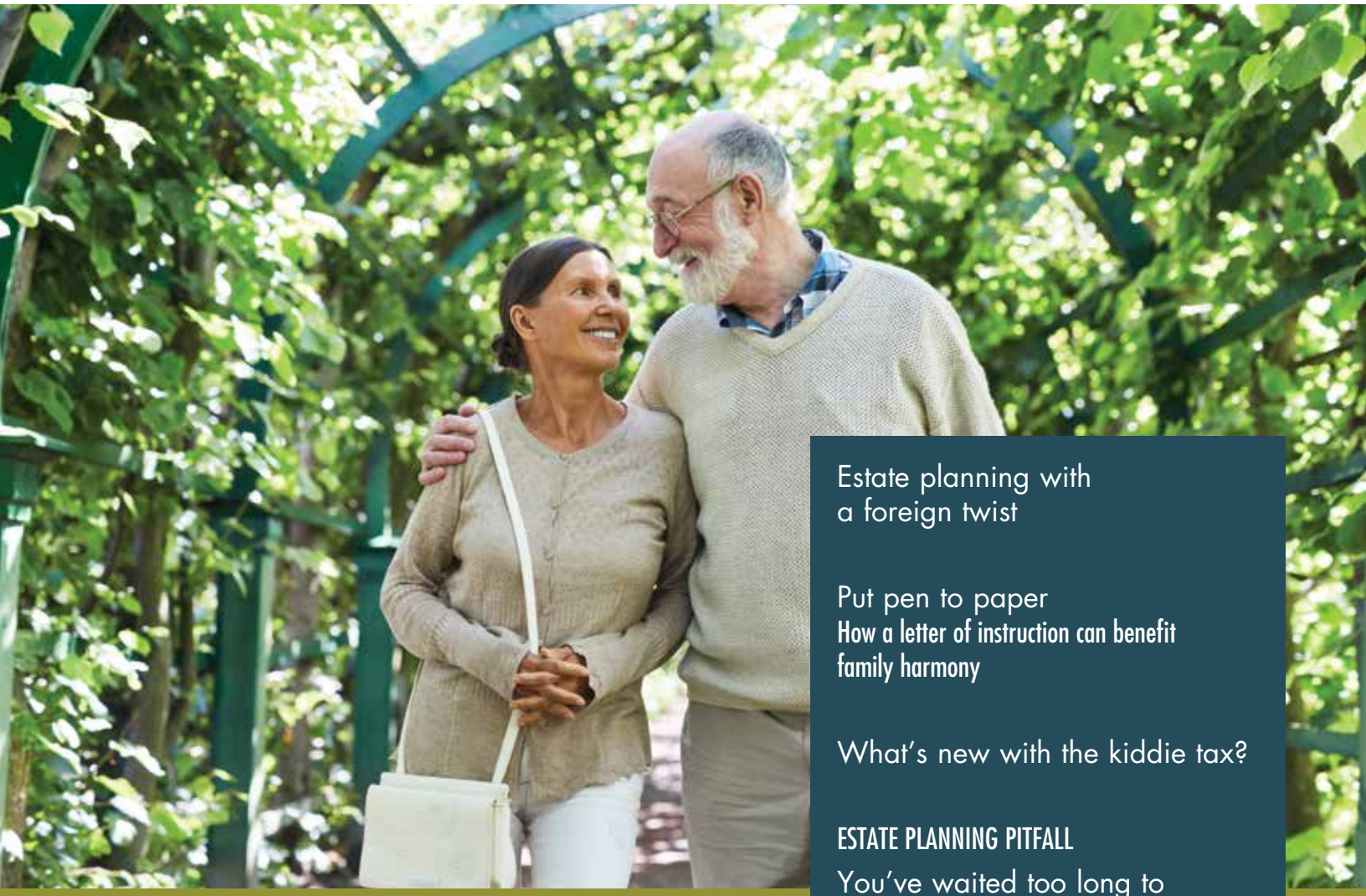
INSIGHT ON ESTATE PLANNING



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You've waited too long to transfer ownership of your life insurance policy

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Estate planning with a foreign twist

George is an American citizen and his wife, Sofia, is a citizen of Colombia. George and Sofia, who have two adult children and five grandchildren, need estate planning guidance. Are there any special considerations?

