.S. estate taxes. NRAs only have a limited amount of credit available to offset U.S. estate taxes. Beyond these exemptions, non-citizens are subject to the same gift and estate tax rates that are levied on U.S. citizens. However, the unlimited estate tax marital deduction that is available to U.S. citizens is not available to estates where the surviving spouse is not a U.S. citizen. In order to obtain the estate tax marital deduction on transfers to a surviving spouse who is a non-citizen, a trust known as a Qualified Domestic Trust, or QDOT, must be established.

The chart below illustrates the major similarities and differences between estate planning for a U.S. citizen, as opposed to planning for a non–U.S. citizen for 2012.

	TRANSFERS TO A NON-CITIZEN	TRANSFERS TO A U.S. CITIZEN
Annual Gifts To Spouse	$139,000	Unlimited Marital Deduction
Annual Exclusion Gifts	$13,000	$13,000
Lifetime Exemption for Gifts	$5,120,000*	$5,120,000*
Unlimited Marital Deduction	No, unless QDOT is established	Yes

*During 2011 and 2012 only, taxpayers have a lifetime exemption of $5,000,000 indexed for inflation, meaning that each taxpayer may give away up to a total of $5,000,000 during lifetime. Effective January 1, 2013, the lifetime exemption will be reduced to $1,000,000.

A more flexible planning solution for non-citizen spouses.

Planning for Non-citizen Spouses. It is important to remember that the citizenship of the spouse who is the beneficiary of the marital trust makes a difference for tax planning purposes, not the citizenship of the donor spouse. For example, in a situation where a husband is a U.S. citizen and a wife is not a U.S. citizen, the husband's will or living trust should contain QDOT provisions, whereas the wife's will or living trust can provide for a typical marital trust, known as Qualified Terminable Interest Property Trust, or QTIP Trust.[4]

QDOT Requirements. The QDOT must have at least one U.S. trustee (a U.S. individual or corporation), and must also satisfy the general marital deduction requirements of U.S. estate tax law under Section 2056 of the tax code. Income distributions to the surviving spouse from the QDOT trust will *not* be subject to estate tax, but distributions of principal to the surviving spouse *will* be subject to estate tax, unless the distributions are made on account of hardship. In some cases, if a non-citizen couple is preparing their estate plan and they are planning to become U.S. citizens in the near future, they may not need to have QDOT provisions in their living trusts; if they die before they actually become U.S. citizens, their executor can elect post-mortem for their marital trusts to qualify as QDOTs.

OTHER PLANNING CONSIDERATIONS FOR NON-CITIZEN SPOUSES

Jointly Owned Property. For U.S. citizens, when the first spouse dies, the estate will generally only include 50% of jointly owned property. However, for non-citizen spouses, the entire value of a joint interest will be included in the estate of the first spouse to die, reduced by contributions which the estate can prove were supplied by the surviving spouse. As a result, it may be a good idea to "undo" joint ownership of assets during both spouses' lives, if it is expected that they will have a taxable estate.

Retirement Assets. Since assets passing to a non-citizen surviving spouse will only receive the marital deduction if they are included in a QDOT, one of the best options for a non-citizen surviving spouse who receives qualified plan assets or IRA assets is to rollover the plan benefits into an IRA-QDOT. The IRA-QDOT will allow the surviving spouse to continue deferring income tax on the retirement assets that remain in the IRA and receive income from the IRA estate tax free. However, principal distributions to the surviving spouse will be subject to both estate and income tax, as with a standard QDOT.

Single Life Spousal Access Trust: A Life Insurance Alternative for Non-Citizens

Since the unlimited marital deduction is not generally available for non-citizen spouses (and a QDOT provides only a partial marital deduction), a Single Life Spousal Access Trust can provide many of the benefits of a marital trust, but can be simpler and more tax efficient than a QDOT in some cases. A QDOT requires complicated drafting in the trust document as well as additional trustee and security requirements and estate tax on the principal distributions. A Spousal Access Trust can provide liquidity for the benefit of a non-citizen spouse and can be drafted and administered the same way for non-citizens as it is for U.S. cititzens. A Single Life Spousal Access Trust funded with a life insurance policy can also provide supplemental income for a non-citizen spouse, while keeping all of the trust assets outside of the taxable estate.

WHAT IS A SPOUSAL ACCESS TRUST?

