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Harry Clinton Owen
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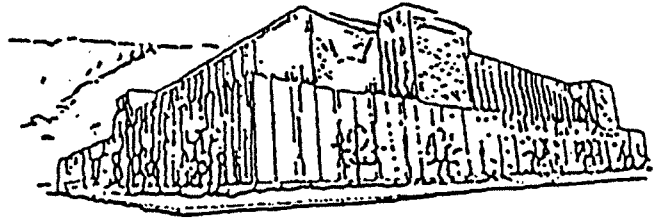
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ESTATE PLANNING IN SITUATIONS WHERE
THE SURVIVING SPOUSE MAY NOT BE A U.S. CITIZEN

by

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A.B. Harvard University, 1964

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presented in partial fulfillment of the requirements

for the degree of

Master of Accounting

The University of Montana

1996

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Business Administration

Estate Planning in Situations where the Surviving Spouse May not be a U.S. Citizen (53 pp.)

Director: Michael R. Brown



The Technical and Miscellaneous Revenue Act of 1988 (TAMRA 88) and Omnibus Revenue Act of 1989 (OBRA 89) substantially changed the Internal Revenue Code as it applies to gift and estate taxes for married couples where one or both of the spouses are not U.S. citizens. The Acts disallowed the unlimited *inter vivos* spousal gift deduction and the unlimited marital deduction for the first spouse to die in situations where the surviving spouse is not a U.S. citizen. In addition, they eliminated for such couples the exception to the joint property rules under which the value of joint property is equally divided between the estates of the spouses. As a result of these changes, estate planning has become more complex in situations where there is an alien spouse.

TAMRA 88 also created the Qualified Domestic Trust (QDOT) as a mechanism to defer estate taxation of assets passed to a noncitizen surviving spouse. The requirements for these trusts are, however, extremely complex and restrictive. As a result, in many cases it may be advantageous to make estate plans which avoid use of these trusts. Equalization of assets between the spouses using annual tax exempt gifts, the purchase of joint and survivor annuities, and the creation of charitable remainder trusts are some of the ways that QDOTs may be avoided and estate taxes minimized.

Nevertheless, the ultimate purpose of estate planning is to allow decedents to ensure that their assets are distributed to their beneficiaries as the decedents wish. Accordingly, there will be many cases where QDOTs will have to be used. In those cases, estate planners will need to be particularly vigilant to avoid the many pitfalls the new laws create.

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CHAPTER I
INTRODUCTION

General

The principal purpose of estate planning is to meet the estate distribution desires of the decedent. The decedent, prior to death, should be able to specify to whom he or she wishes to pass the estate and the amount or proportion of the estate which should go to each recipient. Usually a major planning consideration is the minimization of estate taxes.

If the decedent is married, there are specific procedures which may be used to reduce estate taxes. Among the most important are the marital deduction,¹ tax free gifts to spouses,² and joint tenancy.³ The surviving spouse's estate will be taxed on the value of all of that spouse's property, including the marital deduction property remaining when he or she dies.

Since the enactment of the Technical and Miscellaneous Revenue Act of 1988 (TAMRA 88), however, the marital deduction, spousal gift, and joint tenancy are no longer available for tax reduction if the surviving spouse is not a citizen of the United States.⁴ In lieu of the deduction, TAMRA 88 created the Qualified Domestic Trust (QDOT), which purports to be a mechanism for allowing a marital deduction to be taken where the surviving spouse is a noncitizen.⁵ In reality, however, although property placed

in a QDOT escapes taxation when the first spouse dies, all distributions of principal from the QDOT are subject to tax at the decedent's marginal estate tax rate.⁶ As a result of the TAMRA 88 changes, estate planning where a spouse is not a U.S. citizen presents unusual problems.

The purpose of this paper is to elucidate the many difficulties and the few opportunities which TAMRA 88 and subsequent amendments have created for the noncitizen surviving spouse. Chapter I (the introduction) traces the legislative history of the marital deduction as it applies to resident alien surviving spouses and briefly contrasts the current tax rules pertaining to the marital deduction, joint property, and inter-spousal gifts for citizen and noncitizen spouses. Chapter II details the sections of the Internal Revenue Code and Treasury Regulations pertinent to QDOTs, and Chapter III discusses tax planning considerations.

Background

Legislative history

Generally, on the death of U.S. citizens and residents⁷ federal estate tax is levied on all property owned by the decedent worldwide.⁸ Conversely, the estate of nonresident aliens is taxed only on U.S. situs property. A deduction is allowed to the decedent's estate for all qualifying property (subsequently defined) passing to the surviving spouse. Thus the marital deduction permits the avoidance of estate tax on the property of the first spouse to die, although complete avoidance is often not advisable.

Prior to enactment of TAMRA 88, an unlimited marital deduction was allowed

regardless of the citizenship of the surviving spouse. In essence, the deduction provided a deferral mechanism, rather than a complete avoidance of the estate tax. Property passing to the surviving spouse was taxed on his or her death to the extent the property had not already been consumed.

The marital deduction was initially created by the Revenue Act of 1948 and was intended to equalize treatment of estate and gift taxation of residents of community property states and common law states. In the former, income was assumed to be jointly earned. Accordingly, on the death of the first spouse, a married couple's property was divided equally, and only half the property was taxed to the first decedent. Conversely, in common law states property was frequently held in the name of one spouse and was taxed to that spouse. Because of the progressive rate structure of the estate tax, couples with identical estates paid higher taxes in common law states prior to adoption of the marital deduction.

Minor modifications to the marital deduction rules were made in the Tax Reform Act of 1976, which increased the allowable marital deduction, and in the Economic Recovery Act of 1981, which removed all limitations on the value of estate and gift transfers between spouses. In essence, the changes recognized spouses as one economic unit.⁹

The Technical and Miscellaneous Revenue Act of 1988 (TAMRA 88) amended the Internal Revenue Code to disallow any marital exemption for noncitizen surviving spouses unless collection of estate taxes was assured. The Act defined a special trust, called a Qualified Domestic Trust (QDOT), which is designed to guarantee the collection

of estate taxes. According to the requirements of the QDOT, taxes are imposed when there are distributions of corpus from the trust, as well as on the death of the surviving spouse and anytime the trust fails to meet stipulated requirements (described later). In addition, TAMRA 88 amended the rules for inclusion of joint property in a decedent's estate and deductions allowed on gifts between spouses.

The House of Representatives' Committee Report on TAMRA 88 explained the rationale for changing the marital deduction rules. The deduction was enacted on the assumption that, on the death of the surviving spouse, estate taxes would be collected on all property not already consumed. For a U.S. citizen surviving spouse to escape tax on his or her worldwide estate, the surviving spouse would have to move the property out of the United States, give up residence, and renounce citizenship. However, the Internal Revenue Code minimizes the ability to escape tax in this manner by imposing special estate taxes on tax motivated expatriation.¹⁰ A noncitizen surviving spouse, on the other hand, can escape taxation simply by moving property out of the country and giving up U.S. residence. Therefore, in the opinion of the Congress, allowing a marital deduction for noncitizens was inconsistent with the assumptions underlying the deduction, i.e., that the property would ultimately be subject to estate taxes.¹¹

The Omnibus Budget Reconciliation Act of 1989 (OBRA 89) extended the unlimited marital deduction to nonresident alien decedents (the first spouse to die). It also made important changes in the way the QDOT is administered.

Spousal deductions

Section 2056(a) of the Internal Revenue Code allows an unlimited marital deduction; however, the deduction is not allowed where the surviving spouse's interest in the property is restricted to a life estate or is otherwise terminable.¹² Stated in different terms, the marital deduction is limited to properties over which the surviving spouse may exert complete control and which, accordingly, will be taxable ultimately to his or her estate. Where the surviving spouse is given only the income from property (a life estate) or where the surviving spouse is in some manner restricted from disposing of the principal amount, no deduction is allowed. This restriction is consistent with the assumptions underlying the deduction: that the property will, to the extent it is not consumed, be taxed in the surviving spouse's estate. The restriction on the deductibility of terminable interests has several exceptions, the principle of which are life estates with the power of appointment, Qualified Terminable Interest Properties (QTIPs), and charitable remainder trusts.¹³ In none of these cases, however, will the terminability of the interest result in subversion of the assumptions underlying the deduction. In the case of the life estate, the property will be taxed upon the exercise, release, or lapse of the surviving spouse's power of appointment, when either a gift is made of the property during the life of the surviving spouse, or upon death of the spouse.¹⁴ Similarly, the QTIP will be taxed when gifted, or on the surviving spouse's death.¹⁵ The allowance of the deduction for qualifying charitable trusts presents no inconsistency because charitable gifts are allowable deductions.¹⁶

Section 2056(d) of the Internal Revenue Code specifically bars application of the

marital deduction where the surviving spouse is not a U.S. citizen unless the property is passed to the surviving spouse in a Qualified Domestic Trust (QDOT). As will be explained in Chapter II, the rules governing QDOTs are onerous, in particular the requirement that all distributions of principal from the trust, except in the case of hardship, be taxed at the time of distribution. Unlike the citizen surviving spouse, the noncitizen spouse may not consume any portion of the marital deduction property principal amount without incurring estate taxes.

