

May 2012

**TO: Our Clients and Their Advisors**

**RE: Qualified Domestic Trust (“QDOT”)**

Estates With A Non-Citizen Spouse Are Not Protected

Special planning is required when a surviving spouse is not a citizen of the United States. Generally, the unlimited marital deduction is not available to the estate of the decedent spouse if the surviving spouse is a non-citizen. The Internal Revenue Code provides that estate tax can be deferred in such a situation (analogous to the unlimited marital deduction for citizen spouses) if the assets are placed into a Qualified Domestic Trust (“QDOT”). The trust must be for the sole benefit of the surviving spouse. There are several technical requirements in the Code for a trust to be treated as a QDOT:

- a. at least one trustee of the QDOT must be an individual citizen of the United States or a domestic bank or trust company. If an individual serves as sole Trustee, a bond or letter of credit security arrangement is required in the amount of 65% of the value of the QDOT assets, for those trusts with assets in excess of \$2 million.
- b. the trustee must withhold estate tax from any distribution of principal from the QDOT, unless made for immediate hardship purposes. The amount to be withheld is calculated based upon the estate tax return (Form 706) previously filed for the deceased spouse who created the QDOT.
- c. the surviving spouse must have a qualifying income interest for life, requiring the annual payment of income solely to the surviving spouse, which will not be subject to estate tax at the time of distribution.
- d. upon the death of the surviving spouse, the then principal amount of the QDOT will be subject to estate tax, as if it was originally included in the estate of the deceased spouse.
- e. if the Will of the decedent spouse does not establish a QDOT, the non-citizen surviving spouse has nine months from the date of death to create one for him or herself.

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Planning Considerations:

- a. Annual exclusion transfers of up to \$134,000 (indexed to inflation) can be made to the non-citizen spouse while he or she is alive.
- b. If assets are held in a joint account with a non-citizen spouse, the entire value of the account will be included in the decedent's estate, less the contribution of the surviving spouse that can be substantiated. Record keeping is essential to convince a revenue agent as to the true source of marital monies that purchased U.S. jointly held assets. If all or a portion of the entire value of the asset is included, estate tax will apply because the marital deduction is not available. Thus, it is extremely important that these joint accounts be converted to tenant-in-common status or the assets be split into individual names to take advantage of the unified credit exemption (currently \$5,120,000) as well as the availability of the QDOT.
- c. A non-citizen spouse who is the beneficiary of an IRA or other tax deferred retirement account should roll over the plan benefits into an IRA-QDOT. These plan benefits will not be currently subject to estate tax. The plan assets will continue to grow tax deferred and distributions of income, although subject to income tax, will not be subject to estate tax. Principal distributions, however, will be subject to income and estate tax.
- d. Gifts or inheritances received from non-resident family members, should be made payable to a discretionary trust for the benefit of the donee to avoid inclusion in the recipient's taxable estate.
- e. Life insurance should be acquired by an irrevocable life insurance trust for the benefit of the surviving spouse and other family members, to provide additional principal for the surviving non-citizen spouse without exposure to estate tax as well as to provide additional liquidity to pay estate taxes. These assets will pass outside of the estate of the surviving spouse and distributions can be made income and estate tax free. During the lifetime of the insured, there can be access to the cash value of the policy for emergencies or supplemental retirement income.

Our office is available to assist you or your clients in exploring these and other sophisticated gift and estate tax planning opportunities including family limited partnerships, qualified personal residence trusts and charitable scenarios which will assist in the preservation of wealth for future generations. Our other areas of specialization include real estate, tax dispute resolution, tax planning, business law representation and retirement planning issues.