The short answer is "yes." But the long view is that the couple may still be able to meet their main estate planning objectives.

When both spouses are U.S. citizens

When both spouses in a legal marriage are U.S. citizens, the family may benefit from various estate tax breaks that were enhanced by the Tax Cuts and Jobs Act (TCJA). This includes the:

Unlimited marital deduction. A transfer from one spouse to another — whether it's during life or after a spouse's death — is exempt from federal gift and estate tax. An unlimited amount of assets can be transferred.

Gift and estate tax exemption. The federal exemption covers amounts that are bequeathed to nonspouse beneficiaries such as your children. The generous estate tax exemption of $5 million was doubled to $10 million by the TCJA, subject to inflation indexing, for 2018 through 2025. The amount for 2019 is $11.4 million. Under the unified gift and estate tax exemption, a spouse may also benefit from a lifetime gift tax exemption of $11.4 million in 2019. However, using the lifetime gift tax exemption erodes the available estate tax exemption.

Annual gift tax exclusion. This exclusion shelters from tax any gifts made during your lifetime, without affecting your lifetime gift tax exemption. In 2019, you can give $15,000 per recipient without using any of your lifetime exemption. The exclusion is doubled to $30,000 per recipient if you and your spouse properly "split" the gift. Plus, certain gifts are further excluded. For instance, you may make unlimited payments for medical expenses, so long as they're paid directly to the provider, and for tuition, so long as they're paid directly to the institution.

When one spouse isn't a U.S. citizen

Estate planning can become considerably more complicated when one or both spouses aren't U.S. citizens. First, it's important to ascertain the status of both spouses. The IRS

QDOTs 101

A U.S. citizen may establish a qualified domestic trust (QDOT) and name his or her spouse as the beneficiary. As a result, the spouse receives assets estate-tax-free. However, QDOTs must meet certain requirements designed to ensure that the assets stay in the United States and ultimately are subject to estate taxes.

For example, if you leave an inheritance to a citizen spouse, he or she can avoid estate taxes by spending the money or giving it away (using his or her own exemption or annual exclusion). But when a noncitizen spouse withdraws principal from a QDOT, the general rule is that it's immediately subject to estate taxes as part of *your* estate. There are, however, exceptions that may exempt the withdrawal from the estate tax.

defines a U.S. resident for federal gift and estate tax purposes as someone who's domiciled in the United States at the time of death. One becomes domiciled in a place by living there, even briefly, with a present intention of making that place his or her permanent home.

Whether you've established domicile in the United States depends on several factors. The factors include time spent in the country vs. time spent abroad; the locations and relative values of your residences and business interests; visa status; community ties; and locations of family members.

If you're a noncitizen who's a resident of the United States, the IRS treats you similarly as it would a U.S. citizen. That means you're entitled to the same federal gift and estate tax exemption and annual gift tax exclusion, including the tax benefit of gift-splitting. However, for a noncitizen who isn't a U.S. resident (a nonresident alien), the estate tax exemption plummets from $11.4 million to a comparatively miniscule $60,000 for amounts going to anyone other than a U.S. citizen spouse.

Thus, having U.S. property holdings can result in a large estate tax bill when a nonresident alien dies and leaves property to anyone other than his or her surviving U.S. citizen spouse. For this purpose, taxable property includes real estate and tangible personal property (such as cars, boats and works of art) located in the United States.

Determining the location of intangible property — such as stocks, bonds and partnership interests — creates additional complications. For example, if a nonresident alien gives a family member stock in a U.S. corporation, the gift is exempt from U.S. gift tax. But a bequest of that same stock at death is subject to estate tax. Conversely, a gift of cash on deposit in a U.S. bank is subject to gift tax, while a bequest of the same cash would be exempt from estate tax.