Joint property

In addition to disallowing the marital deduction for noncitizen surviving spouses, TAMRA 88 also changed the law governing taxation of joint property. Generally, property jointly owned with other parties is included in a decedent's gross estate to the extent of the consideration furnished by the decedent when the property was acquired.¹⁷ Consistent with its desire to provide equitable treatment for married couples in both common law and community property states, Congress made an exception to the general rule. Under the exception, one half of the value of property owned jointly with a spouse, as tenants by the entirety or as joint tenants with the right of survivorship (as long as there are no joint tenants other than the spouse), is included in the decedent spouse's estate, regardless of the amount of consideration provided by each spouse.¹⁸

After enactment of TAMRA 88, property owned as tenants by the entirety or as joint tenants with right of survivorship with a noncitizen spouse must be treated under the general rule and may not utilize the exception.¹⁹ That is, the value of property owned

jointly with a spouse who is not a U.S. citizen is included in the gross estate of a decedent citizen spouse to the extent of the consideration provided by the decedent.

Gifts between spouses

Consistent with the unified basis of the estate and gift taxes, an unlimited deduction is allowed for gifts to a spouse, subject to the same terminable interest rules as apply to the estate marital deduction.²⁰ However, TAMRA 88 disallowed the unlimited deduction for gifts to noncitizen spouses.²¹ As partial compensation for the disallowance of both the gift and the estate marital deductions, Congress created a \$100,000 per year deduction for gifts from a citizen to a noncitizen spouse.²²

TAMRA 88, as amended by OBRA 89, created numerous changes which affect estate planning where the surviving spouse is a citizen of a country other than the U.S. Chapter II of this paper examines the requirements of the QDOT (the estate tax deferral mechanism adopted by OBRA 88), and Chapter III discusses estate planning under the new rules.

CHAPTER II
REQUIREMENTS FOR QUALIFIED DOMESTIC TRUSTS

Restrictions on the Marital Deduction

General

The Omnibus Budget Reconciliation Act of 1989 (OBRA 89) disallowed the federal estate tax marital deduction for property passing to a surviving spouse who is not a U.S. citizen at the date of the decedent spouse's death unless two conditions are met. First, the property must pass to a Qualified Domestic Trust (QDOT), or to a trust which is reformed to meet all QDOT requirements after the decedent's death, or directly to the surviving spouse who then transfers the property to a QDOT. Second, the decedent spouse's executor must make a timely (as defined below) QDOT election on the estate tax return (Form 706, Schedule M).²³

If the surviving spouse places property in a QDOT, the transfer must be made prior to the date the decedent's estate tax return is filed but no later than the final QDOT election date. The final election date for QDOTs is one year after the latest date the decedent's estate tax return can be filed, including extensions. Since the last date to file the estate tax return is nine months after the decedent's death²⁴ and that date may be extended up to twelve months,²⁵ the final election date for QDOTs is thirty-three months after the decedent's death.²⁶

Resident spouse becomes citizen

The surviving spouse is considered to be a U.S. citizen at the date of the decedent's death if the spouse attains citizenship before the decedent's estate tax return is filed and is continuously a resident of the U.S. from the date of death until the time the return is made.²⁷ The definition of residence is living in a place with no present intention of moving.²⁸

Treaty conflicts

If the decedent is a nonresident alien or a U.S. citizen who holds dual citizenship, the disallowance of the marital deduction may be in conflict with the provisions of a bilateral estate and gift tax treaty. In that event, the estate must choose whether to adhere to the treaty provisions or the QDOT regulations.²⁹

QDOT Requirements

The Internal Revenue Code and the Treasury Regulations contain four requirements for a trust to qualify as a QDOT. These requirements relate to conformance with state law, qualifications for the trust principal, trustee requirements, and rules for ensuring payment of estate taxes. The first three requirements are described here. The fourth requirement is discussed in the following section.

Conformance with state law

The QDOT instrument must be established and maintained under the laws of either a U.S. state or the District of Columbia. If the trust is established under the laws of another nation, the trust instrument must also provide that the trust will be administered under the laws of a designated U.S. state or the District of Columbia.³⁰

Trust principal qualifications

Property passing from the decedent to a QDOT must qualify for the federal estate tax deduction. Specifically it must be a life estate with power of appointment,³¹ Qualified Terminable Interest Property (QTIP),³² or a charitable remainder trust where the surviving spouse is the sole noncharitable beneficiary.³³ Property will also qualify if it meets the requirements of an estate trust.³⁴

Property meeting the marital deduction requirements which passes directly to a surviving spouse may be eligible for the QDOT marital deduction. The property will qualify if the surviving spouse places the property in a trust which conforms to the trustee requirements and the rules for ensuring payment of estate taxes, described below.³⁵

Trustee requirements

At least one trustee of the QDOT must be an individual citizen of the U.S. or a domestic corporation. In addition, the U.S. trustee must have the right to withhold estate taxes on any distribution from the QDOT other than trust income.³⁶

Ensuring Payment of Estate Taxes

The requirements imposed by the Treasury Regulations to ensure collection of estate taxes differ, depending on the size of the QDOT. The fair market value of the QDOT is determined at the date of the decedent's death, or at the alternate valuation date 6 months after death, if appropriate, and does not change thereafter. There are two categories: QDOTs with assets in excess of \$2,000,000 (large QDOTs) and those with no more than \$2,000,000 (small QDOTs). In determining whether the \$2,000,000 large QDOT/small QDOT threshold has been crossed, multiple QDOTs are aggregated.³⁷

QDOTs larger than \$2,000,000

Large QDOTs must meet one of three requirements, in addition to those prescribed in the preceding section. Under the first alternative, the trust instrument must provide that the U.S. trustee be a bank or that, otherwise, one trustee be the U.S. branch of a foreign bank as long as there is also a U.S. trustee. The second alternative is for the trust instrument to specify that the U.S. trustee furnish a bond in favor of the Internal Revenue Service in an amount equal to 65% of the fair market value of the trust assets. This valuation is to be exclusive of any trust indebtedness. The third alternative is for the trust instrument to require the U.S. trustee to furnish an irrevocable letter of credit in the amount of 65% of the trust's fair market value, exclusive of any indebtedness.³⁸

QDOTs of no more than \$2,000,000

Small QDOTs -- those whose fair market value is no more than \$2,000,000, exclusive of indebtedness -- may adhere to one of the three Treasury requirements

imposed on large QDOTs. Small QDOTs have an additional alternative. The bank trustee, bond, and letter of credit requirements of the large QDOT may be avoided if the trust instrument stipulates that no more than 35% of the fair market value of the trust assets may consist of real property located outside the U.S.³⁹

Principal residence and foreign real property rules

In applying the \$2,000,000 large QDOT/small QDOT threshold test, up to \$600,000 of the value of a principal residence and related personal effects may be excluded. Also, if the QDOT trustee chooses to obtain a bond or letter of credit, the value of the principal residence (up to \$600,000) may be excluded from the total value of the trust. The value of the principal residence may not, however, be excluded in determining whether foreign real property comprises more than 35% of the value of the trust.⁴⁰

If the 35% foreign real property option is chosen, a look-through rule comes into effect. Under this rule, if the QDOT owns more than 20% of the voting stock or value of a corporation with 15 or fewer shareholders or more than 20% of the capital interest of a partnership with 15 or fewer partners, the trust is deemed to own proportionally any foreign real property included in the assets of that corporation or partnership. For example, if the QDOT holds a 50% interest in a corporation with 15 or fewer shareholders and the corporation has foreign real property assets of \$200,000, the QDOT is deemed to own \$100,000 of the foreign real property of the corporation. That \$100,000 will be used in determining the percentage of the QDOT assets which are comprised of foreign real property.⁴¹

