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PLANNING FOR THE NON-CITIZEN SPOUSE

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In an increasingly mobile world, U.S. trust and estate practitioners, even those whose area of practice is generally limited to domestic estate planning, are faced with having to provide planning advice for U.S. citizen clients (or non-citizen clients holding U.S. situs property) with non-U.S. citizen ("non-citizen") spouses. The general unavailability of the marital deduction from estate and gift taxes for transfers to non-citizen spouses makes planning for these clients complicated. This article summarizes certain of the rules related to planning for non-citizen spouses, and discusses related planning techniques.

I. Basic Rules

A. Application of U.S. Estate and Gift Tax

U.S. domiciliaries, regardless of citizenship, and U.S. citizens (collectively, "U.S. Persons") are subject to U.S. Federal estate and gift taxes on transfers of worldwide assets.[1] In 2016, U.S. Persons are entitled to a total lifetime exemption from estate and gift taxes for $5.45 million of transferred assets (indexed annually for inflation).[2] There are also available (i) an annual exclusion from U.S. gift tax (for 2016, $14,000 per donee, or $28,000 per donee total for married couples for whom gift splitting is available)[3] and (ii) an unlimited exclusion from U.S. gift tax for the payment of certain educational and medical expenses paid directly to the relevant educational institution or health care provider.[4] Estate, gift and GST tax on transferred amounts above the lifetime exemption and gift tax exclusion amounts are imposed at a Federal rate of 40 percent.[5]

Non-U.S. Persons are subject to U.S. gift and estate tax only on property deemed situated in the United States ("U.S. situs property"). This includes U.S. real estate and tangible personal property located in the United States. Shares in U.S. corporations, debt obligations of U.S. persons, and certain intangible property rights issued by or enforceable against U.S. persons generally are subject to U.S. estate tax but not gift tax.[6] The lifetime exemption for estate and gift tax purposes is not available to individuals who are not U.S. Persons. Such non-U.S. Persons are instead granted a $60,000 estate tax exemption, which is not indexed for inflation,

1 Sections 2001(a) and 2501(a)(1) of the Internal Revenue Code of 1986, as amended (the "Code").

2 Code Sections 2010(c) and 2505(a). There is a lifetime exemption from generation-skipping transfer ("GST") tax of the same amount. Code Section 2631(c). With certain exceptions, the GST tax is generally applicable to transfers to individuals two or more generations younger than the donor.

3 Code Section 2503(b).

4 Code Section 2503(e).

5 Code Sections 2001(c), 2502 and 2641. State taxes also may be applicable in certain cases.

6 In all cases, the application of a double tax treaty must be considered.

and which is not available to shelter gifts by non-U.S. Persons.[7] As noted in more detail below, the amount of this exemption may vary if a tax treaty is applicable. This exemption does not cover gifts made during the individual's life.

Unlike the objective test for U.S. income tax residence,[8] the test of U.S. domicile is determined by a subjective analysis of the place a person regards as his or her "home" at the time of a transfer. A person acquires domicile in a place by (i) living there, for even a brief period of time, (ii) with the intention of remaining there indefinitely.[9] Application for a "green card" is one of the strongest indicators of an intent on the part of the applicant to remain in the United States indefinitely, in part because the application itself evidences an intent of the applicant to reside in the United States and not return abroad.

B. Estate Tax Marital Deduction – General Application

In general, an unlimited marital deduction from U.S. estate tax is available, so that spouses may devise and bequeath property outright to one another without the imposition of any estate tax.[10] A transfer to a surviving spouse that is subject to any contingency ordinarily will not qualify for the marital deduction.[11] In particular, Code Section 2056(b)(1) provides that an interest in property passing to a surviving spouse that terminates or fails upon some occurrence or contingency (for example, 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 shall have the

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7 Code Section 2102(a), (b)(1). If any unified credit against gift tax was utilized with respect to gifts made during the life of the decedent, such credit used is deducted from the amount of credit available to the estate. Code Section 2102(b)(3)(B). This could occur where an individual made gifts during life while domiciled in the United States, but died while domiciled outside the United States.

8 Generally, a non-citizen of the United States is considered a resident of the United States for income tax purposes if the individual (i) is admitted for permanent residence (i.e., holds a "green card"), (ii) elects to be treated as such or (iii) has a "substantial presence" in the United States in a given calendar year. Code Section 7701(b)(1)(A). Whether an individual has a "substantial presence" in the United States is based on a weighted three-year average day count calculation. Code Section 7701(b)(3)(A).

9 Treas. Reg. Section 20.0-1(b)(1). Although the domicile test is subjective, the analysis of a person's intention to remain in the United States (or elsewhere) is determined by reference to external, objective factors. The key to an analysis of domicile is that an individual must have presence in a jurisdiction coupled with the requisite intention. In order for domicile to be changed, intention and change of physical presence must coincide. Much of the analysis in domicile cases turns on proving of the intention of the individual. As noted in *Estate of Bloch-Sulzberger*, 6 T.C. Memo 1201 (1947), "[t]he intention of the person is extremely important [in the domicile analysis]. Domicile is the place which he regards as his home, the place where he intends to live."

10 Code Section 2056(a). Of particular relevance to same-sex couples, the marital deduction is applicable to transfers between legally married spouses, but not between couples who have entered into civil unions. For the purposes of this provision, a couple is considered to be "married" if the marriage is considered valid in the state or foreign jurisdiction where the marriage was executed.

11 Code Section 2056(b).

right to possess or enjoy any part of such property after such termination or failure.[12] This provision would exclude many trusts from qualifying for the marital deduction.

However, there are several exceptions to the general rule requiring that the spouse's interest not be terminable. For example, the following interests are specifically described in the Treasury Regulations under the Code (the "Treasury Regulations") as interests the transfer of which by a decedent to his or her surviving spouse may qualify for the marital deduction, notwithstanding the ordinary terminable interest rule:

(1) a life estate in a surviving spouse that is coupled with a general power of appointment over the property with respect to which the surviving spouse is a life tenant;[13]

(2) an interest passing to a surviving spouse that will terminate or fail on the death of the surviving spouse only if such death occurs (i) within a period not exceeding 6 months after the decedent's death, or (ii) as a result of a common disaster causing the death of the decedent and the surviving spouse, and such termination or failure does not in fact occur;[14]

(3) certain interests in proceeds under a life insurance, endowment, or annuity contract payable in installments where the spouse holds a general power of appointment;[15] and

(4) an interest in a qualified charitable remainder trust where the surviving spouse is the only beneficiary who is not a charitable beneficiary or an employee stock ownership plan.[16]

Most importantly, property which qualifies as "qualified terminable interest property" ("QTIP property") will qualify for the marital deduction, notwithstanding that the surviving spouse's interest is terminable.[17] QTIP property is defined as 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.[18]

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12 This exemption to the marital deduction also applies where such interest is acquired for the surviving spouse, pursuant to directions by the decedent, by an executor or trustee. Code Section 2056(b)(1)(C).

13 Code Section 2056(b)(5).

14 Code Section 2056(b)(3).

15 Code Section 2056(b)(6).

16 Code Section 2056(b)(8). For the purposes of this exception, a "charitable beneficiary" is an organization described in Code Section 170(c), an "ESOP beneficiary" is an employee stock ownership plan (as defined in Code Section 4975(e)(7)) that holds a remainder interest in qualified employer securities (as defined in Code Section 664(g)(4) transferred to such plan in a qualified gratuitous transfer (as defined in Code Section 664(g)(1)), and a "qualified charitable remainder trust" is a charitable remainder annuity trust or a charitable remainder unitrust (as defined in Code Section 664).

17 Code Section 2056(b)(7).

18 *Id.*

In each case, an interest in property will qualify for the marital deduction only if it is treated as passing from the decedent to his or her surviving spouse.[19] With respect to QTIP property, the property can pass to the surviving spouse through a life estate or (more commonly) a trust that includes a qualifying income interest for life in the spouse. A "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.[20] In order for QTIP property to qualify for the marital deduction, an election must be made on the decedent's estate tax return.

Property qualifying for QTIP treatment is subject to estate tax at the death of the spouse holding the income interest.[21] This means that QTIP treatment generally results in estate tax avoidance only where assets are spent by or for the surviving spouse during his or her lifetime. To the extent assets remain in the QTIP trust upon the beneficiary spouse's death, the trust assets are then subject to tax. In addition, property qualifying for QTIP treatment will be subject to gift tax imposed upon the surviving spouse if, during the life of the surviving spouse, he or she in any way disposes of all or a part of his or her qualifying income interest.[22]

C. Estate Tax Marital Deduction – Transfers to Non-Citizen Spouses

Importantly, Code Section 2056(d) provides that, notwithstanding the foregoing, the estate tax marital deduction is not available where the recipient spouse is not a U.S. citizen.[23] The deduction is not available even where the surviving spouse is a U.S. green card holder or

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[19] An interest in property is considered to pass to a person from the decedent if, and only if such interest:

(1) is bequeathed or devised to such person by the decedent;

(2) is inherited by such person from the decedent;

(3) is the dower or curtesy interest (or statutory interest in lieu thereof) of such person as surviving spouse of the decedent;

(4) has been transferred to such person by the decedent at any time;

(5) was, at the time of the decedent's death, held by such person and the decedent (or by them and any other person) in joint ownership with right of survivorship;

(6) was subject to the power of the decedent (either alone or in conjunction with any person) to appoint such interest and has appointed such interest to such person, or if such person takes such interest in default on the release or nonexercise of such power; or

(7) consists of proceeds of insurance on the life of the decedent receivable by such person.

Code Section 2056(c). Except in the case of joint property or a power of appointment in the Donor, if it is not possible to ascertain to whom an interest passes, the interest will be deemed not to have passed to a surviving spouse.

[20] Code Section 2056(b)(7)(B)(ii). These provisions do not apply to any power exercisable only after the death of the surviving spouse.

[21] Code Section 2044.

[22] Code Section 2519(a).