A Spousal Access Trust is a type of Irrevocable Life Insurance Trust (ILIT) that enables the spouse of the grantor to receive distributions from the trust during his/her lifetime. Married couples often create ILITs to replace income in the event of an untimely death, pay estate taxes and other expenses of estate administration, and to equalize inheritances among their children. An ILIT cannot be revoked, altered, or amended by the grantor (i.e., the party creating the ILIT) after it is created, and the trust typically names the children of the grantor(s), and in some cases the grandchildren of the grantor(s), as the beneficiaries of the trust. A Spousal Access Trust names the spouse of the grantor, in addition to the children of the grantor, as a trust beneficiary. As long as the trust is drafted and administered correctly, all of the trust assets will be kept outside of the taxable estate. A variable life insurance policy, which has the potential for high cash value accumulation during the insured's lifetime, can be an ideal choice for funding a Spousal Access Trust.

HOW DOES A SPOUSAL ACCESS TRUST WORK?

Each person is allowed to make annual exclusion gifts up to $13,000 per person each year without having to pay gift taxes. The grantor of the trust will make annual exclusion gifts each year to the trust and can also use the $5,000,000 gift exemption, if necessary. The trustee of the Spousal Access Trust will use the gifts to purchase a life insurance policy on the grantor's life. The trust, as the owner and beneficiary of the policy, will receive the policy death benefit free of estate and income taxes, and the policy cash value will grow inside the trust during the grantor's life.[5] The trust document will typically provide that distributions can be made from the trust to the grantor's spouse and children, usually for health, education, maintenance and support.

BENEFITS

- The trust will receive the death benefit free from income and estate taxes.
- An irrevocable trust can protect assets from creditors and protect the family's privacy.[6]
- When gifts are used to purchase life insurance, lifetime giving can increase the amount of money left for the heirs.
- A Spousal Access Trust allows distributions to the grantor's spouse and children during his/her lifetime, allowing access to the policy cash value.
- The trustee can make distributions to provide supplemental retirement income for the grantor's spouse via policy loans and withdrawals.

CONSIDERATIONS

- Transfers of assets to an ILIT are irrevocable, and may only be used for the benefit of the trust beneficiaries.
- Taking policy loans and withdrawals from a life insurance policy during the insured's lifetime can reduce the available death benefit and cash value, and may cause the policy to lapse. Cash value available for loans and withdrawals may be more or less than the amount originally invested, and lapse or surrender of a policy with a loan may cause the recognition of taxable income.
- Variable universal life insurance has annual fees and expenses associated with it in addition to life insurance related charges (which differ with the product chosen), including surrender charges and investment management fees. Variable universal life insurance products are long-term contracts and are sold by prospectus. They are subject to market risk due to the underlying sub-accounts, and are unsuitable as a short-term savings vehicle. The primary purpose of variable universal life insurance is to provide lifetime protection against economic loss due to the death of the insured person. Cash values are not guaranteed if the client is invested in the investment accounts. There are risks associated with each investment option, and the policy may lose value.
- Policies classified as modified endowment contracts may be subject to tax when a loan or withdrawal is made. A federal tax penalty of 10% may also apply if the loan or withdrawal is taken prior to age 59½ from a modified endowment contract.
- Life insurance death benefit proceeds are generally excludable from the beneficiary's gross income for income tax purposes. There are a few exceptions such as when a life insurance policy has been transferred for valuable consideration.
- Gifts to the trust may qualify as annual exclusion gifts if they are present interest gifts (gifts in which the donee has all immediate rights to use, possession and enjoyment, including income). The beneficiary should have Crummey rights over the gift, allowing them to demand within a specified period that the trustee transfer their share of the gift.
- If both members of a married couple are each creating Single Life Spousal Access Trusts, they should take care to avoid possible application of the reciprocal trust doctrine, which was developed to prevent tax avoidance. If the courts determine that the grantors created related trusts in exchange, the trust will be includable as part of the estate of its beneficiary.

CASE STUDY: ROBERT JACKSON AND ANNA ARISTONDO

Robert Jackson and Anna Aristondo, both age 45, have settled in Michigan with their family and a growing business. Although Robert is an American citizen, Anna is a Spanish citizen and is not planning to change her citizenship. Robert would like to be able to provide for Anna and their three children after his death, and would also like to supplement their retirement income during his life. For Robert, the Spousal Access Trust can provide a solution to his dilemma. Robert can make annual exclusion gifts of $29,188 a year to a Spousal Access Trust. The trust will purchase a $1,000,000 Protection VUL policy on Robert's life (Non Smoker, Preferred Risk), and will fund the policy with a $29,188 premium for 10 years. Anna will be the trustee during her life. In her estate plan, Anna can establish a typical marital trust (QTIP trust) for the benefit of Robert, and if necessary, they can also consider purchasing a survivorship life insurance policy for additional liquidity.