Reporting requirements

If the 35% foreign real property option is used or if the value of the principal residence is excluded from the total valuation of the trust or in determining the amount of a bond or letter of credit, a report must be submitted annually at the end of the trust's taxable year. The report must also be filed if a principal residence subject to the exclusion is sold or ceases to be the principal residence. The report must summarize the nature of the QDOT assets and provide a fair market value for each listed asset. Furthermore, if the principal residence is sold during the year, the report must include the adjusted sales price and the amount of that price which will be used to purchase a new principal residence.⁴²

The QDOT Election

General rule

As previously noted, the QDOT election must be made on the last estate tax return filed before the due date of the return, including any extension granted. If the estate tax return is filed late, the election must be made on the first return filed but, at any rate, may not be made later than one year after the due date plus extension. The QDOT election is irrevocable.⁴³ A QDOT election may not be made for a portion of an existing trust, even if the trust qualifies as a QDOT in all other respects. However, if the trust can be divided, a severed portion, constituting a new trust, may be designated a QDOT if the appropriate election is made.⁴⁴

Protective elections

A protective QDOT election may be made under four circumstances: when there is a legitimate question about the residency or citizenship of the decedent, when the citizenship of the surviving spouse is in doubt, when it is not clear whether particular assets are includible in the decedent's gross estate, or when there are questions about the amount or nature of property the surviving spouse is to receive. The protective election permits designated property to be placed in a QDOT after questions of citizenship, residency, or inclusion of the property have been resolved even if the resolution is after the expiration of the QDOT election deadline. The election, once made, is irrevocable.⁴⁵

Conforming Marital Trusts and Nontrust Marital Transfers

Marital trusts

If property is passed from the decedent to a noncitizen surviving spouse in a trust which does not meet the QDOT requirements, as long as the property in the trust conforms to the marital deduction rules, the trust may be reformed to meet the QDOT requirements. The reformation may be made in accordance with terms in the trust instrument or pursuant to a judicial proceeding.⁴⁶

Nontrust marital transfers

If property passes outright to a noncitizen surviving spouse from the decedent, as long as the property qualifies for the marital deduction, the property will be treated as if it had passed in a QDOT as long as the surviving spouse irrevocably transfers the property to a QDOT before the decedent's estate tax return is timely filed, including any

extensions granted. The QDOT may be a trust created by the decedent, by the surviving spouse, or by the executor of the decedent's estate. If the QDOT to which the surviving spouse transfers the property contains property passed from the decedent, all the property in the trust must qualify for the marital deduction. If, on the other hand, the trust contains property not eligible for the marital deduction, that trust may not be used as a QDOT.⁴⁷ Furthermore, the surviving spouse may only transfer property to the QDOT which was included in the decedent's estate and which passed from the decedent to the surviving spouse. If only a portion of an asset was included in the decedent's estate (for example, 50% of a house, the other half of which was owned by the surviving spouse), only that part which was included in the decedent's estate may be transferred to the QDOT.⁴⁸

Any property which passes directly from the decedent to a noncitizen surviving spouse and which the spouse subsequently transfers to a QDOT is treated as having passed from the decedent directly to the QDOT solely for purposes of qualifying for a marital deduction in the decedent's estate. For all other purposes -- including income, gift, estate, and generation skipping transfer taxes -- the transfer is considered to have been made by the surviving spouse. However, if the spouse makes a qualified disclaimer under Internal Revenue Code Section 2518(c)(3), he or she will not be considered to be the transferor of the property.⁴⁹

Assignable annuities and individual retirement accounts may be assigned to a QDOT regardless of the method of payment elected under the plan. Individual retirement annuities are not assignable but may be included in QDOTs under special rules. Another exception allows individual retirement accounts, although assignable, to be handled

under the same rules as individual retirement annuities.⁵⁰

Nonassignable annuities

Nonassignable annuities and other arrangements are defined as annuities or other arrangements which are eligible for the marital deduction but which are ordinarily not assignable or transferable under federal or state law or the terms of the plan itself. The Treasury Regulations, however, specifically allow the transfer of these nonassignable annuities and arrangements to a QDOT. In addition, the Regulations allow the surviving spouse to follow the procedures outlined here for assignable individual retirement accounts, at the discretion of the spouse.⁵¹

Nonassignable annuities and other arrangements are treated as passing to the surviving spouse in a QDOT if the spouse agrees to adhere to one of two procedures designed to ensure the collection of estate taxes. Under the first arrangement, the surviving spouse agrees to pay on an annual basis the estate taxes on the corpus portion of each annuity payment. Under the other option, the surviving spouse agrees to turn over the corpus portion of each annuity payment to the QDOT within 60 days of receipt. In both cases, a signed agreement must be executed.⁵²

Imposition of Estate Taxes

Taxable events

There are three events which trigger the imposition of estate taxes. First, tax is imposed on any distribution of principal from the trust during the surviving spouse's lifetime. The tax is based on the fair market value of the property at the time of the

distribution and includes the amount of tax withheld by the trustee to pay the tax. If the tax is paid out of other assets in the trust, the taxes paid are considered an additional trust distribution which itself is subject to tax. The death of the surviving spouse is the second taxable event. The amount subject to tax is the fair market value of the trust's assets at the time of the spouse's death or at the alternate valuation date, if applicable. The third type of taxable event occurs if the trust ceases to qualify as a QDOT, e.g., if the trust ceases to have a U.S. trustee. The amount subject to tax is the fair market value on the date of disqualification. In each of the three taxable events, the amount of tax imposed is the amount of estate tax that the decedent would have paid had that amount been included in his or her estate.⁵³

Distributions not subject to tax

Distributions of trust income to the surviving spouse are not subject to estate taxation. Trust income is income as defined in the Internal Revenue Code Section 643(b) but does not include capital gains. In addition, the definition of income used in the state law under which the trust is administered governs the trust, even if the specific terms of the trust instrument conflict with the state law.⁵⁴

In the event of hardship, the surviving spouse may receive distributions of trust corpus without incurring estate taxes. Hardship is defined as “an immediate and substantial financial need relating to the spouse's health, maintenance, education, or support, or the health, maintenance, education, or support of any person that the surviving spouse is legally obligated to support.” However, such distributions may not be

made if the spouse has other resources “reasonably available” which may be used.⁵⁵

Finally, provision is made for payment of taxes and ordinary and necessary expenses of the trust without triggering any estate tax. In addition, the surviving spouse may be reimbursed for taxes paid on assets which are transferred into the QDOT, e.g., a lump sum distribution from the decedent’s retirement arrangement paid directly to the spouse and immediately transferred into the trust.⁵⁶

Amount of Tax

General

As described in the preceding section, the amount subject to tax, when a taxable event occurs, is the fair market value of the corpus distribution or the fair market value of the trust, upon the death of the surviving spouse or upon the failure of the trust to qualify as a QDOT. Tax is imposed as if the amount subject to tax had been included in the decedent’s estate, and the tax rate used is the estate tax rate existing at the time of the decedent’s death.⁵⁷ The tax is net of the allowed unified credit⁵⁸ and the credits for state death taxes,⁵⁹ tax on prior transfers,⁶⁰ and foreign death taxes.⁶¹

Benefits allowed

Certain estate tax benefits are specifically allowed. A noncitizen surviving spouse is treated as a citizen for purposes of determining whether QDOT property is included in his or her estate and also for determining which credits, deductions, and deferral provisions apply. Examples of these include the credits for death taxes paid, foreign death taxes, the alternate valuation date,⁶² charitable deductions,⁶³ and the marital

deduction.⁶⁴ Also, even though the QDOT is not includible in the surviving spouse's gross estate, if the spouse's interest qualifies for a marital deduction as a charitable remainder trust, the deduction will be allowed.⁶⁵

Allowance of Prior Transfer Credit

Property subject to QDOT election

Special rules are provided for determining the prior transfer tax credit allowed under Internal Revenue Code Section 2013 for property which passes to a noncitizen surviving spouse.