[23] Code Section 2056A applies to transfers to noncitizen spouses, unless there is a relevant treaty that provides different rules, and the taxpayer claims treatment under the treaty.

domiciliary, who is subject to U.S. gift and estate tax on the transfer of worldwide assets. The Treasury Regulations make clear that the domicile of the donor spouse is irrelevant to the availability of the marital deduction.[24] However, if property is passed from a decedent spouse to a surviving spouse in a manner that, but for the fact that the surviving spouse is not a citizen of the United States, would qualify for the marital deduction, and upon the death of the surviving spouse his or her estate is also subject to U.S. estate tax, then the Federal estate tax paid by the decedent spouse's estate with respect to such property will be allowed as a credit to the estate of the surviving spouse.[25]

An exception to the general rule of Code Section 2056(d) exists if property passes to the non-citizen spouse in a qualified domestic trust (a "QDOT"), discussed below.[26] In addition, if the surviving spouse is not a U.S. citizen at the time of the decedent spouse's death, but thereafter becomes a U.S. citizen before the filing of the estate tax return,[27] and was domiciled in the United States at all times between the death of the decedent spouse and the date the surviving spouse became a U.S. citizen, then the marital deduction will be allowed, assuming transfers to such surviving spouse would have otherwise qualified for the deduction.[28] If the surviving spouse becomes a U.S. citizen after the estate tax return is filed, this exception is not available.

D. Gift Tax Marital Deduction

Analogous to the application of the estate tax, gifts between spouses generally benefit from an unlimited marital deduction,[29] although gifts in trust or otherwise terminable gifts are subject to rules similar to those discussed in the estate tax context.[30] There are similar

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[24] Treas. Reg. Section 20.2056A-1(a). The citizenship or domicile status of the donor spouse may affect whether his or her estate can utilize any treaty benefits to increase the unified credit amount applicable to the estate and the availability of the marital deduction. Treasury Regulation Section 20.2056A-1(c) provides that an estate may not take advantage of both QDOT treatment (described below) and treaty benefits with respect to assets passing to a surviving spouse. Thus, an estate may not avail itself of both the marital deduction under the treaty and the marital deduction under the QDOT provisions of Code Section 2056A with respect to the remainder of the marital property that is not deductible under the treaty.

[25] Code Section 2056(d)(3). Taxes paid from a qualified domestic trust for the benefit of such spouse are also credited. The credit is calculated without regard to when the decedent spouse died and without regard to Code Section 2013(d), which generally reduces the value of property transferred to a decedent by the amount deducted on the transfer to the decedent under the marital deduction in Code Section 2056.

[26] Code Section 2056(d)(2)(A).

[27] For the purposes of this rule, a return filed prior to the due date (including extensions) is considered to be filed on the last date that the return is required to be filed (including extensions), and a late return is considered to be filed on the date it is actually filed. Tres. Reg. Section 20.2056A-1(b). Therefore, a late return may permit an estate to claim a marital deduction if the surviving spouse does not become a U.S. citizen before the filing due date, but late filing can lead to the application of penalties. *See, e.g.*, *Estate of Liftin* v. *United States*, 108 AFTR2d 2011-7108 (Ct. Fed. Cl. 2011), 111 AFTR2d 2013-1426 (Ct. Fed. Cl. 2013), *aff'd*, 754 F.3d 975 (Fed. Cir. 2014).

[28] Code Section 2056(d)(4).; Treas. Reg. Section 20.0-1(b)(1).

[29] Code Section 2523(a).

[30] Code Section 2523.

exceptions permitting the marital deduction from gift tax for transfers made, for example, in a charitable remainder trust, through a life estate coupled with a power of appointment, and through QTIP transfers.[31]

As in the estate tax context, gifts made to a donee spouse who is not a U.S. citizen will not benefit from the gift tax marital deduction. Importantly, there is no provision permitting the use of a QDOT to bypass this exception.[32] Additionally, there is no exception allowed under the U.S. gift tax for a recipient spouse who becomes a U.S. citizen after receiving a lifetime gift from his or her spouse.[33] The Treasury Regulations make clear that the citizenship or domicile of the donor is irrelevant;[34] therefore, so long as the donee spouse is a U.S. citizen at the time of the gift, the marital deduction will be allowed, regardless of whether the donor spouse is a U.S. Person. Whether or not a marital deduction is available, in any case where one or both parties are resident in another jurisdiction, it may be prudent to seek out advice regarding the implications of a proposed gift in the other jurisdiction. For example, the United Kingdom imposes an inheritance tax on lifetime transfers with a value above a certain limit where the donor is a U.K. domiciliary, the donee is the donor's non-U.K. domiciled spouse, and the donor dies within seven years of the transfer.[35]

Expenditures to support the couple and their family, or otherwise to meet the legal support obligations of spouses to one another, should not be considered gifts between the citizen and non-citizen spouse.[36] Also, gifts between spouses are not considered taxable events for income tax purposes, even where the recipient spouse is not a citizen.[37]

Although the unlimited marital deduction is not available where the donee spouse is not a citizen, Code Section 2523(i) increases the gift tax annual exclusion amount to $100,000, adjusted for inflation, for gifts to a non-citizen spouse (regardless of the citizenship or residence of the donor spouse).[38] The indexed amount for 2016 is $148,000.[39] In order to qualify for this increased annual exclusion, the gift must meet the present interest requirements and also be in a form that would qualify for the marital deduction but for the recipient's non-citizen status.[40]

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[31] *Id*. Differences do exist, including that there is no gift tax exemption for interests in life insurance or interests that terminate only if the spouse does not survive the donor by more than 6 months.

[32] Code Section 2523(i).

[33] Treas. Reg. Section 25.2523(i)-1(d), Example 5.

[34] Treas. Reg. Section 25.2523(i)-1(a).

[35] See HMRC website at: http://www.hmrc.gov.uk/manuals/ihtmanual/ihtm11033.htm (visited on January 15, 2016).

[36] *See*, *e.g.*, M. Read Moore, PRACTICAL ESTATE PLANNING FOR CLIENTS WITH NONCITIZEN SPOUSES, SJ066 ALI-ABA 201 , 251 ("On the other hand, payment of a spouse's hospital expenses should not even be a gift in the first place because the donor spouse has an obligation to support the noncitizen spouse, which presumably includes payment of the spouse's medical bills.").

[37] *Hughes* v. *Commissioner*, T.C. Memo 2015-89.

[38] Code Section 2523(i).

[39] IRS Revenue Procedure 2015-53.

[40] Treas. Reg. Section 25.2523(i)-1(c).

This means that if a transfer is made during life to a trust that could qualify as a QTIP trust if the recipient spouse were a citizen, the increased exclusion is not available, because a QTIP election will not have been made.[41]

Except for the unavailability of the unlimited marital deduction and the increased annual exclusion amount for transfers to spouses, the gift tax provisions of the Code generally govern the taxation of gifts to non-citizen spouses. This means that transfers to non-citizen spouses will not be subject to gift tax if such transfer would not have been subject to gift tax if made to a third party. For example, transfers that qualify for exemption from gift tax under Code Section 2503(e) (i.e., amounts paid on behalf of an individual that are either tuition payments made directly to an educational institute or payments made directly to medical care or insurance providers) may be made for non-citizen spouses without incurring gift tax.[42]

E. Gift Splitting

Code Section 2513 provides that if both parties consent, a gift made by one spouse to any person other than his or her spouse shall be considered as made one-half by the transferor and one-half by his or her spouse.[43] Gift splitting generally permits one spouse to make gifts of up to $28,000 per donee in 2016 without incurring gift tax liability or making use of any portion of his or her lifetime exemption, assuming the other spouse consents. However, gift splitting between spouses is permitted only if each spouse is a U.S. citizen or domiciliary at the time of such gift.

A non-U.S. Person spouse is permitted to make gifts utilizing the annual exclusion from gift tax, but such gifts would need to come from such person directly, rather than through gift splitting with a spouse.[44] Because an individual who is not a U.S. citizen and not domiciled in the United States is subject to U.S. gift tax only on the transfer of U.S. situs property, the annual exclusion would only need to be applied against a gift of such U.S. situs assets. Where non-U.S. situs property is held by the non-U.S. spouse, it generally can be transferred to any person without the imposition of any U.S. gift tax. The non-U.S. spouse also can transfer U.S. situs assets to the U.S. spouse (utilizing the unlimited marital deduction from gift tax to avoid gift tax on the transfer) and can use annual exclusion amounts to make gifts of U.S. situs assets to other persons. However, where property desired to be transferred is in the hands of the U.S. person spouse, it may not be possible to utilize the non-U.S. spouse's annual exemption from gift tax to make gifts.

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41 Treas. Reg. Section 25.2523(i)-1(d), *Example* 4.

42 Treas. Reg. Section 25.2503-6(b).

43 In order to elect to split gifts, each spouse must file his or her separate individual gift tax return (Form 709) (although both returns should be sent to the IRS in the same envelope) completing the portion related to gift splitting (for the 2015 Form 709, lines 12-17 of Part 1), and also must sign the other spouse's gift tax return consenting to splitting gifts (for the 2015 Form 709, on line 18 of Part 1). See instructions for IRS Form 709.

44 *See* 34 Am. Jur. 2d Federal Taxation ¶ 40256.

F. Portability

Code Section 2010(c)(2)(B), made permanent in 2013, allows for "portability," generally permitting a surviving spouse to use his or her deceased spouse's unused lifetime exemption from estate and gift tax. To take advantage of portability, the executor of the decedent's estate must file an estate tax return computing the unused lifetime exemption amount, called the "deceased spousal unused exclusion amount" or "DSUE amount," and must elect to transfer the DSUE amount to the surviving spouse.

A deceased U.S. spouse's unused lifetime exemption is not portable to a non-U.S. Person surviving spouse (except to the extent allowed under a treaty).[45] This can be a significant loss of a planning opportunity if the U.S. spouse does not utilize his or her lifetime exemption.

