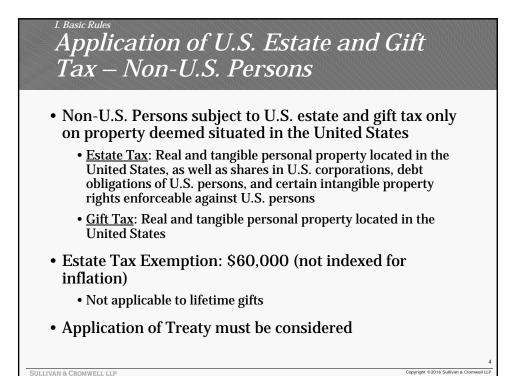


Application of U.S. Estate and Gift Tax – U.S. Persons

- U.S. citizens and domiciliaries ("U.S. Persons") are subject to U.S. Federal estate and gift tax on transfers of worldwide assets, with a few exceptions, including:
 - <u>Lifetime Exemption</u>: \$5.45 million in 2016 (indexed for inflation)
 - <u>Annual Exclusion</u>: \$14,000 per donee in 2016 (indexed for inflation)
 - <u>Medical/Educational</u>: Certain medical and educational expenses paid directly
- Estate and gift tax imposed at a Federal rate of 40%
- Domicile involves a subjective analysis of the place a person regards as his or her "home"; separate from "substantial presence" income tax analysis





- Unlimited deduction generally available for transfers to a U.S. citizen spouse
- · Outright bequests generally free from estate tax
- Bequests of interests subject to a contingency generally do not qualify for estate tax marital deduction
 - Under I.R.C. §2056(b)(1), an interest in property passing to the surviving spouse that terminates or fails upon some occurrence or contingency (*e.g.*, the death of the surviving spouse) will not qualify for the marital deduction where such interest
 - (i) passes to someone other than the surviving spouse (or the estate of the surviving spouse) upon such termination or failure and
 - (ii) such other person has the right to possess or enjoy any part of such property after such termination or failure
 - Would exclude many trusts from qualifying for the marital deduction



- Exceptions to prohibition against spouse having a terminable interest include:
 - A life estate in the surviving spouse coupled with a general power of appointment;
 - An interest passing to the surviving spouse that requires the surviving spouse to survive by more than 6 months;
 - Certain interests in proceeds under a life insurance, endowment, or annuity contract payable in installments where the spouse holds a general power of appointment; and
 - An interest in a charitable remainder trust where the surviving spouse is the only non-charitable beneficiary.
- **Most Important Exception**: Qualified terminable interest property ("QTIP") trusts

T. Basic Rules Estate Tax Marital Deduction – QTIP Property

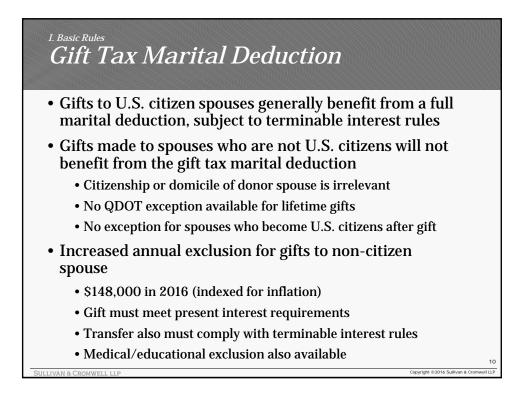
- **QTIP Property**: Property (1) that passes from the decedent, (2) in which the surviving spouse has a qualifying income interest for life, and (3) to which the relevant election is timely made
 - Qualifying income interest for life is an interest where:
 - (i) the surviving spouse is entitled to all the income from the property, payable annually or at more frequent intervals, or has a usufruct interest for life in the property, and
 - (ii) no person has a power to appoint any part of the property to any person other than the surviving spouse
 - · Election made on decedent's estate tax return
- QTIP property may pass to the surviving spouse in a life estate or (more commonly) in trust
- QTIP property is subject to U.S. estate tax on the death of the surviving spouse