If anything should happen to Robert today, Anna and the children will be protected by the death benefit. However, during Robert's lifetime, the trustee could also make distributions to Anna and the children for their health, education, maintenance and support, and may use the policy cash value for this purpose. By the time Robert retires in 20 years at age 65, the policy's cash value is projected to be $603,130. Based on current projections, the policy would remain in force until Robert attains age 100. The illustrated amount assumes the payment of an annual premium of $29,188 for 10 years, a growth rate of 7.46% net of investment fees and current charges.

YEAR	ANNUAL GIFT	ANNUAL PREMIUM	NET CASH SURRENDER VALUE (7.46% NET GROWTH RATE)	NET DEATH BENEFIT (OPTION 2)
1	$29,188	$29,188	$13,303	$1,025,303
10	$29,188	$29,188	$344,929	$1,345,229
20	$0	$0	$603,130	$1,603,130
30	$0	$0	$1,093,286	$2,093,286
40	$0	$0	$1,974,775	$2,974,775

This is a supplemental illustration authorized for distribution only when preceded or accompanied by a basic illustration and appropriate prospectuses. The data shown is taken from the accompanying illustration, the purpose of which is to show how the performance of the underlying investment accounts could affect the policy cash value and death benefit. It assumes a hypothetical rate of return and/or current interest crediting rate and may not be used to project or predict investment results. Unless indicated otherwise, these values are not guaranteed.

This material is authorized for distribution only when preceded or accompanied by the appropriate client guide, product and fund prospectuses. The prospectuses contain complete details on investment objectives, risks, fees, charges and expenses as well as other information about the investment company. Please read the prospectuses carefully containing this and other information on the product and the underlying portfolios and consider these factors carefully before investing. This material is not intended as investment advice.

SUMMARY

While the QDOT exists as an option for married couples in which one or both members is not a U.S. citizen, a Spousal Access Trust is an alternative that can provide greater flexibility and liquidity, as well as the estate and income tax benefits of a traditional ILIT. A Spousal Access Trust can be used for couples where only one member is a U.S. citizen or in situations where both members of the couple are non-citizens. A Spousal Access trust can also provide non-tax benefits, such as creditor protection for the beneficiaries and professional management of trust assets. Variable life insurance products, with the potential for high cash value accumulation inside of the policy, can be an excellent choice for funding a Spousal Access Trust. Our JH Solutions software can provide a comprehensive client presentation for demonstrating the benefits of a Spousal Access Trust.

For more information on Spousal Access Trusts or JH Solutions, please contact your local John Hancock representative or call the Advanced Markets Group at 1-888-266-7498, option 3.

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1. U.S. gift tax (see IRC 2501(a) 1 & 2511(a)) / U.S. estate tax (see IRC Sections 2101(a) and 2106(a)).
2. Treas. Regs. 20.0-1(b) (1), 25.2501-1(b). Note the residency test for gift and estate tax for RAs is different than the income test for RAs, which focuses on the physical presence of the RA. This means that a non-citizen RA may be classified as a citizen for income tax purposes but not for gift and estate tax purposes.
3. Under the current law, which is based on the "Unemployment Insurance Reauthorization and Job Creation Act of 2010," the maximum estate tax rate is 35% with a $5,000,000 exemption for each individual. For 2012, this $5,000,000 will be indexed for inflation, taking into account inflation that occurred from January 1, 2010, through December 31, 2011. The $5,000,000 exemption amount can be used either during lifetime, as a gift tax exemption amount, or at death as an estate tax exemption. In addition, each individual has a $5,000,000 exemption to the generation-skipping transfer (GST) tax; this $5,000,000 can be used during life or at death. If an individual passes away with an unused amount of exemption remaining, that individual's surviving spouse can use the unused amount to shelter a transfer from either gift or estate taxes. Effective January 1, 2013, the exemption amount for each of the gift, estate and GST taxes will drop to $1M and the top tax rate for each will be 55%.
4. The requirements for a QDOT are set forth in Internal Revenue Code Section 2056A. The election for treatment as a QDOT must be made on the decedent's estate tax return. If the value of the QDOT assets exceeds $2 million, it is considered a large QDOT and must either a) name a U.S. bank or trust company to act as trustee or b) furnish a bond or letter of credit in the amount of 65% of the QDOT. Treas. Regs. 20.2056-2.
5. See IRC Section 2041. To avoid giving the beneficiary spouse any incidents of ownership with a Survivorship Spousal Access Trust, the authority to make distributions to the surviving spouse may need to be limited to an independent trustee with absolute discretion. See PLR 200617008. Consult your tax advisors.
6. Assuming the proposed initial gift was not a fraudulent conveyance meant to inhibit creditors.

IM6081 3/12 MLINY03131216490 Policy Form: 09PROVUL