Because portability is permitted under Code Section 2010, which is applicable only to the estate of U.S. citizens and domiciliaries,[46] portability is not available with respect to the unused exemption of a decedent who was not a U.S. Person at the time of his or her death. This is generally not of any great significance, since the estate of a decedent who is not a citizen or domiciliary of the United States is only permitted a unified credit of $13,000 (shielding $60,000 of U.S. situs assets from U.S. estate tax).[47] However, Code Section 2102(b) provides that a higher credit will be allowed to the estate of such a decedent to the extent required by a tax treaty entered into by the United States.[48] In a case where the amount of credit under a treaty is substantial, the loss of portability may be of significance.

Where the surviving spouse of a U.S. Person decedent is not a U.S. citizen but is a U.S. domiciliary, portability is permitted. In this case, assets passing to the surviving spouse may pass into a QDOT (discussed below) in order to take advantage of the marital deduction from estate tax. Portability is permitted in this case, but the DSUE amount of the decedent spouse must be re-determined upon the occurrence of the last event that subjects the QDOT to QDOT tax (discussed below), which is usually the death of the surviving spouse.[49] In this case the DSUE amount of the deceased spouse generally may only be used for bequests made upon the death of the surviving spouse, not for gifts made during the life of the surviving spouse. However, where the surviving spouse becomes a U.S. citizen after a QDOT is created, and the requirements of domicile and/or distributions from the QDOT discussed below are satisfied, then the QDOT tax will cease to be applicable to the QDOT, and the DSUE amount of the decedent spouse may be determined and utilized by the surviving spouse during his or her lifetime.[50]

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45 The authors are not aware of any U.S. estate tax treaty that directly addresses portability.

46 Code Section 2001(a).

47 Code Section 2102(b)(1).

48 For example, the U.S.-Canada Income Tax Convention makes available to a non-U.S. Person some or all of the lifetime exemption available to a U.S. Person, depending on the portion of the decedent's assets that constitute U.S. situs property. Article XXIX B, Paragraph 2 of the United States-Canada Income Tax Convention.

49 Treas. Reg. Section 20.2010-2(c)(4)(i).

50 Treas. Reg. Section 20.2010-2(c)(4)(ii).

II. Use of QDOTs

A. *General Rules*

As noted above, the marital deduction for U.S. estate tax generally is not available where the donee spouse is not a citizen of the United States. Notwithstanding this general rule, a decedent may transfer assets to his or her non-citizen spouse without the decedent's estate incurring U.S. estate tax if such assets pass into a QDOT for the benefit of the surviving spouse.[51] As with use of a QTIP trust, passing assets to a spouse under a QDOT ordinarily permits deferral, not complete avoidance, of U.S. estate tax. In the case of a QDOT, this is true even with respect to principal amounts distributed to the surviving spouse for his or her living expenses. In general, and as discussed below, distributions from a QDOT to the surviving spouse in excess of income, and the disposition of the assets remaining in the QDOT upon the death of the surviving spouse, are subject to U.S. estate tax.

The QDOT rules are designed to ensure that the non-U.S. citizen surviving spouse cannot remove the QDOT assets from the United States and avoid the application of U.S. estate tax upon his or her death. The QDOT rules do not require the decedent spouse to be a U.S. citizen or resident. QDOTs may be utilized by non-citizen, non-domiciliary aliens to pass U.S. situs assets (such as real property and tangible personal property located in the United States, as well as stock in U.S. corporations) to a non-citizen spouse without the immediate imposition of U.S. estate tax on such a transfer.[52]

B. Requirements for QDOT Treatment

In order to be classified as a QDOT, a trust for the benefit of a non-citizen surviving spouse must meet several statutory and regulatory requirements. These requirements include:[53]

(1) The trust must be an "ordinary" trust, as defined in Treasury Regulation Section 301.7701-4(a), meaning a trust "created either by a will or by an inter vivos declaration whereby trustees 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";[54]

(2) The trust must otherwise qualify for the Federal estate tax marital deduction under Code Section 2056(b)(5) (life estate with general power of appointment), Section

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[51] Code Section 2056(d)(2).

[52] Treas. Reg. Section 20.2106-1(a)(3).

[53] Code Section 2056A(a)(2) explicitly provides that QDOTs are required to comply with any requirements prescribed by regulations "to ensure the collection of any tax imposed."

[54] Treas. Reg. Sections 20.2056A-2(a) and 301.7701-4(a). Where property is located in a jurisdiction that does not recognize trusts, transfer to a QDOT may be impossible. Code Section 2056A(c)(3) defines a "trust" to include "other arrangements which have substantially the same effect as a trust" to the extent provided in the Treasury Regulations. However, no such regulations have been issued.

2056(b)(7) (qualified terminable interest property, including joint and survivor annuities under Section 2056(b)(7)(C)), or Section 2056(b)(8) (surviving spouse is the only non-charitable beneficiary of a charitable remainder trust), or meet the requirements of an estate trust described in Treasury Regulation Section 20.2056(c)-2(b)(1)(i) through (iii);[55]

(3) At least one of the trustees must be an individual who is a U.S. citizen with a tax home in the United States or a U.S. corporation (a "U.S. Trustee");[56]

(4) The 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 from such principal distribution the U.S. estate tax payable on such distribution (the application of the estate tax to such a distribution is discussed below);[57]

(5) The trust must be maintained in, and the administration of the trust must be governed by the laws of, one of the states of the United States or the District of Columbia;[58] and

(6) The decedent spouse's executor must elect to treat the trust as a QDOT; once a QDOT election is made, this election is irrevocable.[59]

A QDOT election is made on the decedent spouse's estate tax return.[60] The election may not be made for part or a portion of a trust, but instead must be made for the entire trust. However, if a trust is severed prior to the due date of the election in accordance with regulatory requirements, then a QDOT election may be made for any one or more of the severed trusts.[61]

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[55] Treas. Reg. Section 20.2056A-2(b)(1).

[56] Code Section 2056A(a)(1)(A) and Treas. Reg. Section 20.2056A-2(d)(2). With respect to this provision, "tax home" means such individual's home for purposes of section 162(a)(2) (relating to traveling expenses while away from home), except that an individual will not be treated as having a tax home in a foreign country for any period for which his abode is within the United States. Code Section 911(d)(3).

[57] Code Section 2056A(a)(1)(B). Code Section 2056A(b)(14) provides that the Trustee's power to withhold taxes will not cause the trust to fail to be a qualified terminable interest.

[58] Treas. Reg. Section 20.2056A-2(a).

[59] Treas. Reg. Section 20.2056A-3(a). A protective election can be made if the executor of the decedent's estate reasonably believes that, at the time the Federal estate tax return is filed, there is a <u>bona</u> <u>fide</u> issue that concerns either the residency or citizenship of the decedent, the citizenship of the surviving spouse, whether an asset is includible in the decedent's gross estate, or the amount or nature of the property the surviving spouse is entitled to receive. Treas. Reg. Section 20.2056A-3(c).

[60] *Id*. The election must be made "on the last federal estate tax return filed before the due date (including extensions of time to file actually granted) or, if a timely return is not filed, on the first federal estate tax return filed after the due date."

[61] Treas. Reg. Section 20.2056A-3(b).

While, ideally, a U.S. citizen or domiciliary who is married to a non-U.S. citizen will create a QDOT for the benefit of his or her spouse under the terms of his or her Will or other testamentary document, the QDOT rules permit reformation of trusts to conform with the statutory and regulatory requirements and provide that assets passing directly to a non-citizen surviving spouse will be treated as passing to a QDOT if the surviving spouse transfers or irrevocably assigns the assets to a QDOT before the due date of the Federal estate tax return of the decedent spouse's estate. Both of these scenarios are discussed in further detail below.

The Treasury Regulations provide also that a QDOT will cease to qualify as a QDOT if the trust "utilizes any device or arrangement that has, as a principal purpose, the avoidance of liability for the QDOT tax described below, or the prevention of the collection of the tax."[62] For example, such standard is violated where the U.S. Trustee is a domestic corporation established with insubstantial capitalization by the surviving spouse or members of the surviving spouse's family.

C. *Requirements Based on Value of Assets*

Additional QDOT security requirements are dependent on the value of the assets held by the QDOT. A QDOT holding assets with a fair market value of $2 million or less (a "small QDOT") is subject to less onerous security requirements than a QDOT with assets in excess of $2 million (a "large QDOT"). If more than one QDOT is held for the benefit of a surviving spouse, the value of the assets held in all QDOTs for such surviving spouse are aggregated.[63] A trust may alternate between the different applicable security requirements as long as it meets at least one of the requirements at all times during the term of the trust.[64]

The fair market value of the assets passing or deemed to pass to a QDOT is the value as finally determined for U.S. Federal estate tax purposes, without any reduction for indebtedness with respect to such assets.[65] In determining the value of assets held by a QDOT, the executor of the estate of the decedent spouse may elect to exclude up to $600,000 attributable to real property and related furnishings[66] that are owned directly by the QDOT and used by the surviving spouse as or in connection with a personal residence.[67] If the surviving spouse ceases to utilize such real property as a personal residence, or if such real property is sold, the value of such property is no longer excluded from the calculation of the value of assets held by the trust,

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62 Treas. Reg. Section 20.2056A-2(d)(1)(v).

63 Treas. Reg. Section 20.2056A-2(d)(1)(ii)(A).

64 Treas. Reg. Section 20.2056A-2(d)(1)(i).

65 *Id*.

66 Fine art, antique furnishings and automobiles may not be included in this amount. The value must be determined without reference to debt on the property.