- I.R.C. § 2056(d) provides that the general estate tax marital deduction is not available where the recipient spouse is not a U.S. citizen
 - This is true even where the surviving spouse is a green card holder or domiciled in the United States and thus subject to gift and estate tax on worldwide assets
 - Citizenship/domicile of the decedent spouse is irrelevant, except to the extent that a treaty may be applicable
- Estate tax paid by estate of decedent spouse allowed as a credit to the estate of the surviving spouse if:
 - (i) assets were passed in a way that would have qualified for the marital deduction if the surviving spouse had been a U.S. citizen and
 - (ii) estate of the surviving spouse is subject to U.S. estate tax

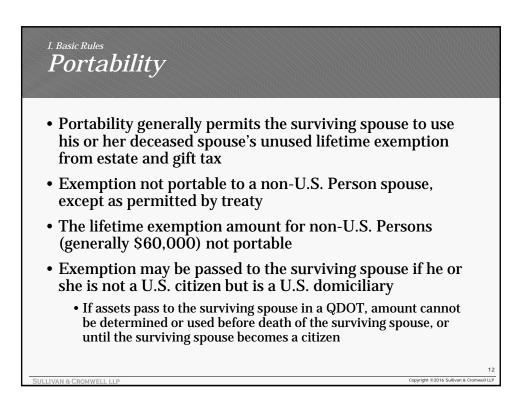


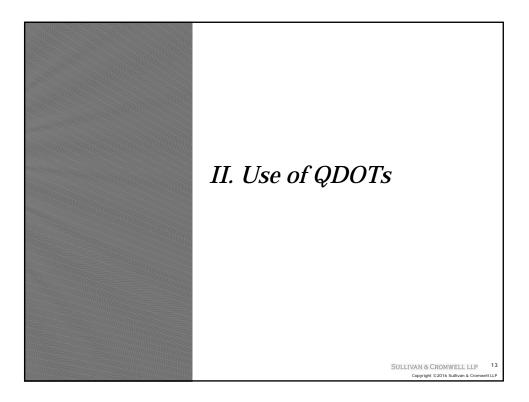
- **Surviving Spouse Becomes Citizen**: Exception to I.R.C. §2056(d) where the surviving spouse becomes a U.S. citizen after death of spouse but before the filing of the estate tax return
 - Surviving spouse must have been domiciled in the United States at all times between the death of the decedent spouse and the filing of the return
 - Property must have passed in a manner that would otherwise qualify for the marital deduction
- **QDOT**: Exception to I.R.C. §2056(d) for property passing to a qualified domestic trust ("QDOT") for the surviving spouse

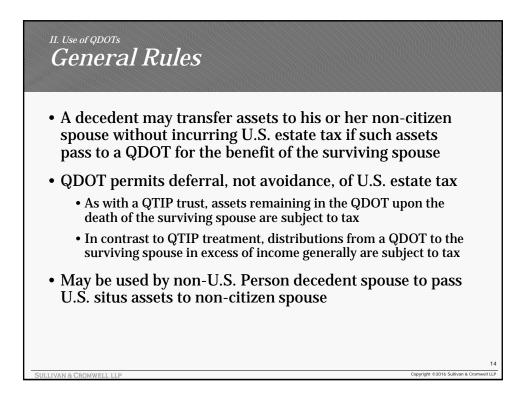


^{1. Basic Rules} Gift Splitting

- I.R.C. §2513 allows gifts made by one spouse to be considered as made one-half by the donor and one-half by his or her spouse
 - Both spouses must consent to gift splitting
 - Permits either spouse to make an annual gift of \$28,000 per donee
- Gift splitting only permitted if both spouses are U.S. citizens or domiciliaries
 - Non-U.S. Person spouse may transfer non-U.S. situs property to any person free of U.S. gift tax
 - Non-U.S. Person spouse also may make annual exclusion gifts of U.S. situs assets or transfer assets to a U.S. Person spouse
 - But limitation of gift splitting with a non-U.S. Person spouse may present complexity in gifting if assets are held by U.S. Person spouse

