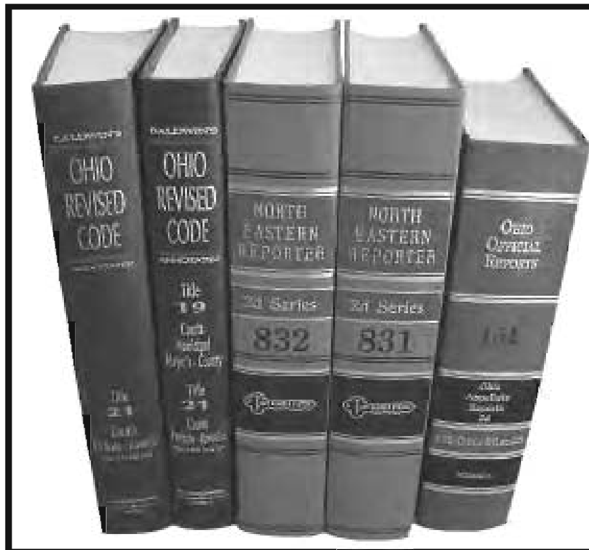

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The Noncitizen Spouse: Implications for Estate Planning and Administration

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The noncitizen spouse presents special considerations in both estate planning and estate administration. In reviewing these implications, this article will assume the situation of a married couple comprised of a U.S. citizen and a resident noncitizen.[1] For purposes of simplicity, it will be assumed that the "fiscal domicile" of both spouses will lie with the United States under any applicable estate and gift tax treaty between the U.S. and the country of the spouse's citizenship and that the property being transferred is sited in the U.S. Under this set of circumstances, treaty ramifications will be minimized. Treaty provisions may still apply, however, and this article will address those in turn.

For purposes of presenting a consistent example, the article will further assume that the wife is the citizen and the husband is the resident noncitizen. We will begin with an analysis of estate planning implications and follow with the challenges presented in estate administration.

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I. Estate Planning

When advising the couple consisting of the U.S. citizen wife and the resident noncitizen husband, we need to be familiar with both the federal gift tax and estate tax laws. We will find that when funds are flowing from the resident noncitizen to the citizen, the normal transfer tax rules will apply. When the transfer is in the opposite direction, meaning that property is moving to the noncitizen, the rules change dramatically. We will look first at the gift tax and then the estate tax. Following those analyses, we will examine the possible effect of a treaty between the U.S. and the noncitizen's country.

A. Gift Tax

Under the federal gift tax regime, a transfer from the resident noncitizen husband to the citizen wife enjoys the unlimited marital deduction of IRC § 2523. This deduction includes the familiar types of gifts: the outright transfer, the life estate with power of appointment,[2] the qualified terminable interest property (QTIP) election,[3] and the annuity or unitrust interest in a charitable remainder trust.[4] When the property moves in the direction of the noncitizen, however, the result is quite different. In this situation, IRC § 2523(i) eliminates the marital deduction otherwise available and substitutes a supersized annual exclusion amount equal to approximately ten times the exclusion available under IRC § 2503(b). As such, only a present interest gift, or the portion of a gift consisting of a present interest, will qualify for the exclusion.[5] In calendar year 2009, the gifting limit to a noncitizen spouse is $133,000.[6] (The annual exclusion is capped at $13,000 in 2009. Owing to separate indexing of the noncitizen exclusion, the gifting limit to a noncitizen spouse is not exactly ten times the annual exclusion, which would have resulted in a limit of only $130,000.)[7]

From the standpoint of tax policy, the unlimited gift tax marital deduction for interspousal transfers involving two U.S. citizens favors a deferral of tax until the property leaves the marital unit, either when gifted to a nonspouse or upon the second death. The policy behind the rules on gifts to noncitizen spouses seems to be that limitations should be imposed on transfers that leave, or will potentially leave, the U.S. transfer tax system. Where gifted property may not be available for subsequent taxation, the policy affords only a limited exclusion to the gift ($133,000 per year, as indexed) and, beyond that, taxes the transferred property. In effect, the policy allows minimal potential leakage from the transfer tax regime. The policy is best understood in the case of a gift to a noncitizen spouse who is not a U.S. resident, whose estate at death would be subject to only the limited U.S. estate taxation imposed on noncitizen nonresidents under IRC §§ 2101 *et seq.*[8] In our paradigmatic transfer from the citizen wife to the resident noncitizen husband, who as a resident would be subject to normal U.S. estate taxation upon his death,[9] the policy seems to take into account the possibility that he could depart U.S. residency prior to his death.