67 Treas. Reg. Section 20.2056A-2(d)(1)(iv)(A). This property may be located within or without the United States, but must be used as the principal residence or one other personal residence of the surviving spouse, and may not be rented at any time to a third party. Treas. Reg. Section 20.2056A-2(d)(1)(iv)(D). Under the rules as written, it is unclear whether a cooperative apartment would qualify for this exclusion.

unless the proceeds of the sale are reinvested in a new personal residence for the surviving spouse within twelve months of the date of sale.[68]

Care should be taken to properly value the assets transferred to a QDOT to determine whether the QDOT is a large QDOT or small QDOT. If either (i) the bond or letter of credit security arrangements (as discussed below) are chosen by the U.S. Trustee, 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, then the marital deduction will be disallowed for the entirety of the assets held in the trust 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.[69] Relief from this adverse result may be granted if there was reasonable cause for the undervaluation and the fiduciary of the estate acted in good faith with respect to the undervaluation.[70] If an undervaluation is less than the 50% threshold, but still causes a QDOT originally reported as having $2 million or less in assets to have assets valued at over $2 million, then the U.S. Trustee has a reasonable period of time (but in any case not more than 60 days after the final determination of the value of the assets) to meet the security requirements of a large QDOT.[71]

1) Large QDOT

The instrument creating a large QDOT must include a requirement that one of the "Bank Trustee security arrangement alternative", the "Bond Security arrangement alternative" or the "Letter of Credit security arrangement alternative" (each described below) be met.

(a) Bank Trustee Security Arrangement Alternative

Under the Bank Trustee security arrangement alternative, either (i) at least one of the U.S. Trustees must be a bank, as defined in Code Section 581, or (ii) a U.S. branch of a foreign bank serves as a co-trustee, along with a U.S. Trustee.[72]

(b) Bond Security Arrangement Alternative

The bond security arrangement alternative requires that the U.S. Trustee furnish a bond in favor of the Internal Revenue Service ("IRS") in an amount equal to 65% of the fair market value of the trust as finally determined for Federal estate tax purposes.[73]

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68 Treas. Reg. Section 20.2056A-2(d)(1)(iv)(G).

69 Treas. Reg. Section 20.2056A-2(d)(1)(i)(D).

70 *Id*.

71 Treas. Reg. Section 20.2056A-2(d)(1)(ii).

72 Treas. Reg. Section 20.2056A-2(d)(1)(i)(A).

73 Treas. Reg. Section 20.2056A-2(d)(1)(i)(B). If the value of the assets as originally determined is undervalued, the U.S. Trustee has a reasonable period of time (but in any case not more than 60 days after the final determination of the value of the assets) to adjust the value of the bond accordingly (although the substantial undervaluation rules, discussed above, still apply). Unless the U.S. Trustee utilizes an alternative security arrangement permitted for large QDOTs or the estate no longer needs to utilize the QDOT rules to receive a marital deduction because the surviving spouse has become a U.S. citizen (as

The bond must be with a satisfactory surety as prescribed by Treasury Regulations and is subject to IRS review.[74] Treasury Regulation Section 20.2056A-2(d)(1)(i)(B)(2) provides a form of bond, and the bond must comply in all material respects with that form. In addition, the bond must be for a term of at least one year and must be automatically renewable at the end of that term, on an annual basis thereafter, unless notice of failure to renew is mailed to the U.S. Trustee and the IRS at least 60 days before the end of the term, including periods of automatic extensions.[75] If notice of failure to renew is sent to the IRS, the IRS will not draw on the bond if, within 30 days of the receipt of such notice, the U.S. Trustee notifies the IRS that an alternative arrangement permitted under the Treasury Regulations has been secured and will take effect immediately prior to or upon expiration of the bond.[76]

If the bond security alternative is used, the trust instrument must provide that in the event the IRS draws on the bond (in accordance with the terms of the bond), then neither the U.S. Trustee nor any other person will seek a return of any part of the remittance until after April 15 of the calendar year following the year in which the bond is drawn upon.[77] After that date, the remittance will be treated as a deposit and returned (without interest) upon the request of the U.S. Trustee, unless it is determined that assessment or collection of the tax imposed on the QDOT (upon distributions to the surviving spouse), or upon the assets remaining in the trust at the death of the surviving spouse, is in jeopardy.[78]

Unless an extension to file the bond is granted, the bond should be filed with the decedent's Federal estate tax return. The U.S. Trustee also must provide a written statement with the bond that provides (i) a list of the assets that will be used to fund the QDOT, (ii) the values of the assets, and (iii) an indication of whether any exclusion for real property (discussed above) is claimed.[79]

(c) Letter of Credit Security Arrangement Alternative

The letter of credit security arrangement alternative requires that the U.S. Trustee provide an irrevocable letter of credit, issued by a bank (as defined in Code Section 581), a U.S. branch of a foreign bank, or a foreign bank with a confirmation by a bank (as defined in Code

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discussed below), the bond must remain in effect until the trust ceases to function as a QDOT and any tax liability finally determined to be due is paid.

74 Treas. Reg. Section 20.2056A-2(d)(1)(i)(B)(1).

75 *Id*.

76 *Id*.

77 Treas. Reg. Section 20.2056A-2(d)(1)(i)(B)(3).

78 *Id*.

79 Treas. Reg. Section 20.2056A-2(d)(1)(i)(B)(4).

Section 581),[80] in an amount equal to 65% of the fair market value of the assets held by the QDOT, as finally determined for U.S. estate tax purposes.[81]

The letter of credit must be irrevocable and provide for sight payment.[82] Treasury Regulation Section 20.2056A-2(d)(1)(i)(C)(2) provides a form of the letter of credit, and the letter of credit must comply in all material respects with that form. In addition, the letter of credit must be for a term of at least one year and must be automatically renewable at the end of that term, on an annual basis thereafter, unless notice of failure to renew is mailed to the U.S. Trustee and the IRS at least 60 days before the end of the term, including periods of automatic extensions.[83] If notice of failure to renew or notice of closure is sent to the IRS, the IRS will not draw on the letter of credit if, within 30 days of the receipt of such notice, the U.S. Trustee notifies the IRS that an alternative arrangement permitted under the Treasury Regulations has been secured and will take effect immediately prior to or upon expiration of the bond.[84]

If the letter of credit security alternative is used, the trust instrument must provide that in the event the IRS draws on the letter of credit (in accordance with the terms of the letter of credit), then neither the U.S. Trustee nor any other person will seek a return of any part of the remittance until after April 15 of the calendar year following the year in which the letter of credit is drawn upon.[85] After that date, the remittance will be treated as a deposit and returned (without interest) upon the request of the U.S. Trustee, unless it is determined that assessment or collection of the tax imposed on the QDOT upon distributions to the surviving spouse or upon the assets remaining in the trust at the death of the surviving spouse, is in jeopardy.[86]

Unless an extension to file the letter of credit is granted, the letter of credit should be filed with the decedent's Federal estate tax return. The U.S. Trustee must also provide a written statement with the letter of credit that provides (i) a list of the assets that will be used to

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80 If the letter of credit security alternative is satisfied with a letter of credit from a foreign bank with confirmation by a bank as defined in Code Section 581, then Treasury Regulation Section 20.2056A-2(d)(1)(i)(C)(3) provides a form with which the confirmation must comply in all material respects.

81 Treas. Reg. Section 20.2056A-2(d)(1)(i)(C). If the value of the assets as originally determined is undervalued, the U.S. Trustee has a reasonable period of time (but in any case not more than 60 days after the final determination of the value of the assets) to adjust the amount of the letter of credit accordingly (although the substantial undervaluation rules, discussed above, still apply). Unless the U.S. Trustee utilizes an alternative security arrangement permitted for large QDOTs or the estate no longer needs to utilize the QDOT rules to receive a marital deduction because the surviving spouse has become a U.S. citizen (as discussed below), the letter of credit must remain in effect until the trust ceases to function as a QDOT and any tax liability finally determined to be due is paid.

82 Treas. Reg. Section 20.2056A-2(d)(1)(i)(C)(1). A "sight" letter of credit is akin to an "on demand" instrument, and is payable once it is presented along with the necessary documents. The issuer of a sight letter of credit commits itself to payment as soon as the requirements of the letter are satisfied.

83 *Id*. If the letter of credit is issued by the U.S. branch of a foreign bank and the U.S. branch is closing, the branch (or foreign bank) must notify the U.S. Trustee and the Internal Revenue Service of the closure and the notice of closure must be mailed at least 60 days prior to the date of closure.

84 *Id*.

85 Treas. Reg. Section 20.2056A-2(d)(1)(i)(C)(4).

86 *Id*.

fund the QDOT, (ii) the values of the assets, and (iii) an indication of whether any exclusion for real property (discussed above) is claimed.[87]

2) Small QDOT

The instrument creating a small QDOT must include a provision that either (i) no more than 35% of the value of the trust assets (determined annually) will consist of real property located outside of the United States, or (ii) one of the security arrangements for a large QDOT, discussed above, will be met.[88] If the value of the assets as originally determined is $2 million or less, but the value as finally determined for Federal estate tax purposes is more than $2 million, then the U.S. Trustee has a reasonable period of time (but in any case not more than 60 days after the final determination of the value of the assets) to meet the security arrangement requirements for large QDOTs. Note, however, that the substantial undervaluation rules, discussed above, will apply.[89]

In determining whether no more than 35% of the value of trust assets consists of non-U.S. situs real property, if the QDOT owns more than 20% of the voting stock or value in a corporation with 15 or fewer shareholders, or more than 20% of the capital interest of a partnership with 15 or fewer partners, then all assets owned by the corporation or partnership are deemed to be owned directly by the QDOT to the extent of the QDOT's pro rata share of the assets of that corporation or partnership.[90] Interests owned by the QDOT in other entities (such as a trust) are treated in a manner consistent with the provisions described with respect to corporations and partnerships.[91]

The value of QDOT assets must be determined annually on the last day of the taxable year of the trust (or on the last day of the calendar year if the trust does not have a taxable year).[92] If, on the last day of any such taxable (or calendar) year, the value of foreign real property owned by the QDOT exceeds 35% of the fair market value of the trust assets as a result of (1) distributions of QDOT principal during that year, (2) fluctuations in the value of the foreign currency in the jurisdiction where the real estate is located, or (3) fluctuations in the fair

87 Treas. Reg. Section 20.2056A-2(d)(1)(i)(C)(5).

88 Treas. Reg. Section 20.2056A-2(d)(1)(ii). The special rules permitting $600,000 of value in personal residences and related furnishings to be excluded in determining the value of QDOT assets are not applicable in determining the percentage of the value of the trust that consists of non-U.S. real property. Treas. Reg. Section 20.2056A-2(d)(1)(iv)(C).