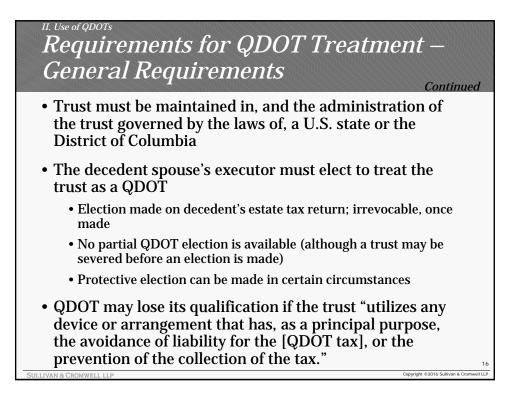


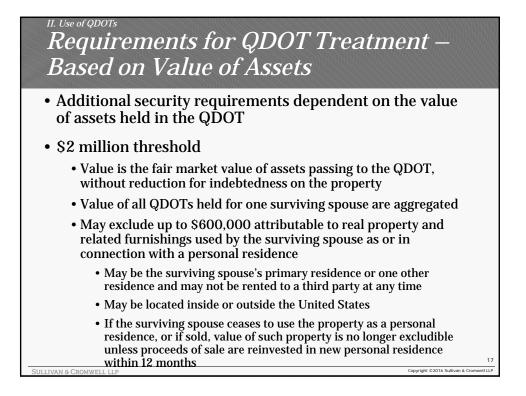


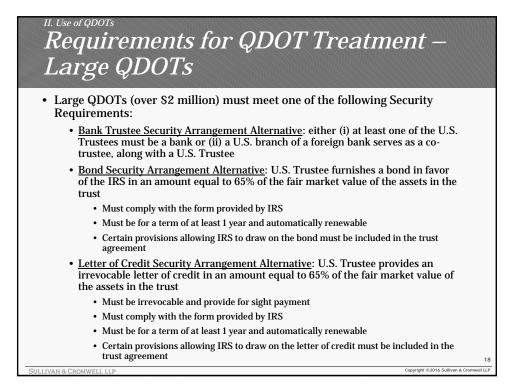




- Trust must be an "ordinary" trust
 - "[T]rustees take title to property for the purpose of protecting or conserving it for the beneficiaries under the ordinary rules applied in chancery or probate courts"
 - · May be problematic in jurisdictions that do not recognize trusts
- Trust generally must otherwise qualify for the Federal estate tax marital deduction
- At least one of the trustees must be a U.S. citizen with a tax home in the United States or a U.S. corporation (a "U.S. Trustee")
- Trust agreement must provide that no distribution of principal may be made from the trust unless the U.S. trustee has the right to withhold the estate tax payable
 - Trustee's power to withhold taxes will not cause the trust to fail to be a QDOT







Requirements for QDOT Treatment – Small QDOTs

- Small QDOTs (less than or equal to \$2 million) must meet one of the following Security Requirements:
 - · One of the security requirements for a Large QDOT
 - Trust agreement must include a provision that no more than 35% of the value of trust assets (determined annually) will consist of real property located outside the United States
- For non-U.S. real property limitation, rule permitting the exclusion of \$600,000 of real property from QDOT value is not applicable to determine percentage of trust assets held in non-U.S. real property
- · IRS will look through certain entities to determine real property ownership
- If value of foreign real property owned by a Small QDOT that is relying on the limitation on non-U.S. real property ever exceeds 35% of the fair market value of the trust assets, trust has until the end of the subsequent year to reduce foreign real estate holdings to meet the 35% limit, or meet one of the other available security arrangements

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Requirements for QDOT Treatment – General Security Requirements

- Trust may alternate between the different applicable security requirements as long as it meets at least one at all times
- Marital deduction will be disallowed for the QDOT if the value of the QDOT assets as originally reported on the estate tax return was 50% or less of the value as finally determined for Federal estate tax purposes (subject to an exception for reasonable cause), if either:
 - (i) the bond or letter of credit security arrangements are chosen or
 - (ii) the QDOT property was originally reported on the decedent's estate tax return as having a value of \$2 million or less but is finally determined for Federal estate tax purposes to be in excess of \$2 million
- If undervaluation is less than the 50% threshold, but the value of QDOT assets is originally determined to be less than \$2 million, but finally valued at over \$2 million, U.S. Trustee has a reasonable period of time to implement a Large QDOT security arrangement
- Trusts executed before November 20, 1995 will be deemed to meet the security requirements, even if the trust agreement does not include the required language, if certain requirements are met