Transfers to a noncitizen spouse

Let's return to the example of George, the U.S. citizen and his noncitizen spouse Sofia. Notably, the unlimited marital deduction doesn't apply to transfers to a noncitizen spouse, regardless of whether the noncitizen spouse is a U.S. resident. Instead, George must use his estate tax exemption to cover assets transferred at death, up to $11.4 million. Furthermore, the lifetime gift tax exemption for gifts to a noncitizen spouse is limited to just $155,000 in 2019.

But all isn't lost. One solution is for George to establish a qualified domestic trust (QDOT) and name his wife as beneficiary (see "QDOTs 101" on page 2). Another possibility is for Sofia to become a U.S. citizen if she's willing to do so. In fact, tax laws provide that, subject to certain requirements, a QDOT will no longer be effective when your spouse formally obtains citizenship.

Turn to your advisor

If you or your spouse is a noncitizen, consult your estate planning advisor to evaluate the potential impact on your estate plan and to discuss strategies for avoiding unintended tax consequences. •

Put pen to paper

How a letter of instruction can benefit family harmony

Your will is the centerpiece of your estate plan. Typically, it's the most important document used in estate planning and is created before any other. In addition, you should have your will periodically reviewed and updated as needed. But you can still rely on other documents to complement your will. For example, if you haven't already done so, consider writing a letter of instruction to accompany your will.

Elements of the letter

A letter of instruction is an informal document providing your loved ones and friends with vital information about personal and financial matters to be addressed after your death. Bear in mind that the letter, unlike a valid will, isn't legally binding. But the informal nature allows you to easily revise it whenever you see fit.

What should be included in the letter? It will vary, depending on your personal circumstances, but here are some common elements:

Documents and financial assets. Start by stating the location of your will. Then list the location of other important documents, such as powers of attorney, trusts, living wills and health care directives. Also, provide information on birth certificates, Social Security benefits, marriage licenses (and, if any, divorce documents), and military paperwork.

Next, create an inventory spreadsheet of all your assets, their location, account numbers and relevant contact information. This may include, but isn't necessarily limited to, items such as checking and savings accounts; retirement plans and IRAs; health and accident insurance plans; business insurance; life and disability income insurance; records of Social Security and VA benefits; and stocks, bonds, mutual funds and other investments.

And don't forget about liabilities as well. Provide information on mortgages, debts and other obligations your family should be aware of.

Funeral and burial arrangements. A letter of instruction typically includes details regarding your funeral and burial arrangements. This can be helpful to grieving family members. If you prefer to be cremated rather than buried, make that clear. In addition, details can include whom you'd like to preside over the service, the setting and even music selections.

List the people you want to be notified when you pass away, and include their contact

information, if available. Finally, write down your wishes for donations to specific charities to be made in your memory.

Digital information. As many of your accounts likely have been transitioned to digital formats, including bank accounts, securities and retirement plans, it's important that you recognize this change in your letter of instruction or update a previously written letter.

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Be sure to include usernames and passwords for digital accounts — especially financial accounts — as well as social media accounts, key sites and links, and the devices themselves.

Personal items. It's not unusual for family members to quarrel over personal effects that you don't specifically designate in your will. Your letter can spell out who will receive random personal effects, including collections, as well as other items that may have little or no monetary value, but plenty of sentimental value.

Final thoughts

A letter of instruction can offer peace of mind to your family members during a time of emotional turmoil. It can be difficult to think about writing such a letter — no one likes to contemplate his or her own death. But once you get started, you may find that most of the letter "writes itself." Also, take comfort in knowing that you're alleviating stress and probably avoiding family disputes later on.

Finally, try to ensure that the letter doesn't conflict with other parts of your estate plan, particularly your will, and lead to confusion. •

What's new with the kiddie tax?