89 *Id*.

90 Treas. Reg. Section 20.2056A-2(d)(1)(ii)(B). For a partnership, the QDOT partner's pro rata share is based on the greater of its interest in the capital or profits of the partnership. All stock in the corporation, or interests in the partnership, as the case may be, owned by or held for the benefit of the surviving spouse, or any members of the surviving spouse's family are treated as owned by the QDOT solely for purposes of determining the number of partners or shareholders in the entity and the QDOT's percentage voting interest or value in the corporation or capital interest in the partnership, but not for the purpose of determining the QDOT's pro rata share of the assets of the entity.

91 Treas. Reg. Section 20.2056A-2(d)(1)(ii)(C).

92 Treas. Reg. Section 20.2056A-2(d)(1)(ii).

market value of any assets held in the QDOT, the QDOT will not be treated as failing to meet the small QDOT security requirements if, by the end of the taxable year (or the last day of the calendar year if the QDOT does not have a taxable year) of the QDOT immediately following the year in which the 35% limit was exceeded, either (1) the value of the foreign real property held by the QDOT does not exceed the 35% threshold or (2) the QDOT meets one or more of the large QDOT security requirements.[93]

3) <u>Special Rules For Trusts Executed on or Before November 20, 1995</u>

The Treasury Regulations allow for trust instruments executed on or prior to November 20, 1995 to be deemed to meet the large QDOT or small QDOT security requirements, even if the instrument does not include the relevant provisions. The requirements for this grandfathering treatment are that (i) the testator or settlor must have died after February 19, 1996 (and in the case of a trust created under a revocable trust indenture or Will, must have lacked capacity to amend the Will or trust instrument at all times after November 20, 1995); (ii) the trust instrument or Will must not provide the U.S. Trustee or executor with a power to amend the instrument in order to meet the requirements of Code Section 2056A; and (iii) the U.S. Trustee must provide a written statement, binding on all successor trustees, with the Federal estate tax return that the trust is being administered (or will be administered) to be in actual compliance with the relevant security requirements and will continue to be so administered for the duration of the trust.[94]

D. *Taxation of QDOTs*

As noted above, the purpose of the QDOT requirements is to ensure that assets passing to a non-citizen spouse generally cannot escape U.S. estate tax, whether or not the surviving spouse is himself or herself subject to U.S. estate tax on worldwide assets. To that end, a special QDOT "estate" tax is imposed upon (i) distributions of other than income from the QDOT to the surviving spouse,[95] (ii) assets held in the QDOT upon the death of the surviving spouse,[96] and (iii) assets held in the QDOT upon the termination of the QDOT status of the trust.[97] An exception to the general rule that distributions other than income will attract a QDOT tax exists for distributions to the surviving spouse on account of hardship.[98] Capital gains are

93 Treas. Reg. Section 20.2056A-2(d)(1)(ii)(D).

94 Treas. Reg. Section 20.2056A-2(d)(6)(ii) and (iii).

95 Treas. Reg. Section 20.2056A-5(b)(1).

96 Code Sections 2056A(b)(1)(B).

97 Code Section 2056A(b)(4).

98 Treas. Reg. Section 20.2056A-5(c)(1). Under such Treasury Regulation, distributions are considered to be made on account of hardship if made to the spouse from the QDOT "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." Amounts that may be obtained from other sources that are "reasonably available" to the surviving spouse are not considered to be hardship distributions. While a spouse might be required to sell publicly traded stock he or she owns outright before taking a hardship distribution from a QDOT, assets such as closely held business interests, real estate and tangible property are not considered to be "reasonably available" to

not included in income for this purpose, and applicable local law defining income is generally respected.[99] Each trustee of a QDOT is personally liable for the payment of the QDOT tax.[100]

Except in certain circumstances discussed below, in calculating the QDOT tax, the assets distributed from the QDOT (or held in the QDOT at the time of any other triggering event) are treated as passing from the decedent spouse (rather than the surviving spouse), and the QDOT tax imposed generally is equal to the additional estate tax that would have been imposed on the estate of the decedent spouse if the amount involved had been included in the decedent spouse's taxable estate and had not been deductible.[101] More specifically, the amount of tax imposed on relevant QDOT distributions is based on the additional estate tax that would been imposed on the estate of the decedent spouse,[102] if such estate had been increased by the sum of (i) the value of assets involved in the relevant taxable event and (ii) the aggregate value of assets involved in all previous taxable events taking place with respect to all QDOTs of the decedent's spouse, and reduced by the Federal estate tax that would have been imposed on the decedent's spouse's estate if it had been increased by the value of assets involved in all previous taxable events.[103]

In determining the additional tax that would have been imposed upon the estate of the decedent spouse, any available credits are taken into account.[104] The relevant tax rate, therefore, is the rate applicable to assets of the decedent's estate, not to property passing under the surviving spouse's estate, as is the case with QTIP trust property. The decedent spouse's lifetime exemption may be used to reduce taxes otherwise payable on a QDOT created by the decedent for his or her spouse.[105]

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the spouse and thus do not need to be sold before a hardship distribution from a QDOT is available. Hardship distributions, although not taxable, must be reported to the IRS, which allows the IRS to audit the applicability of the exemption.

99 Treas. Reg. Section 20.2056A-5(c)(2). This Treasury Regulation provides that income has the same meaning as is found in Code Section 643(b), except that it does not include capital gains. In addition, income does not include items allocated to corpus under applicable local law, regardless of any contrary provisions of the trust indenture. The current regulations under Code Section 643(b) permit greater flexibility in the allocation of receipts to income and principal. Income generally does not include items of income in respect of a decedent as defined in Code Section 691. Treas. Reg. Section 20.2056A-5(c)(2).

100 Code Section 2056A(b)(6). Where there are multiple QDOTs, the assets of any QDOT are subject to being seized in order to satisfy the QDOT tax imposed on any other QDOT created with respect to the same decedent. Treas. Reg. Section 20.2056A-11(d).

101 Code Section 2056A(b). This essentially means that the tax is calculated as if the decedent spouse had died at the time of the triggering event (although the applicable rate is the one in place on the date of the decedent's actual death).

102 If the Federal estate tax imposed on the estate of the decedent spouse has not been finally determined at the time the Form 706-QDT of the QDOT is due, then QDOT tax is applied at the highest estate tax rate applicable to the estate of the decedent. Code Section 2056A(b)(2)(B)(i). The trustee of the QDOT may claim any refund due once the estate tax has been finally determined.

103 Code Section 2056A(b)(2)(A). This method is similar to the way that U.S. Federal gift tax liability is calculated, which takes into consideration past gifts to calculate the tax due on current gifts.

104 Treas. Reg. Section 20.2056A-6(a).

105 Treas. Reg. Section 20.2056A-6(a).

Payments for the ordinary and necessary expenses of the QDOT are not subject to the QDOT tax. Payments of any QDOT tax due on the occurrence of a triggering event are considered to be an additional taxable distribution, although payments of other applicable taxes imposed on the QDOT are not.[106] If the QDOT trustee makes a gross-up distribution to pay the income tax imposed upon the surviving spouse upon an income distribution to which the spouse was entitled, such tax payment is also treated as a taxable distribution.[107] In contrast, QDOT tax is not imposed on a distribution to reimburse the surviving spouse for income tax imposed upon income to which the surviving spouse is not entitled under the terms of the QDOT (for example, capital gains taxable to the surviving spouse).[108] The QDOT tax paid on lifetime transfers to the surviving spouse results in a Code Section 1015 basis adjustment, but does not result in the surviving spouse taking the assets with a fair market value basis.[109]

The fact that the QDOT assets are taxed as if part of the decedent spouse's estate can create inefficiencies under certain facts. Where the surviving spouse is a U.S. domiciliary (or becomes a U.S. citizen after the decedent spouse's death), the surviving spouse's estate should benefit from the full lifetime exemption available for U.S. Persons. However, if the couple's assets are all in the hands of the decedent spouse and pass to the QDOT, the surviving spouse may not be able to make use of his or her exemption. The analysis is different than in the case of a QTIP trust, where the QTIP trust assets are includable in the estate of the surviving spouse and the surviving spouse's lifetime exemption may be applied to reduce taxes on QTIP trust assets upon his or her death.

Because a QDOT must comply with the general requirements for a marital deduction for assets held in trust, the assets of the QDOT will normally also be taxable in the estate of the surviving spouse. Code Section 2056(d)(3) generally avoids double taxation by providing the estate of the surviving spouse with a credit for the tax paid by the decedent spouse's estate (either for estate tax imposed because the original bequest did not qualify for the marital deduction or the QDOT tax on a triggering event). The credit is only for taxes paid after taking into the account the lifetime exemption available to the decedent spouse's estate.

If transfers are made to third parties during the spouses' lifetimes, the exemption of the non-citizen, but U.S. domiciled, spouse can be used by the non-citizen spouse, or by his or her spouse through gift splitting. This issue also can be moderated by placing assets in the name of the non-citizen spouse using the annual exclusion amounts each year, or by having assets likely to appreciate purchased using that spouse's assets. However, given the limitations on transfers to a non-citizen spouse, it may be difficult to get sufficient assets into his or her hands to ensure the full use of the exemption upon the surviving spouse's death.

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106 Treas. Reg. Section 20.2056A-5(c)(3)(ii).