Taxation of QDOTs – Taxation of Tax

- A special QDOT "estate" tax is imposed upon:
 - Distributions from the QDOT to the surviving spouse of assets other than income
 - Assets held in the QDOT upon the death of the surviving spouse
 - Assets held in the QDOT upon the termination of the QDOT status
- Payments of any QDOT estate tax due on the occurrence of a triggering event and gross-up distributions to pay the income tax imposed upon the surviving spouse upon an income distribution to which the spouse was entitled are treated as taxable distributions
- The QDOT tax is not imposed on:
 - Payments for the ordinary and necessary expenses of the QDOT
 - Payments of taxes imposed on the QDOT other than the QDOT tax
 - Distribution to reimburse the surviving spouse for tax imposed upon <u>income</u> to which the surviving spouse is not entitled (and may or may not receive) under the terms of the QDOT (exception does not apply to distributions of capital)

Taxation of QDOTs – Hardship Distributions

- Distributions on account of hardship are excepted from general rule that distributions of principal are taxed
- Hardship Distributions are distributions made "in response to 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"
- Not a hardship distribution if the spouse has other assets reasonably available
 - "Reasonably available" assets include cash and publicly traded stock
 - Closely held business interests, real estate, tangible personal property generally are not "reasonably available"

Taxation of QDOTs – Computation of Tax

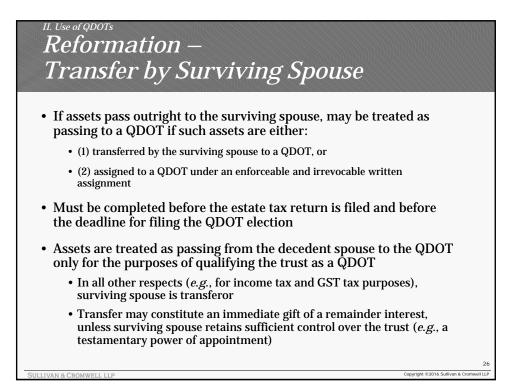
- Tax imposed on assets relating to a triggering event is based on the additional estate tax that would have been imposed on the estate of the decedent spouse, if such amount had been included in the decedent's estate
- Computed by:
 - (1) determining the tax if the assets involved in the relevant taxable event and in all previous QDOT taxable events were added to the decedent's estate,
 - (2) reduced by the estate tax that would have been imposed on the decedent's spouse's estate plus tax relating to previous QDOT taxable events
- Tax rate is rate applicable at time of the decedent's death
- Any available credits (including the lifetime exemption of the decedent spouse) may be used to reduce QDOT tax due
- Because assets are treated as passing from the decedent spouse, the surviving spouse's lifetime exemption may not be used
- Surviving spouse's basis on lifetime distributions is increased for taxes paid, but not increased to fair market value

Taxation of QDOTs – Includible in Surviving Spouse's Estate

- Assets of the QDOT generally also taxable in the estate of the surviving spouse
- Surviving spouse's estate receives a credit for the tax paid by the decedent spouse's estate, so that double tax is avoided
- Transferor for purposes of generation-skipping transfer ("GST") tax exemption:
 - Where the QDOT is also includible in the estate of the surviving spouse (subject to a credit for the QDOT taxes paid), the surviving spouse should be treated as the transferor, as long as the trust is not subject to a "reverse" QTIP election
 - Where the surviving spouse transferred or assigned the assets to the QDOT (discussed below), he or she is the transferor for all purposes (other than for purposes of the trust qualifying as a QDOT)

Reformation – Marital Trust Transfers

- Trust not meeting QDOT requirements may be reformed
 - If reformed under the terms of a trust agreement, must be completed before the due date (including extensions) for the filing of the decedent spouse's estate tax return
 - If reformed by a judicial proceeding, the proceeding should be commenced on or before such date
 - Trust must be treated as a QDOT prior to reformation
- Trust must meet the general marital deduction requirements reformation cannot be used to comply with these