The general rule under that section of the Code is that the estate of persons receiving property transferred to them from the estate of another person will be credited for a portion of the federal estate taxes paid by the transferor if the transfer occurred within ten years prior or two years after the death of the transferee. The Code provides a formula by which the value of the credit decreases as the duration of the time from the transferor's death increases.⁶⁶ For example, a credit amounting to 60% of the estate tax paid by the transferor may be taken in the transferee's estate if the transferee dies during the fifth or sixth year after the transfer took place. However, if the transferee was the spouse of the transferor at the time of transfer and if a marital deduction was taken in the estate of the transferor, no credit may be taken for the marital deduction property.⁶⁷

In the case of a noncitizen surviving spouse who receives property from the decedent spouse in a QDOT, there is no disallowance of the credit because of marital status. The exception occurs because, although the transferring spouse is allowed a

marital deduction when the QDOT is created, on the death of the surviving spouse the amount of the assets remaining in the QDOT is taxed in the transferor's estate. Also, no time restrictions apply. The entire amount of the allowed credit may be taken in the estate of the surviving spouse regardless of the duration between transfer and the surviving spouse's death. The amount of the credit is the lesser of the estate tax paid by the transferring spouse on the remaining QDOT assets and the estate tax paid on that property by the surviving spouse's estate. However, the asset is taxed in the decedent's estate at its value as of the time the transfer occurred. Any appreciation in value is taxable solely to the surviving spouse's estate and is ineligible for a tax credit.⁶⁸

Property not subject to QDOT election

If a noncitizen surviving spouse receives from a decedent spouse property which qualifies for the marital deduction, but no deduction is allowed solely because of the citizenship of the surviving spouse, the prior transfer tax credit rules of Internal Revenue Code Section 2013 apply. However, the credit is determined without reference to the time-based percentage limitations.⁶⁹

Rules for Joint Property

General rule

Chapter I outlines the procedures for the inclusion of jointly held property in the estate of a decedent spouse where the surviving spouse is a U.S. citizen. TAMRA 88 changed the joint property rules and, where the surviving spouse is a noncitizen, requires that property be divided according to the general rule for joint interests. Accordingly,

property held by the entirety or as joint tenants with right of survivorship with a noncitizen spouse is included in the estate of a decedent citizen spouse except to the extent the surviving spouse provided consideration.⁷⁰ The executor of the decedent's estate is required to furnish facts supporting any claim that the surviving spouse furnished consideration. If the decedent provided consideration for only a portion of a property, only that part for which consideration was furnished may be included in a QDOT.⁷¹

Consideration treated as a gift

If the decedent acquired property before July 14, 1988, the surviving spouse is considered to have provided consideration for the property to the extent the decedent treated the consideration furnished as a gift to the surviving spouse under Internal Revenue Code Section 2511. This exception applies only if the donor spouse predeceases the donee spouse. If, on the other hand, the donor spouse survives the donee, all consideration is considered to have been provided by the donor, and the entire value of the property is included in the donor's estate.⁷² Conversely, consideration provided for joint property acquired after July 13, 1988 may not be treated as a gift under Section 2511.

Surviving Spouse Becomes a Citizen

If a noncitizen surviving spouse becomes a U.S. citizen after a QDOT has been established, the QDOT will no longer be subject to the imposition of estate taxes if one of three conditions is met. First, the surviving spouse must have remained a resident of

the U.S. continuously from the death of the decedent until becoming a U.S. citizen.

Second, regardless of residency status, the surviving spouse must have received no taxable distributions from the QDOT. In either of these cases, the QDOT's U.S. trustee must certify to the Internal Revenue Service that the spouse has become a U.S. resident.⁷³

Under the third condition, if the surviving spouse was not continuously resident in the U.S. and also received one or more taxable distributions from the QDOT, the QDOT may avoid further imposition of estate taxes if the spouse, after gaining U.S. citizenship, makes a special election. The election requires the surviving spouse to:

a. Treat taxable distributions from the QDOT before the election as taxable gifts made by the spouse for purposes of computing his or her adjusted taxable gifts and for purposes of determining the tax on actual taxable gifts made by the spouse in the year the election is made and in subsequent years, and

b. Treat any reduction in the decedent's estate taxes due to the decedent's unified credit as a reduction in the spouse's unified credit for the purpose of determining the credit allowable for taxable gifts made by the surviving spouse in the year of election and subsequent years.

Notification of the election must be attached to the next Form 706-QDT filed after the spouse becomes a citizen.⁷⁴

Filing and Paying Taxes

During the surviving spouse's lifetime

Taxable distributions during the life of the surviving spouse are reported on Form

706-QDT. The return is due by the fifteenth day of the fourth month following the calendar year in which the distribution occurred. Distributions made by reason of hardship, although not taxable, must be reported in the same manner as taxable distributions. Similarly, required annual statements, necessitated by the 35% foreign property rule or sale of a principal residence, have the same due date and are also filed with Form 706-QDT.⁷⁵

On the death of the surviving spouse

Form 706-QDT is used to report and pay estate taxes on the value of assets remaining in the QDOT on the death of the surviving spouse. It must be filed and taxes paid on the date nine months after the date of the surviving spouse's death.⁷⁶

Trustee liability

Each QDOT trustee is personally liable for any taxes imposed on the QDOT assets.⁷⁷

Basis for Distributed Assets

Taxable distributions of assets from a QDOT are treated as transfers by gift, and the estate taxes imposed are considered gift taxes.⁷⁸ Accordingly, the basis of the distributed property to the transferee is the same as the basis to the transferor, adjusted for gift taxes paid. However, if the fair market value of the property is less than the basis to the transferor and the transferee sells the property at a loss, the basis to the transferee is the same as the fair market value at the time of the transfer.⁷⁹

CHAPTER III
TAX PLANNING

QDOT Problems and Restrictions

The requirements for establishing QDOTs, contained in the Internal Revenue Code and Treasury Regulations, are numerous, complicated, and must be carefully observed. Failure to comply will result in immediate taxation of all property in the trust.⁸⁰

Asset characteristics

All assets put into a QDOT must meet the qualified marital interest requirements and the additional regulations established to ensure collection of estate taxes. With regard to the qualified marital interest requirements, generally assets passing to the trust from the decedent must satisfy the marital trust rules. Specifically, the same rules apply to general power of appointment trusts,⁸¹ QTIPs,⁸² charitable remainder trusts,⁸³ or estate trusts⁸⁴ must be complied with before a QDOT election can be made.⁸⁵ However, the trust may qualify even if the surviving spouse has no income interest in the trust, provided that in all other respects the trust would qualify for the marital deduction if the spouse were a citizen. Nevertheless, if property passing to the QDOT qualifies for the marital deduction under either the QTIP or life estate with power of appointment exceptions to the terminable interest rule, the surviving spouse must have an income interest in the trust.⁸⁶

Property which has been passed to the surviving spouse by the decedent outside a QDOT may avoid estate tax at the time of the decedent's death if the property is timely transferred to a QDOT. If the trust used for this purpose contains property transferred to it by the decedent, all of the property in the trust must qualify for the marital deduction.⁸⁷ Thus, a trust created by the decedent containing property which does not qualify for the marital deduction may not be used as a QDOT by the surviving spouse.

Real property

The temporary regulations⁸⁸ allow up to \$600,000 in value of a principal residence to be excluded in determining whether the QDOT exceeds a \$2,000,000 threshold. If the QDOT exceeds \$2,000,000, the 35% foreign real property option is not available. In that case, the trust must either: a) have a U.S. bank, or the U.S. branch of a foreign bank, as one of its trustees, or b) provide to the IRS a bond or letter of credit amounting to 65% of the fair value of the trust. If the principal residence is located outside the U.S. and constitutes a significant (i.e., greater than 35%) portion of the estate, the large QDOT rules will have to be met, regardless of the size of the estate. If, further, the bank trustee and the bond requirements are prohibitively expensive, the trustee of the QDOT will be forced either to sell the principal residence or to pay estate taxes on all the property in the QDOT.⁸⁹

If the 35% option is used, an annual valuation and report on all property in the trust must be made to the IRS. In addition to the time and expense involved in preparing the reports, trusts using the 35% option are vulnerable to market value appreciation of

foreign situs real property and changes in the exchange rate. Over time, changes in these two factors may result in substantial increases in value. As a result, the QDOT trustee may be required to sell foreign real estate or be faced with loss of QDOT status and concomitant payment of estate taxes.⁹⁰

Further problems may arise if the principal residence, wherever located, is sold. If the proceeds of the sale are not reinvested in a new principal residence within 12 months, the principal residence exclusion will be lost. Furthermore, if the entire adjusted sales price⁹¹ of the old residence is not reinvested in a new residence, the \$600,000 exclusion must be proportionally reduced.⁹² For example, if the adjusted sales price of the old residence is \$1,000,000 and \$700,000 of that is reinvested in a new residence, the principal residence exclusion would be reduced from \$600,000 to \$420,000 ($\$600,000 * \$700,000 / \$1,000,000$). Once again, the loss of all or even a portion of the principal residence exclusion may have dire consequences for the QDOT.