B. Estate Tax

As with gifts, the resident noncitizen husband in our paradigm enjoys an unlimited marital deduction for testamentary transfers to his citizen wife, assuming that the bequests fall within the scope of IRC § 2056. When the bequest moves from the wife to the noncitizen husband, however, the estate tax marital deduction is denied unless the property is placed in a "qualified domestic trust".[10] A QDOT, as this trust is called, is the only non-treaty mechanism for claiming a marital deduction on assets passing for the benefit of a noncitizen spouse.[11] There is no limitation on the amount that can pass into a QDOT. The trust, however, must meet definite statutory and regulatory criteria, and the executor of the decedent's estate must make an election to qualify the trust as a QDOT.[12]

In order to meet the statutory requirements of a QDOT, a trust must have at least one trustee who is either a U.S. citizen or a domestic corporation, and such trustee must have the right to withhold estate tax from any trust distribution.[13] (This estate tax, which is imposed under IRC § 2056A, will be discussed later in this article under the heading Estate Administration.) Further required attributes of a QDOT are provided by regulation. They include:

- If the assets of the QDOT (or all QDOTs combined) exceed $2,000,000 (as determined for estate tax purposes), then either (i) one trustee must be a bank organized under U.S. law or that of a state or the District of Columbia, (ii) the U.S. citizen trustee must post a bond with the IRS, or (iii) the U.S. citizen trustee must furnish an irrevocable letter of credit.[14]

- The trust, if not for the identity of the spouse as a noncitizen, must qualify for the federal estate tax marital deduction under, most notably, either § 2056(b)(5) (the life estate with power of appointment), § 2056(b)(7) (the QTIP marital deduction), or § 2056(b)(8) (with the spouse as the only noncharitable beneficiary of a charitable remainder trust).[15] Simply stated, the spouse must have a life income interest (as under a life estate/power of appointment trust or QTIP trust) or have an annuity or unitrust interest under a CRT.
- The trust must be maintained under and governed by the laws of a state of the U.S. or the District of Columbia.[16]
- The trust must meet certain regulatory requirements designed to insure the collection of tax.[17]

So long as the Code and Regulations are followed, our paradigmatic citizen wife can transfer an unlimited sum to a QDOT for the benefit of her noncitizen husband. As we saw under the discussion on gift taxes, however, she cannot make tax-free gifts during her life to her noncitizen husband that exceed an inflation-adjusted $133,000 per year. There is no corresponding QDOT election in the gift tax regime. In relation to the unlimited QDOT transfers that are possible at death, the $133,000 per year gift tax exclusion seems rather primitive. Our citizen wife would have to make annual gifts over a period of many years in order to pass large tax-free sums to her noncitizen husband.

C. Effect of Tax Treaties

These results restricting bequests to a noncitizen spouse can be altered by a treaty between the U.S. and the country of which the spouse is a citizen. Examples are treaties with Canada, Germany and France.

Under the U.S.-Canada treaty, the estate of a U.S. citizen or resident decedent, whose "fiscal domicile" under the treaty lies with the U.S., receives a "marital credit" for a bequest to the noncitizen Canadian spouse. This credit results in a tax-free transfer up to the U.S. exemption equivalent, which in the year 2009 is $3,500,000. The exemption equivalent is calculated without reduction for any lifetime gifts which might otherwise operate to decrease the exemption available at death.[18] In order to claim this "marital credit," the decedent's executor must elect under the treaty and affirmatively waive the benefit of any U.S. estate tax marital deduction otherwise available, namely the QDOT deduction.[19] The credit available under the treaty is in addition to the otherwise available U.S. estate tax credit. Therefore, although a QDOT election cannot be applied to spousal bequests over $3,500,000, the decedent's unified credit will still be available to apply against the tax.

The U.S. treaties with Germany[20] and France[21] afford substantially the same result as the treaty with Canada.

With the exception of the Canadian, German and French treaties, the estate planner will be hard pressed to find relief from the denial of the marital deduction under IRC § 2056(d) for non-QDOT transfers to noncitizen spouses. Subsection (d) of IRC § 2056 was enacted by the Technical and Miscellaneous Revenue Act of 1988 (TAMRA), and the effect was to override the marital deduction provisions in pre-existing treaties. Canada, Germany and France obtained relief for their citizens in subsequent protocols to their treaties, but other countries have been slow to follow.

II. Estate Administration

A. General Considerations

Whether or not the practitioner was involved in predeath planning, he or she is faced with the situation of the administration of the estate of a citizen decedent whose surviving spouse is a noncitizen resident, or of the estate of the deceased noncitizen resident with a citizen spouse. Thus, our paradigmatic example continues in the post-mortem setting.

The estate of the deceased noncitizen resident, who is the husband in our example, is subject to worldwide taxation because of his status as a U.S. resident at the time of his death.[22] Because he is subject to the same estate tax regime as a U.S. citizen, all applicable marital deductions are available. An estate tax treaty, however, may govern the taxation of certain property sited or deemed sited in his country of citizenship, such as real property, and the marital deduction available to him for the transfer of such foreign property to his U.S. citizen spouse may be limited under the internal laws of the treaty country. The applicable treaty and the laws of the other country must be consulted.[23]

Transfers by the U.S. citizen wife to her surviving noncitizen resident husband will not, barring treaty provisions to the contrary, qualify for the estate tax marital deduction unless either (i) the transfer involves the QDOT mechanism[24] or (ii) the spouse becomes a U.S.

citizen within the estate tax return period.[25] The QDOT can be set up after the decedent's death by either the executor or the spouse, so long as there is an irrevocable transfer of the property to the qualifying trust and the appropriate election is made.[26] Furthermore, a trust established by the decedent can be reformed to qualify as a QDOT.[27]