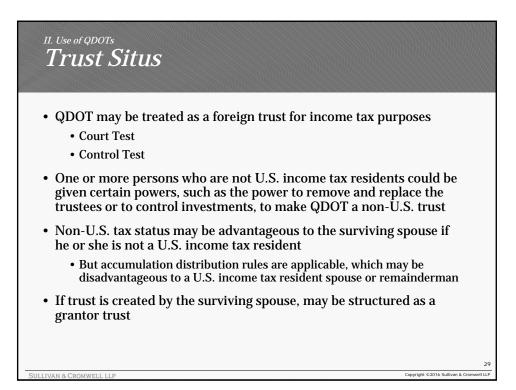
II. Use of QDOTS Outright Transfers

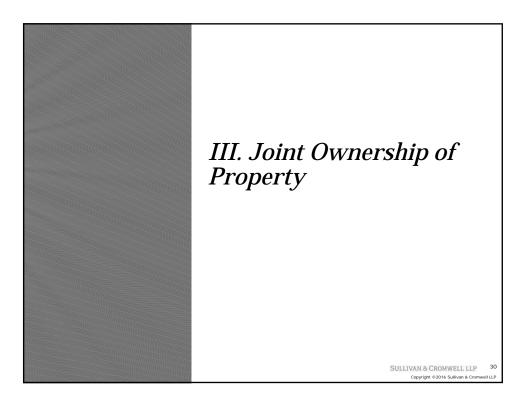
- In some circumstances, it may be preferable for assets to pass to a surviving non-citizen spouse outright rather than in a QDOT.
 - Where foreign tax credits are available to eliminate U.S. estate tax otherwise payable
 - Where U.S. estate tax paid is available as a credit to reduce foreign taxes otherwise payable
 - Where assets are expected to appreciate very significantly during the surviving spouse's lifetime

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- Before Filing of Return: Marital deduction is available for bequests made to a surviving spouse who:
 - (1) becomes a U.S. citizen before the filing of the decedent's estate tax return, and
 - (2) was a domiciliary of the U.S. at all times after death of the decedent spouse
- After QDOT Created: QDOT no longer subject to QDOT tax after the surviving spouse becomes a U.S. citizen if either:
 - (1) the surviving spouse was a U.S. domiciliary at all times after the death of the decedent spouse, or
 - (2) no taxable distributions have been made from the QDOT before the surviving spouse becomes a U.S. citizen
- If above requirements not met, can avoid QDOT tax going forward if the surviving spouse:
 - Elects to treat any taxable distribution from the QDOT prior to the election as a taxable gift made by such surviving spouse; and
 - Elects to treat any portion of the decedent spouse's unified credit utilized previously to reduce QDOT tax as reducing the surviving spouse's unified credit







- Spouses often find it most convenient to own real property and personal property as tenants by the entirety or joint tenants with rights of survivorship
- Unavailability of marital deduction may create adverse estate and gift tax consequences where a U.S. spouse owns property jointly with a noncitizen spouse
- Rules to be discussed are for joint tenancies created after July 14, 1988

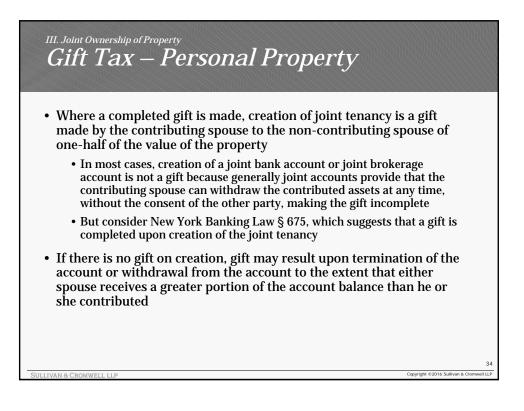
III. Joint Ownership of Property Estate Tax