Because of the potential problems described in the preceding paragraphs, in cases where the QDOT holds no foreign real property, it may be advisable to draft the trust instrument so as to bar ownership of any non-U.S. real estate.⁹³

Administrative expenses

There are unavoidable expenses associated with the administration of all trusts, but QDOTs have higher than usual costs. Although small QDOTs may be able to avoid some of the expenses of large QDOTs, e.g., bank trustees or the expense of a bond or letter of credit, the cost of preparing annual trust property valuations may be substantial,

and, as a proportion of trust assets, these expenses may, indeed, be onerous. If the trustee of a small QDOT is unable to utilize the 35% real property rule and must have a bank trustee, bond, or letter of credit, the burden may well be even greater.⁹⁴

A further potential administrative burden for the small QDOT is the look-through rule, which is applied in determining whether more than 35% of the fair market value of QDOT assets consists of foreign situs real property. If a small QDOT holds more than the allowed percentage ownership of a closely held corporation or partnership (15 or fewer stockholders or partners), the QDOT is deemed to be the owner of a proportional share of any foreign real property owned by the corporation or partnership.⁹⁵ If the look-through rule applies, the small QDOT is required to report to the IRS the value of its holdings in all the assets of the look-through entity.

The Treasury Regulations mandating security requirements for QDOTs may be difficult to achieve. Posting a bond to satisfy the requirements may not be a viable alternative, as it may be impossible to obtain a bond, or the cost may be prohibitive. The bank trustee requirement may also be difficult to meet. Banks may be loathe to serve in such a position because of the potential liability for any unpaid estate taxes they would have to assume.⁹⁶

Because the QDOT rules are complex, there is a greater than normal possibility of error in drafting the trust document. Furthermore, the newness of the QDOT requirements suggests that many practitioners, both attorneys and accountants, will be unfamiliar with all the intricacies of the trust rules. In addition, interpretation of the regulations will evolve through both administrative pronouncements from the Treasury

Department and the IRS and decisions from the courts. All of these considerations argue that the trust document should be drafted to give explicit authorization to the trustee to amend the QDOT as necessary to ensure compliance with the requirements of the Internal Revenue Code and Treasury Regulations.⁹⁷

Tax considerations

Although, as noted above, property passing to a surviving spouse outside a QDOT may avoid estate taxes if the property is placed in a qualifying trust by the surviving spouse, there may, nonetheless, be tax consequences for the surviving spouse. Generally, any property placed in a QDOT by the surviving spouse is considered to be transferred to the QDOT by the decedent spouse only for purposes of determining the decedent's estate taxes. Depending on the trust beneficiaries and the terms of the QDOT, the surviving spouse may be subject to income, gift, generation skipping, and certain excise taxes (e.g., on appreciated property transferred into a foreign trust⁹⁸) on the property he or she transfers into the QDOT.⁹⁹

The Treasury Regulations provide an example of the application of these rules. The decedent spouse bequeaths \$700,000 directly to the surviving spouse who, in turn, creates a QDOT and funds it with that amount. The trust instrument specifies that the spouse will receive all the income from the QDOT, and the property remaining on the spouse's death will go to the grandchildren. If the decedent's executor makes a proper election on the estate tax return, the \$700,000 may be taken as a marital deduction in the decedent's estate. However, the surviving spouse is subject to gift tax for the remainder

interest she has given to the grandchildren. Subsequently, on the death of the spouse, the \$700,000 will be included in her estate for tax purposes and will also be subject to the generation skipping transfer tax.¹⁰⁰

There are several ways available to avoid or mitigate the tax consequences incurred when the surviving spouse funds a QDOT. First, as illustrated in the preceding example, as long as the surviving spouse retains an income interest in the transferred property, the Section 2702 valuation rules¹⁰¹ are modified so that the taxable value of the gift is reduced by the actuarial value of the retained income interest.¹⁰² Second, no gift occurs if the surviving spouse retains a testamentary power of appointment over the distribution of the remainder, because the gift would be incomplete.¹⁰³ Nevertheless, because the surviving spouse makes the transfer to the QDOT and retains an income interest, the value of the property transferred to the QDOT will be included in the spouse's estate,¹⁰⁴ no valuation freeze by *inter vivos* transfer may occur,¹⁰⁵ and a reverse QTIP election (explained subsequently) is not available. The third means available to avoid immediate tax consequences to the surviving spouse is to use a qualified disclaimer.¹⁰⁶ The disclaimer is effective even though the surviving spouse is an income beneficiary of the QDOT to which the property is transferred as result of the disclaimer.¹⁰⁷ If the trust instrument provides that, upon disclaimer, property will pass to a QDOT, the property will be treated as having passed directly from the decedent to the trust.¹⁰⁸ Such language in the trust instrument allows, but does not require, use of the trust and, thus, preserves flexibility.¹⁰⁹

QDOT taxable events

As described in Chapter II, there are three events which trigger estate taxes on QDOT assets: any distribution of principal during the life of the surviving spouse, death of the spouse, and the trust ceasing to qualify as a QDOT. In all three cases, taxes are imposed as if the distribution had been made from the deceased spouse's estate, i.e., as if there had been no marital deduction, and at the marginal tax rate applicable to that estate. Also, if the tax on a distribution is paid from the QDOT, the tax payment is itself considered to be a further taxable distribution from principal. A solution suggested for this situation is that the trust instrument specify that any payment of tax made by the QDOT is to be made out of trust income.¹¹⁰

Distributions of principal from a QDOT are treated as gifts, and any taxes paid are considered to be gift taxes.¹¹¹ If a surviving spouse receives a distribution of QDOT property from trust principal, the gift tax paid on the property is used to adjust the surviving spouse's basis in that property.¹¹² Even though the distribution is treated as a gift, the \$100,000 annual gift tax exclusion, available during the decedent's lifetime, does not apply.¹¹³ Furthermore, if the surviving spouse becomes a naturalized citizen subsequent to the payment of the tax, there are no provisions for refund of the tax.¹¹⁴

The preceding paragraphs describe most of the complications and disadvantages imposed by the QDOT requirements. There is, however, one tax advantage. Where the surviving spouse is a U.S. citizen, all marital deduction property received from the first spouse to die is included in the estate of the surviving spouse. As a result, the property is ultimately taxed at the highest marginal tax rate of the second spouse to die. Where the

surviving spouse is not a U.S. citizen, however, on his or her death (or whenever principal distributions are made from the QDOT) the QDOT property is taxed in the first decedent's estate. If the estates are large enough to benefit from separate "runs through the tax brackets," the use of QDOTs will result in the payment of lower taxes.¹¹⁵

Qualified retirement plans

If the surviving spouse is the beneficiary of an individual retirement arrangement, whether an individual retirement account¹¹⁶ or an individual retirement annuity,¹¹⁷ he or she may transfer the benefits to a QDOT. As discussed in the previous chapter, individual retirement annuities are considered nonassignable. Individual retirement accounts, on the other hand are assignable, but may be treated as if they were nonassignable for QDOT purposes. As a rule, it will be advisable to handle both types of retirement arrangements as nonassignable to avoid the tax disadvantages encountered when the surviving spouse transfers property into a QDOT. Furthermore, the rules for nonassignable retirement arrangement benefits are more flexible.¹¹⁸

