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# Estate Planning & Elder Law

# Transfer Tax Planning Issues For Non-Citizens

## It is critical to determine the citizenship and residency status of your client

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The scope of the federal tax on the transfer of wealth, including gift and estate taxes, extends to transfers of property passing from United States citizens and residents as well as from non-citizens and nonresidents, with different rules for taxpayers in each category. To properly advise a client in this area, it is critical that the advisor determine the citizenship and residency status of the client and the client's spouse as well as the situs of all assets which could potentially be subject to taxation.

A typical theme when explaining the federal tax on wealth transfers to a client is that the tax is imposed on transfers of wealth down to younger generations. This is because the tax system provides for an unlimited gift tax and estate tax marital deduction on outright transfers to spouses and with respect to certain qualifying trusts. This creates a deferral of tax until the transferee spouse transfers assets to younger generations either during lifetime or at death.

The unlimited marital deduction, however, is generally not available if the surviving spouse is not a United States citizen. In 1988, Congress enacted legislation that disallows the marital deduction for assets passing to a noncitizen spouse unless the property passes to a qualified domestic trust ("QDOT"). This legislation also replaced the gift tax marital deduction for lifetime transfers to noncitizen spouses with a series of restrictive rules.

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### Federal Estate Tax Marital Deduction

The assumption that underlies the marital deduction is that the property passing to the spouse will ultimately be subject to estate taxation on the surviving spouse's death. In the case of a noncitizen spouse, however, Congress determined that this assumption may not be valid since the noncitizen spouse could establish residency outside of the United States which could allow non-U.S. sitused assets to escape federal estate taxation. It is for this reason that transfers to noncitizen spouses will only qualify for the marital deduction if the property winds up in a QDOT, a trust which is designed to allow for tax deferral but in a way which maximizes the likelihood that the property in question will ultimately be taxed.

The 1988 legislation also effectuated an important change in the rules regarding the estate taxation of jointly held property passing by operation of law to a noncitizen spouse. Under the general rule, only one-half of property held jointly by spouses is included in the decedent's estate regardless of the consideration furnished by the decedent. This general rule was held to be inapplicable where the surviving spouse is not a U.S. citizen. As a result, such jointly held property is fully includable in the decedent's estate except to the extent it can shown that the surviving noncitizen spouse furnished consideration for the property.

A QDOT tax is imposed on distributions of principal from the QDOT during the spouse's lifetime (unless such distributions qualify under the hardship rules) and on all assets contained in the trust on the spouse's death. The QDOT tax is equal to the federal estate tax that would have been imposed on the decedent's estate had it included all QDOT taxable amounts less the tax that was originally imposed

In order to plan more effectively for clients facing this situation, it is important to understand the difference between the QDOT tax and the taxation of assets in a QTIP trust or other marital deduction trust. While the assets of a QTIP trust are taxable in the surviving spouse's estate so that the resulting estate tax can be offset by the surviving spouse's unified credit, the QDOT taxable amounts (lifetime principal distributions and assets in the QDOT trust on the spouse's death) are in essence

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deemed to be taxable in the estate of the decedent spouse (first spouse to die) so that the QDOT tax will not be reduced by the surviving spouse's unified credit.

**Lifetime Planning Considerations**

As described above, the QDOT provides for a deferral of the estate tax if the surviving spouse is not a U.S. citizen. The estate planner should therefore structure the estate plan so that assets pass to a QDOT, thereby achieving the desired goal of deferring the imposition of estate tax. This is generally accomplished by creating testamentary QDOTs for each spouse whose spouse is not a citizen and carefully reviewing the ownership of all assets and how they will pass on each death.

A traditional goal of estate tax planners is to assist clients in maximizing the extent to which the unified credit of each spouse can be utilized. Under current law, the unified credit offsets the federal estate tax on $ 2 million dollars of assets ($3.5 million dollars in 2009). This aspect of tax planning often involves transfers of assets from one spouse to the other. As a result of another provision in the 1988 legislation, this objective is more difficult to achieve where one or both spouses is not a U.S. citizen.

The unlimited gift tax marital deduction is not available with respect to lifetime transfers to noncitizen spouses. Instead, the law provides for a $100,000 annual exclusion (indexed each year for inflation) with respect to such transfers. For 2008, this amount is $128,000. This means that up to $100,000 (as indexed) can be transferred to a noncitizen spouse each year. Any excess amount would be taxable and would be chargeable to the transferor's $1million dollars gift tax exemption. This places a significant limitation on the ability to make sure that each spouse has sufficient assets in his or her name so that the order of deaths has no effect on the overall estate tax liability.

