Three Reasons International Families Should Consider Qualified Domestic Trusts

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What kind estate planning is advisable for individuals with a non US citizen spouse? In most cases, a decedent's estate may be transferred to a US citizen spouse without any estate tax, thanks to a high exclusion amount for US citizen and permanent resident decedents in 2009 and an unlimited marital deduction. When a decedent's spouse is a not a US citizen, however, the estate cannot claim the marital deduction—regardless of the citizenship of the decedent. That's not a problem if a decedent's estate is smaller than the applicable exclusion amount, or if the surviving spouse becomes a US citizen prior to filing an estate tax return. But what if you are a non resident alien and have an applicable exclusion amount of only $60,000? Or, what if your spouse doesn't acquire citizenship in time?

Under IRC code sections 2056(d) and 2056A, a Qualified Domestic Trust (QDOT) is the only instrument by which the marital deduction may be claimed when one's spouse is not a US citizen at the time of filing an estate tax return. A QDOT enables families with a low exemption amount or large estate to defer estate taxation, provide income to a surviving spouse, and create valuable time during which a surviving spouse may acquire US citizenship. The IRS allows QDOTs because they defer the estate tax until the death of the second spouse: Tax deferral lowers the probability that a surviving spouse will claim a marital deduction and subsequently die in a foreign country, thereby avoiding all US tax. In this article, we discuss three reasons why individuals with a non US citizen spouse should consider estate planning with QDOTs, and how to avoid several pitfalls.

First Reason: QDOTs Appeal to Individuals with Assets in excess of their Applicable Exclusion Amount.

Individuals with a non US citizen spouse often choose to establish a QDOT to claim the marital deduction because their estates are higher than the applicable exclusion amount. As mentioned above, a QDOT is the only instrument by which the marital deduction may be claimed when one's spouse is not a United Citizen. For non resident aliens, US permanent residents, and US citizens alike, QDOT planning should be seriously considered when assets above one's applicable exclusion amount will be transferred to a non US citizen spouse.

Non Resident Aliens with US Assets over $60,000. In addition to other strategies, QDOT planning should be seriously considered by non resident aliens with assets located in the United States

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that exceed $60,000. Non resident aliens can transfer only $60,000 in 2009 without triggering estate tax at the rate of 45%. With a QDOT, however, the estate tax is deferred until the death of the second spouse.

US Citizens and permanent residents with non US Citizen spouses. If a US Citizen or permanent resident's estate is under $3.5 million upon a death in 2009, the full amount may pass without tax regardless of the spouse's citizenship. Moreover, families with estates above $3.5 million should consider the use of a QDOT along with other estate planning strategies in order to preserve the marital deduction. Families should keep in mind that in 2011, unless Congress acts, the applicable exclusion amount will drop to $1 million. If this is the case, many families with estates above $1 million may one day benefit from QDOT planning. As it stands, however, future changes in the law are uncertain.

***Surviving Spouse is a Non Resident Alien*.** Another problem arises when a US citizen or permanent resident has an estate below the applicable exclusion amount, but where the surviving spouse is a non resident alien. In such cases, the surviving spouse's death may incur substantial estate tax liability upon his or her death. As mentioned above, non resident aliens can transfer only $60,000 in 2009 without triggering estate tax at the rate of 45%. Such individuals may benefit from QDOTs and other estate planning for international families.

Second Reason: Lifetime Income and Estate Tax Deferral

To see the benefits of income and tax deferral, consider the following example. Let's assume that Ronald, a US permanent resident, passes away in 2009, survived by two children and his wife, Marie. Marie is not a US citizen, and Ronald's estate amounts to $5.5 million. For the purposes of this example, we are assuming that there is no joint property. Ronald's exclusion amount is used to shield $3.5 million from estate tax, which is transferred to his children through a trust created prior to Ronald's death. The remaining $2 million passes to Marie, in the form of a $1.5 million personal residence in California and $500,000 in marketable securities. Ronald did not establish a QDOT during his lifetime. Hence, the $2 million would normally be taxable because it exceeds Ronald's exemption amount and Marie doesn't qualify for the marital deduction. However, Marie works with an attorney to create a QDOT that pays a 5-percent unitrust interest to hold the assets. Marie subsequently transfers the assets to the QDOT prior to filing the estate tax return. She pays the trustee fair market value rent in order to live in the residence, and the trustee pays Marie $100,000 annually. Marie receives additional distributions from the QDOT in order to pay the trust's expenses, and to provide funds in the event of hardship for herself or her children.