If the surviving spouse takes the individual retirement arrangement benefit as a lump sum, the spouse may be reimbursed from the QDOT principal for taxes paid on the lump sum distribution without incurring estate taxes on the distribution of trust principal.¹¹⁹ Another option is for the surviving spouse to roll the retirement arrangement benefit over into a spousal retirement trust which conforms to the QDOT requirements.¹²⁰ However, the roll over would not be advisable if the surviving spouse were appreciably younger than 59 ½ since required income distributions from the QDOT/IRA would be

subject to the early withdrawal penalty tax.¹²¹

Two other options for handling individual retirement arrangement benefits should be considered. First, the decedent, prior to death, might name a testamentary QDOT as beneficiary, thus avoiding the necessity of the surviving spouse having to create and fund a QDOT. Second, the decedent, during life, might be advised to avoid accumulating large amounts of wealth in such arrangements. Although the benefits of tax sheltered appreciation would be lost, there might be a greater gain in flexibility and, possibly, a saving in estate taxes if the assets were instead used to equalize assets between the spouses through use of annual lifetime gifts.¹²²

Other Considerations

There are no restrictions placed on the designation of QDOT remaindermen. The surviving spouse, for example, may receive the income from the QDOT during her or his lifetime, but the principal may pass on that spouse's death to children or other persons designated by the first decedent. In this manner the ultimate disposition of the trust assets may be controlled by the decedent rather than by the surviving spouse.¹²³

Ordinarily, if the decedent creates a trust for the benefit of the grandchildren, the value of the trust will be taxable to the decedent's estate, and the estate will also pay the generation skipping transfer tax. If the grandchildren's trust property is qualified terminable interest property (QTIP) which would be deductible to the decedent's estate if passed to the surviving spouse, the estate may make a reverse QTIP election.¹²⁴ Under this procedure, the decedent's estate may take a marital deduction for the value of the

grandchildren's trust, and the trust will be taxable to the surviving spouse on death. However, the decedent's estate will pay the generation skipping transfer tax, preserving the surviving spouse's entire \$1,000,000 generation skipping transfer tax exemption. If, however, the decedent bequeaths property directly to a noncitizen surviving spouse who subsequently transfers the bequest to a QDOT, naming grandchildren as the trust's remaindermen, no reverse QTIP election may be made. The election is unavailable because the surviving spouse, rather than the decedent, is considered to be the transferor of the trust property to the QDOT.¹²⁵

One final limitation imposed by the QDOT requirements is important to note. QDOTs eliminate the possibility of the surviving spouse reducing tax on marital deduction property by making annual \$10,000 gifts from trust principal. Furthermore, a QDOT is not appropriate for use as a bypass trust, a common estate planning tool. In a bypass trust, growth assets are placed in a trust whose principal beneficiaries are the children. The trust may or may not provide income to the surviving spouse. This arrangement avoids taxation of the bypass trust assets in the surviving spouse's estate. Other assets are included in the marital deduction property passing to the surviving spouse who may consume them as necessary or pass them on in nontaxable gifts. Where the estate is not of sufficient size to provide for the surviving spouse out of QDOT income, such a strategy is not available because the QDOT principal cannot be invaded without incurring estate taxes.¹²⁶

Avoiding QDOTs

Because of their severe restrictions, QDOTs should generally be avoided, if possible. The following subsections discuss six QDOT avoidance mechanisms: naturalization, annual gifts, joint and survivor annuities, joint tenancy, bypass trusts, and life insurance.

Naturalization

TAMRA 88 provided that use of the QDOT could be avoided if the surviving spouse became a citizen by the time the estate tax return is filed. Practically, unless an application for naturalization has been initiated before the death of the citizen spouse, it is unlikely the procedure can be completed in the required time.¹²⁷

Annual gifts

Where the unlimited marital deduction for gifts between spouses is disallowed because the recipient spouse is not a U.S. citizen, an annual exclusion of \$100,000 is allowed.¹²⁸ Given a reasonable amount of time and the desire to avoid use of QDOTs, many people may be able to use the \$100,000 annual spousal gift exclusion to shift assets from one spouse to the other so that QDOTs become unnecessary. The equalization of assets between the spouses, where one or both are aliens, by means of these gifts accomplishes the same tax objective as it does where both spouses are U.S. citizens. The tax consequences of these asset shifts are discussed in the next section of the paper. In the event a noncitizen spouse predeceases a citizen, an unlimited spousal deduction is allowed.¹²⁹ The use of the \$100,000 annual spousal gift exclusion needs to be timely

executed since the value of all gifts made within three years of death are included in the gross estate of the decedent.¹³⁰

Use of the \$100,000 annual spousal gift exclusion leads to one undesirable consequence: loss of step up in basis. If the surviving spouse is a U.S. citizen and receives appreciated property from the decedent spouse's estate as part of the unlimited spousal deduction, the basis of the property to the surviving spouse is the fair market value at the time of the decedent's death or at the alternate valuation date, if applicable.¹³¹ However, if the property is received as a gift, as would occur with use of the \$100,000 gift exclusion, the basis of the property to the recipient is the same as the basis to the donor, provided the fair market value of the property at the time the gift is made exceeds its basis to the donor.¹³²

Two cautions are noteworthy. First, to qualify for the gift tax exclusion the gift must qualify for the marital gift deduction,¹³³ that is, no deduction is allowed if the gift to the spouse is subject to termination on occurrence of an event or contingency.¹³⁴ Accordingly, the gift must be irrevocable and may not revert to the donor spouse in the event of, e.g., divorce. Second, state laws, differing from the federal statutes, may impose constraints. For example, New York state has no provision for nontaxable gifts to nonresidents in excess of \$10,000.¹³⁵

Joint and survivor annuities

There is one exception to the disallowance of the marital gift deduction when the spouse is not a U.S. citizen. The provision of rights under a joint and survivor annuity¹³⁶ to a noncitizen spouse is a gift by the annuitant donor spouse for gift tax purposes. However, the gift qualifies for the gift tax marital deduction even though the recipient spouse is not a U.S. citizen.¹³⁷ These annuities, as a result, may provide an attractive means of passing a lifetime income to a noncitizen spouse and avoiding the complexities of a QDOT. However, the annuities provide limited access to principal and do not permit passing on assets to future generations.

Joint tenancy limitations

As described in Chapter I, property held in a tenancy by the entirety or in a joint tenancy with right of survivorship (solely with the spouse) is equally divided on the death of the first spouse. Half the value of the joint property is included in the estate of the decedent, and half is attributed to the surviving spouse, regardless of the amount of consideration provided by each spouse.¹³⁸ However, if the surviving spouse is not a U.S. citizen, the full value of the property is included in the estate of the decedent except to the extent the surviving spouse has provided consideration.¹³⁹ The creation of the joint tenancy (or the tenancy by the entirety) is not considered to be a gift by one spouse to the other, regardless of the amount of consideration provided by each.¹⁴⁰ Nevertheless, even though joint tenancy does not provide the same advantages enjoyed where both spouses are U.S. citizens, it may still be useful for avoiding probate.¹⁴¹

Bypass trusts

Where appropriate, growth assets are often placed in bypass trusts whose beneficiaries are the children. The advantage of this arrangement is that the assets in the bypass trust are taxed in the decedent's estate and bypass taxation later in the estate of the surviving spouse, by which time they may have appreciated in value. Certain assets, such as the decedent's qualified retirement arrangements, may be inappropriate for inclusion in a bypass trust. Accordingly, such assets may need to be placed in a QDOT. However, because QDOTs are expressly designed to be taxable in the surviving spouses estate, they are not appropriate as bypass trusts.¹⁴²

Life insurance

There is a myriad of possibilities for incorporating life insurance into estate plans. Two simple approaches which are worth considering in situations where one or both spouses are not U.S. citizens are discussed here. One is to purchase sufficient life insurance so that estate taxes can be paid. Then, there may be no necessity of putting any assets in a QDOT. Another method is to use a QDOT but supplement it with life insurance, thereby providing the surviving spouse with assets unencumbered by the QDOT regulations.¹⁴³

Estate Size Considerations

Estates of no more than \$600,000

The estates of all decedents, regardless of citizenship, are allowed a unified gift and estate tax credit of \$192,800. Because of the credit, at current tax rates, estates valued at up to \$600,000 pay no estate tax. Decedents with estates in this size category may bequeath their assets as they desire with no tax consequences to their estates. Decedents who die intestate will, however, have their assets divided in accordance with state law, regardless of the size of the estate.