It may be beneficial for a noncitizen spouse to have additional assets in, his or her name so that his or her unified credit can be utilized if he or she is the first to die. In this case, the other spouse should take advantage of the $100,000 annual exclusion and make annual transfers of assets valued at this amount to the noncitizen spouse. In making such transfers, steps should be taken to leverage the $100,000 annual exclusion. For example, gifts of fractional interests in closely held businesses or holding companies, which would be subject to valuation discounts, and gifts of assets having a significant potential for future appreciation, should be considered.

**Post-Mortem Tax Planning**

An estate can still benefit from the marital deduction even if the decedent's will does not leave property to his or her noncitizen surviving spouse in a QDOT, provided that certain steps are taken within the guidelines and timeframes set forth in the code and regulations. Thus, it is important for an attorney involved in the administration of a decedent's estate to identify the surviving spouse's citizenship right away so the proper steps can be taken.

The easiest way for a decedent's estate to elect the marital deduction is to have the noncitizen spouse become a U.S. citizen prior to the time the federal estate tax return is due. If this is not possible or desired, the regulations allow for other methods of obtaining the marital deduction. The proper steps depend on whether the decedent left assets to the surviving spouse outright or in a trust created under the decedent's will (or a combination of both).

If the decedent leaves assets to a noncitizen spouse in a trust created under the decedent's will that is not a QDOT but otherwise qualifies for the marital deduction, the trust should be reformed to qualify as a QDOT. If the terms of the trust do not expressly allow for reformation, the executor must request a court to reform the trust. Judicial reformation proceedings must begin prior to the due date of the Federal estate tax return with extensions.

If a decedent leaves some or all of his or her assets to the spouse outright, QDOT treatment is still available if the surviving spouse creates a QDOT and either actually transfers or irrevocably assigns the property received from the decedent to the QDOT prior to the date the Federal estate tax return is due. This rule applies to probate property as well as nonprobate property such as jointly held assets and retirement assets.

The irrevocable assignment must be enforceable under local law. Property irrevocably assigned but not actually transferred to the QDOT before the estate tax return is filed must actually be conveyed to the QDOT before the administration of the decedent's estate is completed. If there is no administration, the conveyance must be made within one year of the due date of the filing of the estate tax return. The regulations allow protective assignments of property if at the date the return is filed, the exact value of the decedent's property passing to the spouse is unknown (possibly because of the jointly held property rules) or if the decedent spouse's citizenship status is unclear. The regulations also allow the executor to make a protective QDOT election for the same reasons.

Assuming the QDOT only holds property transferred from the surviving spouse, the QDOT created after the decedent's death does not have to otherwise qualify for the marital deduction. Therefore, the QDOT trust does not have to distribute all of the income to the surviving spouse and the QDOT can have other nonspouse beneficiaries. However, because income distributions to the surviving spouse out of the QDOT are not subject to estate tax, in most situations, it would be prudent to distribute all income to the surviving spouse.

If the surviving spouse and/or executor fail to perform the steps required to secure the marital deduction within the time frames of the code and regulations, under the 9100 regulations, the IRS provides an automatic six-month extension. The six-month extension is from the due date of the return, including extensions.

If the six-month extension period has also passed, the IRS sets forth a procedure under the 9100 regulations to request a private letter ruling allowing an extension of time to make "regulatory elections" for those taxpayers who cannot obtain relief under the automatic extension. A regulatory election refers to those elections and

applications for relief from tax whose deadline is prescribed by regulations, a revenue ruling, a revenue procedure, notice or announcement published in the Internal Revenue Bulletin. Section 9100 relief allows the IRS to grant an extension to make a regulatory election when the taxpayer provides evidence, including affidavits from all people with relevant knowledge, that demonstrates that (1) the taxpayer acted reasonably and in good faith, and (2) the grant of relief will not prejudice the interests of the government.

The IRS has issued several private letter rulings in this area. Under many of them, the IRS has granted an extension of time to take certain actions, such as creating a QDOT, irrevocably transferring the assets to the QDOT, electing QDOT treatment on the estate tax return, and actually transferring the assets to the QDOT, when the taxpayers satisfy both the good faith test and the interests of the government test. Taxpayers who complete some or most of these actions within one year of the due date of the return (with extensions) appear to have the most success obtaining extensions from the IRS.

If the IRS denies the taxpayer's request for an extension of time, the IRS will not allow the marital deduction, resulting in immediate tax on all of the assets passing to the noncitizen spouse. However, with careful planning, the estate planner can avoid this result. ■