One of the outcomes of the Tax Cuts and Jobs Act is that children with unearned income may find themselves in a higher tax bracket than their parents. This is because, under the "kiddie tax," as it's sometimes referred to, a child's unearned income is taxed according to the tax brackets for trusts and estates, under which the highest tax rates kick in at far lower income levels. The good news is that there are strategies to allow for family income shifting.

Origins of the kiddie tax

Transferring investments and other income-producing assets to your children can be an effective estate-planning technique. Not only are the assets removed from your taxable

estate, but any income they generate is taxed at your child's presumably lower tax rate.

The Tax Reform Act of 1986 introduced the kiddie tax to recover this lost tax revenue. If the kiddie tax applies, a child's unearned income above a specified threshold (currently, $2,200) is taxed at the kiddie tax rate (originally, the parents' marginal rate; now, the trust and estate rate) — assuming it results in a higher tax than the child would pay without the kiddie tax.

The kiddie tax ceases to apply in the year your child turns age 19 (24 for a full-time student).

Originally, the kiddie tax applied to children under 14, but in 2007 Congress expanded the tax to include all children age 18 or younger, plus full-time students age 19 to 23.

Kiddie tax in action

Before the TCJA, the kiddie tax simply erased the benefits of income shifting. But in its current form, the tax can often be punitive. For example: Mike and Julie are a married couple filing jointly with taxable income of $300,000 per year. They transfer several investments to their 18-year-old son, Nick, which generates $20,000 in taxable interest income annually. If the kiddie tax didn't apply (and assuming his total taxable income is less than $38,700), Nick would be in the 12% tax bracket. Under the pre-TCJA kiddie tax rules, and using the current brackets, Nick's unearned income would be taxed at Mike and Julie's marginal rate of 24%. But under the current version of the kiddie tax rules, which apply the estate and trust brackets, most of Nick's income is taxed at 35% or 37%.

Tax-saving strategies

There are several potential strategies for avoiding the kiddie tax while still taking advantage of income-shifting benefits. They include:

Delaying investment income. The kiddie tax ceases to apply in the year your child turns age 19 (24 for a full-time student). So, you can avoid kiddie tax by delaying investment income until your child reaches the applicable age.

Using tax-exempt investments. Income on tax-exempt municipal bonds or bond funds is exempt from all income taxes, including the kiddie tax.

Increasing earned income. Remember, the kiddie tax applies only to unearned income. Income your child earns from a job is taxed at the child's tax rate, and earnings up to the standard deduction (currently, $12,200) are tax-free. Plus, if your child is 18 or older and has enough earned income to cover more than half of his or her living expenses, the kiddie tax doesn't apply to any of the child's income, earned or unearned.

If you own a business, consider hiring your child. Doing so increases the child's earned income and, so long as the wages are reasonable, your business gets a deduction. And if your child is under 18 and your business is unincorporated, this strategy avoids payroll taxes on your child's wages and reduces self-employment taxes.

This isn't child's play

Shifting income to your children is an option to reduce your tax bill. However, before doing so, look closely at the kiddie tax before you attempt this strategy. Your advisor can help answer your questions. •

ESTATE PLANNING PITFALL

You've waited too long to transfer ownership of your life insurance policy

Generally, the proceeds of your life insurance policy are included in your taxable estate. You can remove them by transferring ownership of the policy, but there's a catch: If you wait too long, your intentions may be defeated. Essentially, if ownership of the policy is transferred within three years of your death, the proceeds revert to your taxable estate.

The proceeds of a life insurance policy are subject to federal estate tax if you retain any "incidents of ownership" in the policy. For example, you're treated as having incidents of ownership if you have the right to designate or change the beneficiary or beneficiaries of the policy; borrow against the policy or pledge any cash reserve; surrender, convert, or cancel the policy; or select a payment option for the beneficiary or beneficiaries.

Typically, if you transfer complete ownership of, and responsibility for, the policy to an irrevocable life insurance trust (ILIT), the policy will — subject to the three years mentioned above — be excluded from your estate. You'll need to designate a trustee to handle the administrative duties. It might be a family member, a friend or a professional. Should you need any additional life insurance protection, it would work best if it were acquired by the ILIT from the outset.