Estates between \$600,001 and \$1,200,000

Estates in this size category may avoid estate taxes completely by using the \$100,000 annual spousal gift tax exclusion to reduce the estates of both spouses to no more than \$600,000. If the possibility of divorce is a concern and there are beneficiaries other than the spouse for whom the decedent wishes to provide, a bypass trust sufficient in size to reduce the decedent's remaining assets to no more than \$600,000 may be appropriate. As previously discussed, the bypass trust is usually funded with assets likely to appreciate in value. The bypass trust may name the surviving spouse as income beneficiary. However, where divorce is a concern, the trust instrument should not grant the surviving spouse a general power of appointment, which would allow the spouse to dispose of trust principal, and the terms of the trust may require termination of the surviving spouse's income interest in the event of divorce. Since, under these terms, the surviving spouse would have neither a general power of appointment nor a qualified

terminable interest, the value of the trust assets would be taxable to the decedent's estate. Nevertheless, the estate taxes paid by the surviving spouse would be minimal if the assets in that spouse's estate were no more than what was received from the decedent plus appreciation and some additional accumulations. In addition to the limitations mentioned earlier, a QDOT may not be used as a bypass trust in this case because QDOT rules require the trust to qualify for the federal estate tax marital deduction -- life estate with power of appointment (general power), qualified terminable interest property, or surviving spouse as the sole noncharitable beneficiary of a charitable remainder trust.¹⁴⁴

Estates in excess of \$1,200,000

There are two ways the first spouse to die may completely avoid payment of an estate tax where the surviving spouse is not a U.S. citizen and the total value of the estate exceeds \$1,200,000. Prior to death, the citizen spouse may fund a joint and survivor annuity with the noncitizen wife as the only beneficiary. The annuitant, after equalizing assets between the spouses, should fund the annuity with all assets remaining in the annuitant's estate in excess of \$600,000. On the death of the annuitant, the \$600,000 remaining in the estate outside the annuity may be bequeathed to the surviving spouse, children, or any other beneficiaries. It will escape taxation because of the unified credit (\$192,800). The annuity will pass, tax free, to the surviving spouse under the marital deduction exception.¹⁴⁵ In the event the donee (noncitizen) spouse predeceases the donor, no portion of the annuity will be includible in the donee's estate.¹⁴⁶

The other method for complete avoidance of estate tax is for the citizen spouse,

after asset equalization, to create either an *inter vivos* or a testamentary charitable remainder trust for all assets in excess of \$600,000. Like the annuity, the beneficiaries of the remaining \$600,000 estate may be designated as the decedent desires. However, the surviving spouse must be the sole noncharitable beneficiary of the charitable remainder trust in order for the trust to qualify for the marital exclusion.¹⁴⁷ Although both these approaches avoid estate taxes, possibly for both spouses, they provide little flexibility because of the limited amount of discretionary assets (\$600,000) available to the surviving spouse and also because their use precludes passing anything but the \$600,000 to children or other beneficiaries.

If there are children or if the decedent wishes to provide for other noncharitable beneficiaries, a wide range of options is available, none of which, however, will completely avoid estate taxes. Estate taxes will be minimized by dividing the couple's assets equally between them. This approach is frequently used when the citizenship of the marriage partners is not an issue, but it is even more beneficial where citizenship may present estate tax complications. For example, assume a husband, D, and wife, S, each has, after deduction of the \$600,000 exemption, a taxable estate of \$750,000. On D's death, if all his taxable assets are placed in a QDOT, no estate taxes will be paid at that time. Assuming no change in the amount or value of the QDOT assets, on S's death the \$750,000 in QDOT assets will be taxed to D's estate at the rates in effect at the time of his death. S's estate will pay taxes on her \$750,000. At present rates, D's and S's estate will each pay taxes of \$248,300, for a total of \$496,600.

On the other hand, suppose both D and S were both citizens and the same

\$750,00 of D's assets were passed to S by spousal deduction at D's death. D's estate would pay no taxes. However, on S's death her estate would be taxed on a total of \$1,500,000 in taxable assets (\$750,000 of her's and \$750,000 from D). The estate tax would amount to \$555,800. That is, the couple who are both citizens would pay \$59,200 more in total estate taxes than the couple, one or both of whom is not a U.S. citizen. If, instead of passing the \$750,000 in taxable assets to S as marital deduction property, D were to put that amount in a bypass trust, providing an income interest to S, the effects would be similar to those created with a QDOT: the property in the trust would be taxed to D's rather than S's estate, S would receive an income interest in the property, and remainder interests could be specified by D. The major difference, however, is that D's estate would be taxed on the value of the property placed in the bypass trust at the time of his death, whereas the QDOT would not be taxed to D's estate until S's death, presumably some time later. As a result, the total estate tax paid by the couple, both of whom are citizens, would be exactly the same as the tax paid by the noncitizen couple. However, the financial impact would still be disadvantageous to the citizen couple because the tax on the bypass trust is due at the time of D's death. But for the non-citizen couple, the same amount of tax is not due until the death of the surviving spouse.

With larger estates, the decedent may be able to provide bequests of some size to several beneficiaries. In addition to caring for the beneficiaries, there may be emphasis on providing for various contingencies; so it may be beneficial to build some flexibility into the trust instruments. Various combinations of trusts, direct bequests, and annuities may be needed. Under these circumstances, the QDOT may play a part by delaying

payment of estate taxes on assets in the QDOT, providing income to the surviving spouse, and ultimately reducing the tax burden on the estate of the surviving spouse by shifting the QDOT asset taxes back to the estate of the first (citizen) decedent.

Estates in excess of \$2,000,000

The considerations for estates larger than \$2,000,000 are the same as those described in the preceding paragraph. There is one additional concern, however, and that is the administrative requirements for QDOTs of this size. QDOTs larger than \$2,000,000 must either have a bank as a trustee or else furnish a bond or letter of credit in an amount equal to 65 percent of the value of the QDOT at the time of the decedent's death or at the alternate valuation date. As previously mentioned, these requirements may be burdensome and expensive. They are best avoided, if possible. The U.S. citizen contemplating an estate of this size may give consideration to limiting the value of the assets in the QDOT to keep it under \$2,000,000. In addition to use of the \$600,000 allowance under the unified credit, the trust size may be limited by passing some assets outright to beneficiaries and purchasing life insurance to pay some estate taxes. A joint and survivor annuity may also be useful. A further technique which may be appropriate would be to put a high value primary residence in the QDOT, since up to \$600,000 of its value may be deducted from the QDOT in determining whether the \$2,000,000 threshold is crossed.

CONCLUSIONS

Provisions of the Technical and Miscellaneous Revenue Act of 1988 (TAMRA 88) and the Omnibus Budget Reconciliation Act of 1989 (OBRA 89) radically changed the estate planning options available to married couples where one or both spouses are not U.S. citizens. The Acts removed the option of taking a spousal deduction in the estate of the first spouse to die for property passing to a surviving noncitizen spouse and disallowed spousal gift deductions unless the donee spouse is a U.S. citizen. They also disallowed the exception to the joint interest rules which permits spouses to split the value of jointly owned property between their two estates except where both spouses are citizens. As partial compensation for these disadvantageous changes, the Acts created a mechanism, the Qualified Domestic Trust (QDOT), which permits estate tax deferral until the death of the surviving spouse and increases the annual gift exclusion to \$100,000 for gifts to noncitizen spouses.

Because the QDOT regulations are extremely complex and restrictive, in many cases it will be advantageous to avoid the use of these trusts. Equalizing the division of assets between the spouses through use of the \$100,000 annual gift exclusion and putting funds into joint and survivor annuities or charitable remainder trusts may obviate the necessity of creating a QDOT and may also minimize estate taxes. Another option is purchasing sufficient life insurance to pay the taxes on the estate of the first spouse to

die. The most effective way for spouses to avoid the estate planning complexities introduced by TAMRA 88 and OBRA 89 is for noncitizen spouses to become naturalized U.S. citizens. Nevertheless, there may be both financial and emotional reasons why such an approach is not feasible.

Ultimately, estate planning is concerned with devising the means of carrying out the asset distribution wishes of the decedent. If those wishes can be carried out with a minimum of complexity and a maximum conservation of assets, so much the better. But if the decedent's desires can only be achieved through more complicated measures, including the creation of QDOTs, the estate planner will, nonetheless, want to be able to employ such measures in the most beneficial way.