107 Treas. Reg. Section 20.2056A-5(b)(1).

108 Code Section 2056A(b)(15).

109 Code Section 2056A(b)(13).

For purposes of the GST tax, since QDOT property is treated as passing from the estate of the decedent spouse, the "transferor" would seem to be the decedent, so that the exemption from GST tax of a non-citizen, but U.S. domiciled, spouse would be unavailable to shelter property held in a QDOT. However, where the QDOT is also includible in the estate of the surviving spouse (subject to a credit for the QDOT taxes paid) because, for example, it qualifies for QTIP treatment, the surviving spouse is treated as the transferor as long as the trust is not subject to a "reverse" QTIP election. Such a "reverse" QTIP election may be made if it is desirable for the decedent spouse to be treated as the transferor in a case where a QDOT qualifies for QTIP trust treatment. The Treasury Regulations take the position that where the surviving spouse transferred or assigned the assets to the QDOT, he or she is the transferor for all purposes (other than for purposes of the trust qualifying as a QDOT).[110]

The trustee (or designated filer) of the QDOT must file Form 706-QDT for any year in which the QDOT has a taxable event (discussed above) or makes a distribution to the surviving spouse on account of hardship.[111] Form 706-QDT is generally due no later than April 15 of the year following the calendar year in which the taxable event or hardship distribution occurred.[112] However, a return filed as a result of the death of the surviving spouse is due with the estate tax return of the estate of the surviving spouse, 9 months (plus any extensions granted) after the date of death of the surviving spouse.[113] A Form 706-QDT filed because of the termination of the QDOT status of a trust must be filed within 9 months of such termination.[114]

E. *Reformation*

1) <u>Marital Trust Transfers</u>

If assets pass to a trust which does not meet the requirements of a QDOT, but would qualify for the marital deduction if the surviving spouse were a U.S. citizen, such assets may be treated as passing to a QDOT (and thus qualifying for the marital deduction) if the trust is reformed to meet the requirements of a QDOT either in accordance with the governing instrument or pursuant to judicial proceedings.[115] The reformation provisions may be used to alter the trust to comply with the requirements specific to QDOTs, but may not be used to amend the trust to meet the requirements for the marital deduction that are separate from the QDOT requirements.[116]

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110 Treas. Reg. Section 20.2056A-4(b)(5).

111 See Instructions for IRS Form 706-QDT, Revised August 2014.

112 *Id*.

113 *Id*.

114 *Id*. The QDOT tax due is allocated, on a <u>pro</u> <u>rata</u> basis, to each QDOT (based on the ratio of the amount of each respective distribution constituting a taxable event to the amount of all such distributions), unless a different allocation is required under the terms of the governing instrument or under local law. Treas. Reg. Section 20.2056A-9.

115 Treas. Reg. Section 20.2056A-4(a)(1).

116 H.R. No. 101-247, 101st Cong., 2d Sess. 1431, n. 96 (1989). *See also*, IRS PLR 9017015.

A reformation made pursuant to the terms of the decedent spouse's Will or the indenture creating the trust must be completed before the due date (including extensions) for the filing of the decedent spouse's estate tax return. If the reformation is made pursuant to a judicial proceeding, the proceeding should be commenced on or before the due date (including extensions) for the filing of the decedent spouse's estate tax return.[117] Prior to such judicial reformation, the trust must be treated as a QDOT, meaning the trustees must file all applicable returns and pay all applicable QDOT taxes.[118]

2) Non-Trust Transfers

If assets are passed outright to a non-citizen surviving spouse in a manner that would qualify for the full marital deduction but for the fact that the surviving spouse is not a U.S. citizen, such assets may be treated as passing to a QDOT (and thus qualifying for the marital deduction) if such assets are either actually transferred to a QDOT or assigned to a QDOT under an enforceable and irrevocable written assignment, in either case before the estate tax return is filed and on or before the deadline for filing the QDOT election.[119] The QDOT may be a trust that was created by the decedent, the decedent's executor or the surviving spouse.[120]

The assets passing to a QDOT under this rule are treated as passing from the decedent spouse to the QDOT only for the purposes of qualifying the trust as a QDOT. In all other respects (e.g., for income tax and GST tax purposes), the surviving spouse is treated as the transferor of the assets.[121] The transfer may constitute an immediate gift of the value of the remainder interest in the QDOT, unless the spouse retains sufficient control over the trust (e.g., a testamentary power of appointment) to avoid this result.[122]

There are certain kinds of assets (such as interests in pensions or annuities) that the surviving spouse may not be able to transfer to a QDOT. If the disposition of those assets would qualify for the full marital deduction but for the fact that the surviving spouse is not a U.S. citizen, and the rights related to such assets are not assignable or transferable to a QDOT, then the transfer of such assets to the surviving spouse will qualify for the marital deduction if the surviving spouse meets certain requirements under the Code to ensure that taxes are paid as if the property had been transferred to a QDOT.[123] In particular, the surviving spouse must agree to

117 Treas. Reg. Section 20.2056A-4(a)(2).

118 *Id.*

119 Treas. Reg. Section 20.2056A-4(b)(1).

120 *Id.*

121 Treas. Reg. Section 20.2056A-4(b)(5). The decedent spouse may be treated as the transferor in the event property is transferred to a QDOT in connection with a surviving spouse's disclaimer. *Id.*

122 Treas. Reg. Section 20.2056A-4, Treas. Reg. Section 20.2056A-4(d), Example 1.

123 Treas. Reg. Sections 20.2056A-1(a)(1)(iv) and 20.2056A-4(c). If the QDOT is named as a beneficiary of such pension or annuity, distributions from such account may be allocated to income and principal based on the provisions of Treasury Regulation Section 20.2056A-4(c).

pay the estate tax imposed on the corpus portion[124] or to transfer that portion of the annuity payments representing corpus, as received, (in either case, other than amounts that would meet the hardship exception) to a QDOT.[125]

There may be certain cases in which it is preferable for assets to pass to a surviving non-citizen spouse outright, and a QDOT should not be created. These circumstances include where foreign tax credits are available to the estate to eliminate U.S. estate tax that might otherwise be payable, or where U.S. estate tax paid would be available as a credit to reduce foreign tax otherwise payable. Where assets are passing to a non-U.S. Person surviving spouse and such assets are expected to appreciate very significantly during the surviving spouse's lifetime, it may be preferable to pay estate tax upon the decedent's death and avoid the later QDOT tax on a much greater amount.

F. Naturalization of Surviving Spouse

As discussed above, under Code Section 2056(d)(4), if a non-citizen surviving spouse becomes a U.S. citizen before the filing of the decedent's estate tax return, and such surviving spouse was a domiciliary of the United States at all times between the death of the decedent spouse and becoming a U.S. citizen, then the full marital deduction is available for bequests made to such surviving spouse. The application of the surviving spouse to become a U.S. citizen before the estate tax return is not sufficient; the surviving spouse must become a U.S. citizen before such filing.[126]

Furthermore, Code Section 2056A(b)(12) provides that a QDOT will no longer be subject to the imposition of the QDOT tax after the surviving spouse becomes a U.S. citizen if either the surviving spouse was a U.S. domiciliary at all times after the death of the decedent spouse and before becoming a U.S. citizen, or no taxable distributions have been made from the QDOT before the surviving spouse becomes a U.S. citizen. The cessation of the application of the QDOT tax will not impact the application of the provisions that include qualified terminable interest property in the estate of the surviving spouse.[127] The U.S. trustee of the QDOT must notify the IRS and certify in writing that the surviving spouse has become a U.S. citizen. Such notice is to be provided on or before April 15 of the year following the year in which the surviving spouse becomes a U.S. citizen, unless an extension is granted, by filing a final Form 706-QDT.[128] Even where it is expected that a non-citizen surviving spouse will become a U.S.

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124 Treas. Reg. Sections 20.2056A-4(c)(2). In addition, the executor of the decedent spouse's estate must file with the estate tax return an Information Statement and an Agreement to Pay Section 2056A Estate Tax described in the Treasury Regulations, and elect QDOT treatment for the unassignable interest.

125 Treas. Reg. Sections 20.2056A-4(c)(3). In addition, the QDOT must be established prior to the filing of the estate tax return and on or prior to the last day a QDOT election may be made, the executor of the decedent spouse's estate must file with the estate tax return an Information Statement and an Agreement to Roll Over Annuity Payments described in the Treasury Regulation, and elect QDOT treatment for the unassignable interest.

126 *See* IRS PLR 9021037 (May 25, 1990).

127 *See* IRS PLRs 9848007, 9826028.

128 Treas. Reg. Section 20.2056A-10(a).

citizen shortly after his or her spouse's death, so that Code Section 2056(d)(4) will be available, it is generally advisable that assets be placed into a QDOT before the deadline for doing so, to preserve the availability of the Code Section 2056A(b)(12) exception, in case the surviving spouse is not able to become a U.S. citizen before the filing of the decedent spouse's estate tax return.

If taxable distributions have been made to a surviving spouse prior to such individual's becoming a U.S. citizen and such surviving spouse was not a domiciliary at all times following his or her spouse's death, he or she can still avoid estate tax on distributions after he or she becomes a U.S. citizen if certain requirements are met. First, the surviving spouse must elect to treat any taxable distribution from the QDOT prior to the election as a taxable gift made by such surviving spouse for purposes of determining adjusted taxable gifts and the tax on future actual taxable gifts.[129] Additionally, the surviving spouse must elect 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 for purposes of determining taxable gifts and bequests that may be made by the surviving spouse after becoming a citizen during life and at death.[130] Such election is to be provided on or before April 15 of the year following the year in which the surviving spouse becomes a U.S. citizen, unless an extension is granted.[131]

G. *Trust Situs*

As noted above, QDOT rules require that a U.S. trustee be appointed and that the trust be maintained in, and the administration of the trust be governed by the laws of, one of the States of the United States or the District of Columbia.[132] Nevertheless, a QDOT can still be treated as a foreign trust for all Federal tax purposes.[133] A trust qualifies as a U.S. trust if (a) a court within the United States is able to exercise primary supervision over the trust administration (the "court test") and (b) one or more U.S. citizens or income tax residents have the authority to control all substantial decisions of the trust (the "control test").[134] Substantial decisions include decisions to make income or principal distributions and the amount of such distributions, to control investments, to allocate receipts to income or principal, to select beneficiaries, to remove, add or replace a trustee and to terminate the trust.[135] Any trust that does not meet both the control test and the court test is considered a non-U.S. trust. Consequently, although a U.S. trustee must make (or participate in, if there are multiple trustees) certain decisions with respect to a QDOT, one or more non-U.S. Persons could be given certain powers, such as the power to remove and replace the trustees or to control investments, thereby making the trust a non-U.S. trust.