In the above example, Marie's QDOT allows for deferral of the estate tax. Because Marie has timely transferred assets to a QDOT, the transfer of assets from Ronald's estate is not subject to estate tax

at the time of Ronald's death. In fact, in the above example all federal tax has been avoided at the first death through the use of appropriate planning. The estate tax will then be postponed until the death of the second spouse—a tremendous advantage for Marie during her lifetime. However, this does NOT mean that the surviving spouse will be able to offset the tax on QDOT assets with her applicable exclusion amount at the time of her death. Assuming Marie never becomes a US citizen, an estate tax will be imposed upon the QDOT assets by reference to *Ronald's* estate. However, she would at least have the benefit of QDOT income during her lifetime.

Third Reason: A QDOT Buys Time

The QDOT in the example above buys time for Marie to acquire her US citizenship. If Marie eventually becomes a US citizen prior to her death, the ordinary rules that apply to US citizen spouses for establishing the marital deduction would apply. Accordingly, the entire $5.5 million can pass to the children without the assessment of estate taxes upon Marie's death. However, Marie must be a resident for the entire period after Ronald's death in order to avoid deferred estate tax. The US trustee must also timely notify the IRS of Marie's acquisition of citizenship.

During the time it takes Marie to acquire her citizenship, she can receive certain distributions that are not subject to a QDOT tax imposed under IRC section 2056A(b). First, she can receive income, such as a unitrust amount between 3-5 percent. In the above example, Marie and her attorney agreed upon the maximum percentage of 5%. Marie cannot, however, receive capital gains or a distribution of principal without liability for QDOT tax. Second, Marie can receive a distribution free of QDOT tax of the principal in the event that she suffers financial hardship and has no other reasonable source of funds for her or her children's health, maintenance, and support. Third, Marie can receive distributions from the QDOT free of QDOT tax for the payment of certain expenses and income taxes generated by the QDOT. Finally, once Marie becomes a US citizen, distributions can be made without imposition of the IRC section 2056A(b) QDOT tax.

Consider the Many Pitfalls

The Rules. From Marie and Ronald's case, we may glimpse some of the myriad rules governing QDOTs. Importantly, at least one of the trustees has to be a US citizen individual or corporation, who has the authority to withhold amounts from distributions of principal in order to pay a special QDOT tax.

The QDOT can be created by Ronald prior to his death, by Ronald's executor, or even by Marie herself. In some cases, a QDOT is created through the reformation of an existing trust or through a judicial proceeding. In these situations, the QDOT should be created prior to filing the estate tax return in

order to avoid the imposition of interest and penalties. Furthermore, the terms of an existing trust should be respected in order to avoid a court procedure. Therefore, it's generally easier for the QDOT to be established prior to the death of the first spouse.

The QDOT cannot make any distributions of principal unless special withholdings are satisfied in order to pay taxes. Moreover, in situations where the QDOT assets are significant, it is required that at least one of the US trustees be a bank or that the US trustee post a substantial bond based on the date of death value of QDOT assets. In addition, because Marie may acquire US citizenship while the QDOT is in place, it should be drafted flexibly so that it can respond to such changes. This is not an exhaustive list of requirements for a valid QDOT, but it may give you some idea of the many rules that must be followed.

What if I die in 2010? The effects of estate tax repeal in 2010 on QDOTs are mixed. On the one hand, there will be no deferral of estate tax for surviving spouses dying in year 2010 under IRC section 2210(b)(2). On the other hand, any distributions from a QDOT during year 2010 (with exceptions) would be subject to the QDOT tax as discussed above.

Not a Panacea. While a QDOT has several advantages, it should not be treated as a one-size-fits-all solution. Certain assets might not be eligible to transfer to a QDOT, and the cost of establishing and maintaining the QDOT might be high relative to its benefits. Moreover, the requirement of a US trustee necessarily results in a loss of control for the non-citizen spouse, and possible additional expenses. Anticipated appreciation of the QDOT assets, the amount of final tax to be paid at the second spouse's death, the ability to make tax-free distributions under a hardship exemption during the spouse's life, and the likelihood of the spouse's acquisition of US citizenship will all influence whether tax deferral under a QDOT is worth the pain and cost. In some situations, individuals may consider the payment of a tax on the death of the first spouse to outweigh the cost and complexity associated with a QDOT.

Individuals and their families should also consider the special rules governing joint property at death for individuals with non US citizen spouses. Under IRC code section 2040(a), a contribution tracing rule may apply when one's spouse is not a US citizen, resulting in the inclusion of all joint property in the taxable estate of the decedent. Moreover, international families always need to keep the role of foreign jurisdictions in mind. Many civil law countries do not recognize trusts, possibly resulting in adverse tax consequences in a different country. Moreover, the benefits of an estate tax treaty might make a QDOT unnecessary.

<u>Conclusion: Consider Your Options</u>

QDOTs are one tool among many which are available to individuals with non US citizen spouses. An appropriate strategy should also consider gifting and alternative testamentary devices. In all cases, the estate plan should be properly coordinated with applicable treaties, rules from the foreign jurisdiction, and estate planning documents already in place. Ideally, the advice and assistance of both foreign and domestic counsel should be sought.