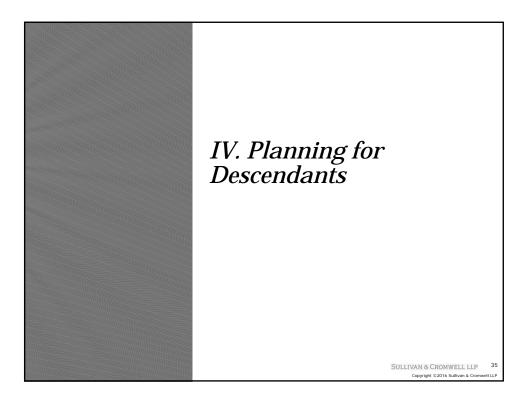
- For U.S. citizen spouses, one-half of the value of jointly held property is included in the estate of the deceased spouse, and the marital deduction is available
- For a non-citizen surviving spouse, amount includable in the deceased spouse's estate is the portion of the value of the asset attributable to the contribution made by the decedent spouse
- Estate has the burden to submit facts sufficient to show that property was not acquired entirely by consideration furnished by the decedent

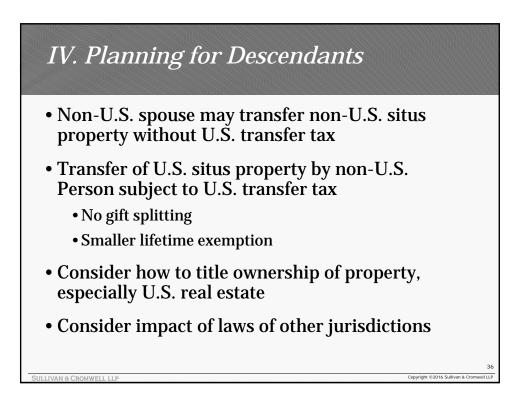


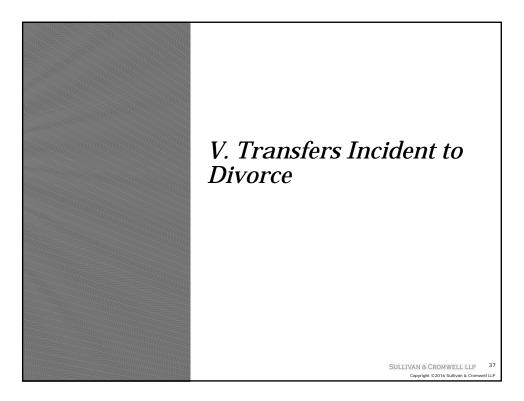
- Creation of joint tenancy will not be treated as a taxable gift to a non-U.S. citizen spouse, regardless of which spouse provided the consideration
- Upon termination of the joint tenancy (other than because of the death of one of the spouses), a taxable gift occurs to the extent that a spouse receives a greater share of the proceeds at the termination than the share representing such spouse's contribution
- For U.S. spouses, unlimited marital deduction is available
 - But there may be a taxable gift where a non-citizen spouse receives a disproportionate amount of proceeds

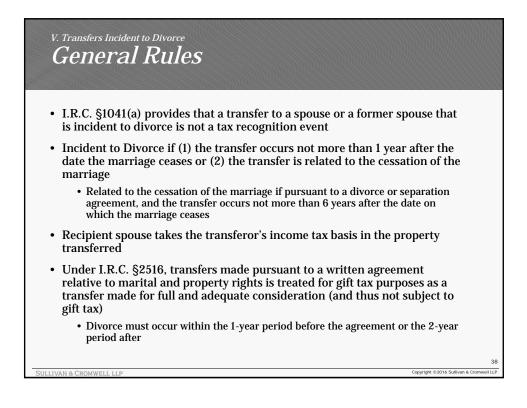
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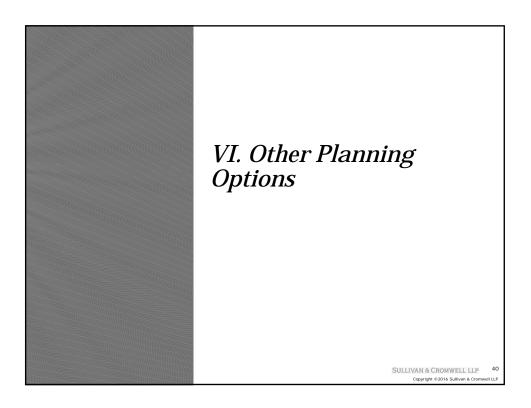