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[129] Treas. Reg. Section 20.2056A-10(b)(1).

[130] Treas. Reg. Section 20.2056A-10(b)(2).

[131] Treas. Reg. Section 20.2056A-10(b)(3).

[132] Treas. Reg. Section 20.2056A-2(a).

[133] The IRS has privately ruled that a trust's status as a foreign trust for U.S. tax purposes will not cause the trust to fail to qualify as a QDOT. IRS PLR 199918039 (May 7, 1999).

[134] Code Section 7701(a)(31)(B) and (a)(30)(E).

[135] Treas. Reg. Section 7701-7(d)(1)(ii).

Where the surviving spouse is not subject to U.S. income taxation on a worldwide basis, it may be beneficial from a U.S. tax perspective to create the QDOT as a non-U.S. trust. If the QDOT is created as a non-U.S. trust, the income of the trust will not be subject to U.S. income tax, except to the extent it is derived from certain U.S. sources or effectively connected with a U.S. trade or business. It should be kept in mind, however, that a QDOT created by a decedent spouse for the benefit of a surviving spouse almost always will be considered a "non-grantor" trust, and if treated as a foreign non-grantor trust, would be subject to the accumulation distribution and throwback tax rules applicable to foreign non-grantor trusts. The application of these rules should not have any negative impact on a surviving spouse who is not a U.S. income taxpayer, but could have a punitive impact on a surviving spouse who is subject to U.S. income taxation or on any U.S. resident or citizen remainder beneficiaries of a QDOT.[136] Therefore, careful consideration should be given to the determination of the income tax status of a QDOT.

If the QDOT is created by the surviving spouse (discussed above), and the surviving spouse is not a U.S. citizen or income tax resident, then the QDOT could be structured as a grantor trust as to the surviving spouse, meaning that all income would be taxable to the surviving spouse, and the U.S. rules regarding throwback taxes and accumulation distributions would not be applicable during the life of the surviving spouse. This could be a very advantageous structure, especially for families where the surviving spouse is a not a U.S. citizen or resident but one or more of the children are U.S. citizens or residents.

III. Joint Ownership of Property by Citizen and Non-Citizen Spouses[137]

Many married couples find it convenient or otherwise desirable to own assets in joint names with right of survivorship,[138] rather than in the name of one or the other spouses. Where both spouses are U.S. citizens, the unlimited Federal marital deduction means that spouses may hold property jointly, irrespective of the amounts contributed by either spouse, without incurring any gift tax liability. However, the lack of a full marital deduction with respect to gifts or bequests to non-citizen spouses means that unintended estate or gift tax consequences can result where a U.S. spouse owns property jointly with a non-citizen spouse.

A. Estate Tax

Where both spouses are U.S. citizens, upon the death of one spouse, one-half of the value of property held jointly with rights of survivorship by the spouses is included in the

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136 Although the income of a QDOT will be distributed to the surviving spouse, capital gains not required to be distributed can result in the build-up of undistributed net income in a foreign non-grantor trust.

137 Except as otherwise noted, this Part III discusses the current rules in effect for the creation of joint tenancies between spouses, effective for joint tenancies created after July 13, 1988. Because these rules were a revival of older rules, they are, with some modification, also generally applicable to joint tenancies created between spouses before January 1, 1982. Different rules are applicable to joint tenancies created during different time periods.

138 References to joint ownership herein refer to joint tenants with right of survivorship or tenants by the entirety. These special rules related to joint ownership do not apply to property held as tenants in common. Joint Committee Print, Staff of the Joint Committee on Taxation, II. Present Law, 1995 WL 17828069, at 7, *See* FN 36 (June 1, 1995). The transfer of property owned by one spouse to tenancy in common is a gift of the transferred percentage, regardless of the type of property.

estate of the deceased spouse, although no estate tax is imposed, as the property passes to the surviving spouse and receives a full marital deduction.[139] In contrast, where the surviving spouse is not a U.S. citizen, the 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.[140] Where the surviving spouse is a non-citizen, the entire value of jointly held property is included in the decedent spouse's estate unless the decedent's executor submits facts sufficient to show that the property was not entirely acquired with consideration furnished by the decedent (including consideration furnished for improvements or mortgage payments) or was jointly acquired by gift, bequest, devise or inheritance.[141] The burden to make such a showing is on the executor.[142] That portion of the value includable in the estate of the decedent spouse would need to be placed into a QDOT in order for such value to escape the imposition of estate tax at death. The portion of the value that is includable in the estate of the decedent spouse is the only portion of the joint tenancy that may qualify for the marital deduction.[143]

B. Gift Tax

1) Real Property

The creation by spouses of a joint tenancy in real property after July 13, 1988[144] will not be treated as a taxable gift to a non-U.S. citizen spouse for Federal gift tax purposes regardless of which spouse provided the consideration.[145] However, upon termination of the joint tenancy other than because of the death of one of the spouses (e.g., upon the sale of the property to a third party), there will be a taxable gift to the extent that a spouse receives a greater share of the proceeds at the termination of the joint interest than the share representing such spouse's contribution.[146] Where the donee spouse is a U.S. citizen, the marital deduction will ensure that the transfer is not subject to any tax. However, where the deduction is not available

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139 Code Section 2040(b). The rules may be different for joint tenancies created before January 1, 1977, the effective date of the Tax Reform Act of 1976 (TRA 1976), P.L. 94-455.

140 Code Section 2056(d)(1)(B).

141 Treas. Reg. Section 20.2040-1(a)(2).

142 Treas. Reg. Section 20.2056A-8(a)(1). Under a grandfathering rule, where a decedent spouse provided the consideration for property before July 14, 1988, to the extent the consideration was treated as a gift to the non-citizen spouse (or, in the case of a decedent spouse who is also a non-citizen, would have been treated as a gift if the decedent had been a U.S. citizen), the surviving spouse will be treated as having provided that portion of the consideration. Treas. Reg. Section 20.2056A-8(a)(2).

143 Treas. Reg. Section 20.2056A-8(a)(3).

144 The effects of the creation and termination of a joint tenancy before January 1, 1982 generally are the same as the rules for tenancies created post-July 13, 1988 (subject to the availability for pre-1982 transfers to elect to treat the creation of a joint tenancy as a gift). Section 2515(a) of the 1954 Code; Treas. Reg. Sections 25.2515-1(b) and 25.2523(i)-2(b)(1). The rules related to joint tenancies created between December 31, 1981 and July 14, 1988 differ somewhat, and may be dependent on local law and life expectancies. Treas. Reg. Section 25.2515-2.

145 Code Section 2523(i)(3), which revived the provisions of Section 2515 (with respect to real property) and 2515A (with respect to personal property) of the Internal Revenue Code of 1954 (the "1954 Code"); Treas. Reg. Section 25.2523(i)-2(b)(1).

146 Treas. Reg. Section 25.2523(i)-2(b)(2)(i).

because the donee spouse is a non-citizen, gift tax will be payable to the extent annual exclusion is not available.

2) Personal Property

The general rule is that the creation of a joint tenancy in personal property after December 31, 1953 is treated as a gift made by the contributing spouse to the non-contributing spouse upon the creation of the joint tenancy of one-half of the value of the property.[147] However, in most cases, the creation of a joint bank account or joint brokerage account will not be treated as a gift by the contributing spouse to the non-contributing spouse. This is because, in most jurisdictions, the rules for joint accounts generally provide that the contributing spouse can withdraw the contributed assets at any time, without the consent of the other party. In this case, the transfer is revocable and considered an incomplete gift.[148] However, when the donee spouse draws upon the account for the donee spouse's own benefit, without any obligation to the donor spouse, the transfer becomes complete and may then result in a taxable gift from the donor spouse to the donee spouse in the amount of the withdrawal.[149]

Significantly, the effect of the creation of a joint tenancy in personal property may be different where the contributing spouse cannot unilaterally withdraw the funds or where state law provides that the creation of the account is a gift to the non-contributing spouse. In this case, there may be a gift of one-half of the transferred property.[150] In New York, Banking Law Section 675 seems to suggest that the creation of a bank or brokerage account is a gift by the contributing individual of one-half of the value of any cash, securities or other property deposited in joint names. However, the IRS has not been totally consistent in its analysis of New York accounts.[151]

IV. Planning for Descendants

Planning for a couple's descendants and other desired beneficiaries may be complicated by the non-U.S. Person status of one or both spouses. A non-U.S. Person is not subject to U.S. estate or gift taxes on worldwide property, which may create the ability to make transfers of non-U.S. assets free of U.S. tax. However, U.S. situs property is subject to U.S. gift and estate tax. Because the lifetime exemption is not available to non-U.S. Persons, where

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[147] Treas. Reg. Section 25.2523(i)-2(c)(1).

[148] Treas. Reg. Section 25.2511-1(h)(4) and (5).

[149] Treas. Reg. Section 25.2511-1(h)(4).

[150] The taxable gift attributable to transfers effected prior to the implementation of the current rules may depend on the parties' rights to sever the tenancy and the relative contributions of the spouses. *See* Treas. Reg. Section 25.2511-1(h)(5).

[151] *See* GCMs 36647 (March 23, 1976) (creation of a joint bank account results in a gift of one-half of the value of property contributed), GCM 37310 (November 2, 1977) (revoking GCM 36647, and holding that, as is the case under the laws of many jurisdictions, no gift results from the creation of a joint account until the non-contributing spouse withdraws from the account with no obligation to repay), and GCM 37869 (February 27, 1979) (proposing to revoke GCM 37310 and reinstate GCM 36647); *see also Estate of Buchholtz* v. *Commissioner*, T.C. Memo 1977-396 (1977) (applying New York law).

substantial U.S. situs property is held by a non-U.S. Person, transfers by such persons may be taxable, and without the benefit of the lifetime exemption amounts. Planning options must be carefully considered where non-U.S. Persons are involved. In particular, when the purchase of U.S. real property is being considered, planners must analyze which spouse should hold the property, or whether ownership through a corporation, trust or other entity is desired. In every instance, it should also be kept in mind that there may be tax or other considerations in other jurisdictions, such as the jurisdiction in which the parents or their descendants are residents or citizens that may impact the planning.