An ILIT can also help you accomplish other estate planning objectives. It might be used to keep assets out of the clutches of creditors or to protect against spending sprees of your relatives. Also keep in mind that, as long as the policy has a named beneficiary, which in the case of an ILIT would be the ILIT itself, the proceeds of the life insurance policy won't have to pass through probate.

Obviously, the sooner you do this, the better. Don't wait until it becomes a dire situation.

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Leaving a Legacy: Incorporating Charitable Giving in Your Estate Plan

The end of the year is a time when many people think about charitable giving. Maybe it's the holiday spirit, wanting to gain a better understanding of year-end finances, or simply that there's no bad time to think about charity. Whatever the case may be, there are a variety of ways to create a charitable legacy in your estate plan. This article discusses a few of the most effective approaches.

Contribute to a Donor Advised Fund

A donor advised fund ("DAF") is a charitable investment vehicle to which a donor can contribute cash, real estate or other assets during life or at death. Gifts to a DAF are immediately tax deductible for the donor, incur no capital gains upon sale, and grow tax-free. Meanwhile, the donor and the donor's chosen advisors (often the donor's children) retain the authority to recommend grants to charities at their own pace, over the course of the fund's life. The burden of administering the fund and ensuring it complies with federal regulations is carried by the DAF's sponsoring charity, often a community foundation. Although the sponsoring charity technically has the final authority to direct the grants, most sponsors act in line with the recommendations of the donor and the donor's chosen advisors. The benefit to a DAF is a lasting legacy that extends beyond death, without the administrative hassle or higher costs of a private foundation or trust arrangement.

Create a Charitable Gift Annuity

A charitable gift annuity is created by agreement between a donor and a single charity. The donor makes a lifetime gift to the charity, which amount is then set aside in an investment account. The charity pays the donor a guaranteed, fixed monthly or quarterly payout for the rest of the donor's life. The payment amount is calculated based on the donor's life expectancy and the annuity rates applied by the charity at the time of the gift. Upon the donor's death, the charity receives the remaining funds in the investment account. The charitable gift annuity provides an income tax deduction during life with the ability to receive an income stream from the amounts gifted.

Create a Charitable Remainder Trust

A charitable remainder trust can be set up during life or upon death. The gift to the trust is irrevocable and is tax deductible in part. Similar to a charitable gift annuity, these trusts are created to pay an income stream to the donor (or if the gift is made upon death, then to the donor's descendants) for their lifetime or other set term; then, when the income term ends, the remaining assets pass to one or more charities designated in the trust instrument. A charitable remainder trust is highly customizable (within certain parameters) and is a tax-efficient way to provide for family and charity.

Create a Charitable Lead Trust

A charitable lead trust is the reverse of the charitable remainder trust. The trust supports one or more charities with payments made from the trust assets during the donor's lifetime. Upon the donor's death, the remaining trust funds pass to the donor's designated beneficiaries. A charitable lead trust allows the donor to enjoy the satisfaction of charitable giving during life while still providing for loved ones at death. In addition to the income tax deduction when the gift is made, the remainder portion of the gift will pass to beneficiaries at a discounted value for estate tax purposes, making this option especially attractive for those with taxable estates.

Start a Private Foundation

A private foundation is a private charitable organization set up by one or more donors. As with donor advised funds, the donor may contribute cash, real estate or other assets to a foundation. The difference with a foundation is that it is administered by a board of trustees chosen by the donor to carry out a stated charitable mission. To be considered a charity for federal tax purposes, a foundation must obtain federal charitable status ("501(c)(3) status") and comply with a slew of federal regulations. While private foundations typically require a significant amount of work and expense to maintain, they can provide their founders with flexibility to direct their charitable intent exactly as they see fit and the ability to leave a legacy that will last well beyond their lifetime.

If you are interested in incorporating charitable giving into your estate plan, 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.