Transfer to Non-Resident Alien Spouse

- I.R.C. §1041(d) provides that the general rule regarding the nonrecognition of gain or loss on transfers of assets to a spouse or to a former spouse incident to divorce is not applicable where the transferee spouse is a nonresident alien
- U.S. citizen or resident spouse who transfers property to a non-resident alien spouse or former spouse in connection with a divorce recognizes any built-in gain or loss in the property transferred
- · However, such transfers should not be subject to gift tax
- Division of jointly held property equally upon divorce between a U.S. citizen or resident and a non-resident alien spouse generally is treated as a nontaxable partition, rather than a taxable transfer





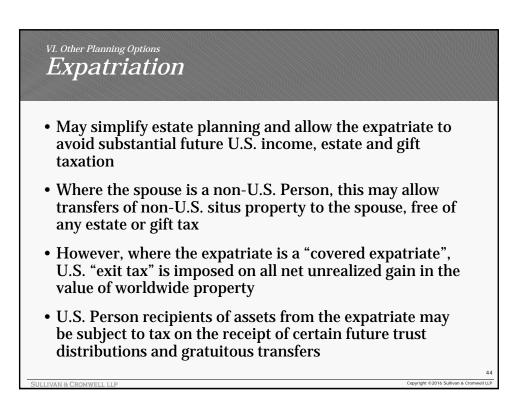
- Under the general rule of I.R.C. §1041(a), a sale of assets between spouses is not considered a tax recognition event
- General rule is inapplicable where the spouse receiving the assets in question is a non-resident alien
- But non-resident alien spouse takes a fair market value cost basis in the transferred property



- Proceeds of life insurance on life of non-U.S. Person is not a U.S. situs asset
 - Non-U.S. Person spouse may hold insurance on his or her life without incurring U.S. estate tax on death
- Where the non-citizen surviving spouse is named as the beneficiary on an insurance policy owned by the U.S. Person spouse, the surviving spouse must transfer or assign the policy to a QDOT in order to avoid the application of estate tax upon the death of the insured spouse
- Changing ownership and beneficiary designation to the non-citizen spouse can avoid the requirement that the proceeds be paid to a QDOT if the insured spouse survives for at least 3 years after such transfer

VI. Other Planning Options Appointment of Non-Citizen Spouse as Fiduciary

- Naming a non-resident alien spouse as a trustee of a trust, and giving that spouse the power to make "substantial decisions", will cause the trust to be treated as a foreign trust
- Tax rules of other relevant jurisdictions also must be considered
 - For example, in certain circumstances, service by a U.K. resident person as the trustee of a trust may cause that trust to be subject to U.K. tax on income and/or gains
- Local law also may limit the ability of a non-citizen spouse to serve in a fiduciary capacity
 - In New York, a non-citizen who is not domiciled in New York will not be issued Letters to serve in a fiduciary capacity over a New York estate or trust unless a New York resident is appointed to serve as a co-fiduciary





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Partner since 2010 Harvard Law School, J.D. 2001 University of Pennsylvania, B.A. 1997 ${\bf Z}$ ena Tamler joined Sullivan & Cromwell's Estates and Personal Group in 2001 and was elected partner in October 2009. She represents high net worth individuals and families in connection with their personal legal matters, with particular focus on sophisticated tax and estate planning matters and the structuring of family business affairs.

Ms. Tamler represents fiduciaries in connection with the administration of estates and trusts and advises a variety of charitable organizations. She has experience with a broad range of international tax and estate planning matters, including the taxation and administration of non-U.S. trusts and the structuring of multijurisdictional estates.

Ms. Tamler is a member of the Committee on Estate and Gift Taxation and a past member of the Committee on Trusts, Estates & Surrogate's Courts of the New York City Bar Association. She is also a member of the Trusts and Estates Group of the UJA-Federation of New York and the Society of Trust and Estate Practitioners. Ms. Tamler is a member of the New York Board of the Anti-Defamation League, prior co-chair of its Lawyers' Division Committee, and co-chair of its Professional Advisory Committee on Planned Charitable Giving. She is a member of the Board of Creative Alternatives of New York.

Ms. Tamler has been recognized as a "Rising Star" in the area of Estate Planning & Probate by New York Super Lawyers (2011-2015).

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