V. Transfers Incident to Divorce

A. *General Rules*

Property settlements that are incident to divorce of two U.S. citizen or resident individuals generally are not treated as recognition events for income tax purposes and are not taxable for gift tax purposes, even in cases where the transfer takes place after the individuals are no longer legally married. Code Section 1041(a) provides that a transfer to a spouse or a transfer to a former spouse that is incident to divorce[152] is not a tax recognition event. Code Section 1041(b) also provides that, for income tax purposes, the property so transferred is treated as acquired by the transferee by gift, with the basis of the transferee in the property being the adjusted basis of the transferor. From a gift tax perspective, Code Section 2516 provides that transfers made pursuant to a written agreement relative to marital and property rights to (i) settle such marital or property rights or (ii) to provide for the reasonable support of issue of the marriage during minority, is treated for gift tax purposes as a transfer made for full and adequate consideration (and thus not subject to gift tax).[153] These rules generally permit U.S. citizen or resident individuals to avoid the imposition of income or gift taxes on property transfers occurring as a result of the divorce of the parties.

B. Transfers to Non-Resident Alien Spouses

Code Section 2516 is applicable to transfers to non-resident alien spouses, and so transfers incident to divorce are not subject to gift tax.[154] In contrast, Code Section 1041(d) provides that the general rule regarding the nonrecognition of gain or loss on transfers of assets

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[152] A transfer between former spouses is "incident to divorce" under Code Section 1041 if (1) the transfer occurs not more than one year after the date on which the marriage ceases or (2) the transfer is related to the cessation of the marriage, meaning that the transfer is made pursuant to a divorce or separation instrument, and the transfer occurs not more than six years after the date on which the marriage ceases. Treas. Reg. Section 1.1041-1T(b). If a transfer between former spouses does not meet either of these requirements, there is a presumption that the transfer is not related to the cessation of the marriage, although this presumption may be overcome "by showing that the transfer was made to effect the division of property owned by the former spouses at the time of the cessation of the marriage." *Id.*

[153] To be considered an agreement that qualifies under Code Section 2516, divorce must occur within the one-year period before the agreement or the two-year period after. Code Section 2516.

[154] Code Section 2516; *See also Davis* v. *United States*, 370 U.S. 65, 73, 82 S. Ct. 1190, 1194, 8 L. Ed. 2d 335 (1962) ("Any suggestion that the transaction in question was a gift is completely unrealistic. Property transferred pursuant to a negotiated settlement in return for the release of admittedly valuable rights is not a gift in any sense of the term."); *Harris* v. *Commissioner*, 340 U.S. 106, 71 S. Ct. 181, 95 L. Ed. 111 (1950).

to a spouse or to a former spouse incident to divorce under Code Section 1041(a) is not applicable where the transferee spouse is a non-resident alien.[155] Instead, the ordinary tax recognition rules apply to the transferor and the transferee, meaning that a U.S. citizen or resident spouse who transfers property to a non-resident alien spouse or former spouse in connection with a divorce would recognize any built-in gain or loss in the property transferred.[156] The transferee's basis in such property is equal to the fair market value of the property at the time of the transfer.[157]

The 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, and the basis of the transferee spouse is determined by the basis of the property when it was jointly owned.[158] Where jointly held property is divided unequally, the transferor spouse realizes gain only as to the transfer of joint property in excess of a one-half interest in the property.[159]

VI. Other Planning Options

A. Sale to a Non-Citizen Spouse

As noted above, under the general rule of Code Section 1041(a), a sale of assets between spouses is not considered a tax recognition event. Code Section 1041(d) provides that this general rule is inapplicable, not only in the case of a dissolution of the marriage but also for transfers in the course of an intact marriage, where the spouse receiving the assets in question is a non-resident alien.[160] Code Section 1041(d) is clearly limiting for tax planning purposes,

[155] Note that the Code Section 1041 analysis is dependent upon the income tax status of the transferee, not the transferee's status as a U.S. Person for estate and gift tax purposes.

[156] This section V.B. describes the analysis in a state that applies equitable distribution upon divorce. In states that apply community property principles to assets held by spouses, equal division of community property is treated as a nontaxable partition of property rather than a transfer. Rev. Rul. 76-83, 1976-1 C.B. 213 (1976).

[157] *Davis* v. *United States*, 370 U.S. 65, 73, 82 S. Ct. 1190, 1194, 8 L. Ed. 2d 335 (1962). The theory behind this treatment is that the transferor receives, in exchange for property passing to the former spouse, the release of any marital and support rights of the transferee spouse. The transferor spouse is treated as having sold the property transferred for cash, and then having used the cash to purchase the release of the other spouse's marital rights. The transferee spouse is treated as purchasing the transferred property for full fair market value (being equal to the value of her released marital rights).

[158] Rev. Rul. 81-292, 1981-2 C.B. 158 (1981) ("An approximately equal division of the total value of jointly owned property under a divorce settlement agreement in a non-community property state is a nontaxable division. The basis and holding period of each asset is the same as when the property was jointly owned."). *See also Cofield* v. *Koehler*, 207 F. Supp. 73 (D. Kan. 1962) (concluding that husband who held bonds jointly with his wife did not realize taxable income when, upon divorce in a common law state and partition of jointly owned property, the bonds were awarded to the wife in exchange for other jointly owned property of equal value).

[159] *See* Rev. Rul. 74-347, 1974-2 C.B. 26 (1974).

[160] As noted above, Code Section 1041 rules are tied to the recipient spouse's income tax status and Code Section 1041(a) does still apply where the recipient spouse is a U.S. resident for income tax purposes, regardless of the citizenship of either spouse.

although it does lead to the non-resident alien spouse taking a fair market value cost basis in the transferred property (as opposed to a resident alien or citizen spouse, who would take the transferor spouse's tax basis in the transferred property).[161]

B. Life Insurance

The proceeds of life insurance held on the life of an individual who is not a U.S. citizen or domiciliary is not considered to be a U.S. situs asset and therefore is not includable in the U.S. taxable estate of such individual.[162] This means that a non-U.S. Person spouse may hold insurance on his or her life without incurring U.S. estate tax on his or her death.

In contrast, if a U.S. Person has any incidents of ownership over an insurance policy on his or her life at the time of death, the proceeds of such policy are includable in his or her estate, and where a non-citizen surviving spouse is named as the beneficiary on the policy, 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.[163]

However, changing the ownership and beneficiary designation of a policy to the non-citizen spouse during the insured's life can avoid the requirement that the proceeds be paid to a QDOT in order to avoid the application of estate tax if the insured spouse survives for at least three years after such transfer. The increased annual exclusion for gifts to non-citizen spouses (discussed above) could be utilized to make the initial transfer (as well as subsequent transfers to pay premiums) without incurring gift tax. If the non-citizen spouse survives the insured spouse and is not a U.S. domiciliary or citizen at the time of his or her death, estate tax will not be applicable to the proceeds of the policy on the death of either spouse. The use of a life insurance trust for the benefit of the non-citizen spouse also may avoid the application of estate tax upon the death of the non-citizen spouse.

C. Expatriation

Upon realizing the complexity and tax cost associated with the U.S. income, gift, and estate tax systems for individuals without substantial personal connections to the U.S., an increasing number of U.S. citizens and residents are considering expatriation from the United States. Certain expatriates may face a U.S. "exit tax" on all net unrealized gain in the value of their worldwide property, and U.S. Person[164] recipients of assets from the expatriate may be

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161 *Davis* v. *United States*, 370 U.S. 65, 73, 82 S. Ct. 1190, 1194, 8 L. Ed. 2d 335 (1962).

162 Code Section 2105(a).

163 Code Section 2056(d)(2)(B).

164 Internal Revenue Bulletin 2015-39 (September 28, 2015) ("Section 28.2801–2 of the proposed regulations defines terms for purposes of new chapter 15. The proposed regulations define the term "citizen or resident of the United States" as an individual who is a citizen or resident of the United States under the estate and gift tax rules of chapter 11 and chapter 12, respectively, in subtitle B of the Code. Accordingly, whether an individual is a "resident" is based on domicile in the United States, notwithstanding that section 877A adopts the income tax definition of that term. The Treasury Department and the IRS believe that, because section 2801 imposes a tax subject to subtitle B, the tax definition of resident under subtitle B generally should apply for purposes of section 2801. See §§ 20.0–1(b)(1) and 25.2501–1(b).").

subject to tax liability on the receipt of certain future trust distributions and gratuitous transfers.[165] In some cases, expatriation can result in substantial tax savings by eliminating the imposition of tax on worldwide assets, and, under certain facts, may permit the transfer of assets to a non-citizen spouse without the imposition of any U.S. transfer tax. However, expatriation can sometimes be a costly endeavor, and in the case of an individual with U.S. citizen or domiciled family members (such as children) whom he or she would like to benefit, expatriation may not result tax savings.

VII. Appointment of Non-Citizen Spouse as Fiduciary

When selecting fiduciaries under estate planning documents, individuals often wish to name their spouses. However, where an individual's spouse is not a U.S. citizen or resident, this appointment may have undesirable tax consequences, and in some cases may not be permissible under local law. Additionally, naming a non-resident alien spouse as a trustee of a trust, and giving that spouse the power to make "substantial decisions" with respect to the trust, will cause the trust to be treated as a foreign, rather than a domestic, trust for Federal tax purposes. Furthermore, naming a spouse who is a resident or citizen of a foreign country as trustee or executor may cause the trust or estate to be taxable by the relevant foreign country. 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. For example, in New York, a non-citizen who is not domiciled in New York will not be issued letters by a court 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.[166]

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[165] Code Section 877A(f).

[166] New York Surrogate's Court Procedure Act Section 707(c).