NOTES

1. IRC §2056(a).
2. IRC §2523(a).
3. IRC §2040(b).
4. IRC §2056(d)(1).
5. IRC §2056(d)(2).
6. IRC §2056A(b).
7. IRC §2001(a).
8. IRC §2031(a).
9. Streng, 11-11th T.M., *Estate Planning*, A-26.
10. IRC §2107.
11. Prentice Hall, “*A Complete Guide to the Technical and Miscellaneous Revenue Act of 1988*,” Bulletin 49 Extra (1988), ¶4241.
12. IRC §2056(b)(1).
13. IRC §§2056(b)(5), (7), and (8).
14. IRC §§2514 and 2041.
15. IRC §§2519 and 2044.
16. IRC §2055(a).
17. IRC §2040(a).
18. IRC §2040(b).
19. Regs. §20.2056A-8.
20. IRC §2523(a).

21. IRC §2523(I)(1).
22. IRC §2523(I)(2).
23. Regs. §20.2056A-1(a).
24. IRC §6075(a).
25. IRC §6161(a)(1).
26. Regs. §20.2056A-1(a)(1)(iii).
27. IRC §2056(d)(4).
28. Regs. §§20.2056A-1(b) and 20.0-1(b)(1).
29. Regs. 20.2056A-1© and PLR 9521031.
30. Regs. §20.2056A-2(a).
31. IRC §2056(b)(5).
32. IRC §2056(b)(7).
33. IRC §2056(b)(8).
34. Regs. §20.2056(c)-2(b)(1).
35. Regs. §20.2056A-2(b)(3).
36. IRC §§2056A(a)(1)(A) and (B).
37. Regs. §20.2056A-2T(d)(1)(ii)(A).
38. Regs. §20.2056A-2T(d)(1)(I).
39. Regs. §20.2056A-2T(d)(1)(ii).
40. Regs. §20.2056A-2T(d)(2)(iii).
41. Regs. §20.2056A-2T(d)(2)(ii)(B).
42. Regs. §20.2056A-2T(d)(3).
43. Regs. §20.2056A-3(a).
44. Regs. §20.2056A-3(b).

45. Regs. §20.2056A-3(c).
46. Regs. §20.2056A-4(a).
47. Regs. §20.2056A-4(b)(1).
48. Regs. §20.2056A-4(b)(3).
49. Regs. §20.2056A-4(b)(5).
50. Regs. §20.2056A-4(b)(7).
51. Regs. §20.2056A-4(c)(1).
52. Regs. §§20.2056A-4(c)(2) and (3).
53. Regs. §§20.2056A-5(a) and (b).
54. Regs. §20.2056A-5(c)(2).
55. Regs. §20.2056A-5(c)(1).
56. Regs. §20.2056A-5(c)(3).
57. Regs. §20.2056A-6(a).
58. IRC §2010.
59. IRC §2011.
60. IRC §2013.
61. IRC §2014.
62. IRC §2032.
63. IRC §2055.
64. IRC §2056.
65. Regs. §20.2056A-6(b)(3).
66. IRC §2013(a).
67. IRC §2013(d)(3).
68. Regs. §20.2056A-(7)(a).

69. Regs. §20.2054A-7(b).
70. Regs. §20.2056A-8(a)(1).
71. Regs. §20.2056A-8(a)(3).
72. Regs. §20.2056A-8(a)(2).
73. Regs. §20.2056A-10(a).
74. Regs. §20.2056A-10(b).
75. Regs. §20.2056A-11(a).
76. Regs. §20.2056A-11(b).
77. IRC §2056A(b)(6).
78. Regs. §20.2056A-12.
79. IRC §1015.
80. Regs. §20.2056A-5(b)(3).
81. IRC §2056(b)(5).
82. IRC §2056(b)(7).
83. IRC §2056(b)(8).
84. Regs. §20.2056(c)-2(b)(1)
85. W.T. Diss, "QDOTs To the Rescue: Complications and Solutions," *Trusts and Estates* (October 1993), 56.
86. Federal Tax Coordinator 2d, Vol. 22A, *Estate Tax*, 46,435.
87. D.L. Siegler and L.L. Plaine, "Despite Some Easing in Final Regs., QDOT Rules Remain Intensely Complicated," *Journal of Taxation* (December 1995), 371.
88. Temp. Regs. §20.2056A-2T(d)(1)(iii).
89. R.C. Lawrence, III, S.B. Straske, II, and M.J. Ashenfelter, "Proposed Regulations Cause Stir For the Foreign Individual," *Trusts and Estates* (August 1994), 48.
90. Lawrence, "Proposed Regulations Cause Stir," 48.

91. IRC §1034(b)(1).
92. Temp. Regs. §20.2056A-2T(d)(1)(iii)(G).
93. Siegler, "IRS Revises Security Arrangements," 16.
94. Lawrence, "Proposed Regulations Cause Stir," 47.
95. Temp. Regs. §20.2056A-2T(d)(1)(ii)(B).
96. D.W. Daly, III, "Ransoming the QDOT With a Life Insurance Trust," *Journal of the American Society of CLU & ChFC* (July 1994), 74.
97. Siegler, "IRS Revises Security Arrangements," 13.
98. Diss, "QDOTs to the Rescue," 61.
99. Regs. 20.2056A-4(b)(5).
100. Regs. 20.2056A-4(d)(5).
101. IRS §2702 deals with special valuation rules for the transfer of an interest in a trust to members of the transferor's family. The general rule under §2702(a)(2)(A) is that the value of an interest retained by the transferor is zero. However, §7520 provides exceptions where, among other situations, the transferor has the right to receive fixed or percentage amounts from the trust at least annually.
102. Regs. §25.2702-1(c)(8).
103. Regs. §20.2056A-4(d)(1).
104. IRS §2036(a)(1).
105. Pennel, 84 3 T.M., *Estate Tax Marital Deduction*, A-79.
106. IRC §2518(c)(3) and Regs. 20.2056A-4(b)(5).
107. E.A. Slott, "The Facts About QDOTs: Beware the Estate Tax Traps," *The CPA Journal* (April 1992), 69.
108. Siegler, "QDOT Rules Remain Intensely Complicated," 372.
109. P. Montgomery, "Estate Planning for Nonresident Spouses," *Pillsbury Madison & Sutro LLP Tax Page*, gfm@pmstax.com, Copyright 1993, 1995.
110. Diss, "QDOTs To the Rescue," 61.

111. Regs. 20.2056A-12.
112. Regs. 1.1015-5(c)(4) and (5).
113. Diss, "QDOTs To the Rescue," 62 (endnote 31).
114. *Ibid.*, 61.
115. Pennell, *Estate Tax Marital Deduction*, A-83.
116. IRC §408(a).
117. IRC §408(b).
118. Regs. 20.2056A-4(b)(7) and (c).
119. Regs. 20.2056A-5(c)(3)(iv).
120. Public Letter Ruling 9109021.
121. S.B. Sherman, "Qualified Plan Benefits Create Problems for Noncitizen Spouse," *Trusts and Estates* (February 1993), 73.
122. Sherman, "Qualified Plan Benefits," 73.
123. Montgomery, "Estate Planning for Nonresident Spouses."
124. IRC §2652(a)(3).
125. Regs. 20.2056A-4(d)(5).
126. Daly, "Ransoming the QDOT," 76.
127. *Ibid.*, 75.
128. Regs. 25.2523(I)-1(c).
129. IRC §2056(d).
130. IRC §2035(a).
131. IRC §1014(a).
132. IRC §1015.
133. Regs. §25.2523(I)-1(c)(1).

134. IRC §2523(b).
135. Slott, "The Facts About QDOTs, 69.
136. IRC §2523(f)(5).
137. Regs. §25.2523(I)-1(b).
138. IRS §2040(b).
139. IRC §2056(d)(1)(B). However, any consideration provided by a citizen donor spouse for property acquired before July 14, 1988 which was treated as a gift to the donee spouse is deemed consideration furnished by the donee spouse, unless that spouse is the first to die. [Regs. 20.2056A-8(a)(2).]
140. Regs. §25.2523(I)-2(b).
141. Streng, 11-11th T.M., *Estate Planning*, A-91.
142. Daly, "Ransoming the QDOT," 76.
143. *Ibid.*, 76.
144. Regs. §20.2056A-2(b)(1).
145. Regs. §25.2523(I)-1(b).
146. IRC §2523(f)(6)(D).
147. IRC §2523(g)(1).

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