As to reformation, trusts governed by Ohio law are benefited by the private settlement agreement section of the Ohio Trust Code.[28] This section expressly contemplates reformation of a trust for purposes of qualifying as a QDOT. It reads:

> Matters that may be resolved by a private settlement agreement include, without limitation, the following: …
>
> (6) modifying the terms of the trust in the manner required to qualify any gift under the terms of the trust for the estate tax marital deduction available [for transfers] to noncitizen spouses, including the addition of mandatory governing instrument requirements for a qualified domestic trust under section 2056A of the Internal Revenue Code and regulations promulgated under it, in any case in which all parties interested in the trust have submitted written agreements to the proposed changes or written disclaimer of interest.[29]

The remainder of this article assumes that the QDOT has been properly established, either by the decedent prior to her death, by the trustee or noncitizen surviving spouse after death or by reformation after death. Issues concerning that administration of the QDOT remain.

B. Administration of the QDOT

For property passing into a QDOT, estate taxation is merely deferred. Under IRC § 2056A, taxation is imposed on the value of most distributions of principal from the trust and, upon the death of the spouse, on the remaining value of the trust.[30] These occurrences giving rise to the tax are referred to in the statute as "taxable events".[31] Distributions of income to the spouse are not subject to the Section 2056A tax,[32] and principal distributions on account of hardship are excepted as well.[33]

The taxation of QDOT distributions and terminations is consistent with the policy of taxing marital transfers to noncitizens at the time when the property exits or potentially exits the U.S. transfer tax system. This policy allows only minimal potential leakage from the taxing regime, such as with hardship distributions from a QDOT or limited annual lifetime gifts to the noncitizen spouse.

The IRC provides a calculation of the Section 2056A tax that serves to isolate the current taxable events by grossing up and recalculating the estate tax on the estate of the original decedent. After the occurrence of a taxable event, the trustee of the QDOT looks back to the taxable estate of the decedent and uses the estate tax rates and credits which were in effect on the date of such decedent's death. The trustee then calculates a tentative tax on the sum of the original taxable estate, the amount of distributions of principal from the QDOT during prior calendar years, and the value of the current year taxable events, including principal distributions and, if the spouse died during that year, the remaining value of the QDOT. After making this first tentative tax calculation, the trustee proceeds to make a second calculation, this time considering only the original taxable estate and the prior distributions of principal. To arrive at the Section 2056A tax, the trustee then subtracts the second tentative tax calculation from the first.[34] To the extent that the decedent had unused unified credit, it can be taken by the trustee against the Section 2056A tax. The return for the Section 2056A tax is the Form 706-QDT.

The mechanism for isolating current taxable events in the Section 2056A calculation is similar to the mechanism for grossing up prior taxable gifts with current taxable gifts on a Form 709 or aggregating adjusted taxable gifts with the taxable estate on a Form 706. The unique feature of the Form 706-QDT is that the preparer must gross up transfers with those of a different taxpayer, namely, the estate of the first deceased spouse, and apply the rates and exemptions applicable to that decedent.

Treaty provisions can also affect the Section 2056A tax calculation. For example, the U.S.-Canada treaty provides a credit against the Section 2056A tax imposed at the death of the spouse in the case where trust property consists of property situated outside the U.S. The credit is equal to the amount of Canadian federal or provincial "gains at death" tax on such property.[35]

The Section 2056A charge is "tax-inclusive". Thus, if the Section 2056A tax is paid from the assets of the trust, as opposed to being withheld from the principal distribution to the spouse, the tax payment is treated as another principal distribution to the spouse.[36] In the return due for the calendar year in which the deemed distribution is made, a further Section 2056A tax will be due.

In the QDOT situation, it is sometimes the case that the spouse later becomes a U.S. citizen. What then?

In certain circumstances, the noncitizen surviving spouse's attainment of U.S. citizenship will cause no further imposition of the Section 2056A tax. This is the result when either the spouse was, at all times prior to becoming a citizen, a resident of the U.S. since the death of the decedent, or the spouse (regardless of residency) has never received a distribution from the QDOT which was subject to the tax.[37] The spouse is now within the U.S. transfer tax system, and the normal rules for a citizen or resident will apply. If the ever-resident spouse who becomes a citizen had previously received a QDOT distribution and the trustee had paid a Section 2056A tax, the spouse's estate would be eligible for a tax-on-prior-transfer (TPT) credit under Section 2013, calculated without limitations otherwise owing to the date of the original decedent's death.[38]

If the noncitizen surviving spouse was not at all times a resident since the date of the original decedent's death and had, prior to becoming a citizen, received a principal distribution that was subject to the Section 2056A tax, the situation is complicated. Here, the spouse can be free of any further Section 2056A tax if he makes a two-fold election.[39] The first part of the election is to treat all the prior QDOT principal distributions to the spouse as prior taxable gifts made by the spouse.[40] The effect of this election will be to gross-up taxable gifts for purposes of (i) calculating any gift tax on taxable gifts made by the spouse under § 2501 from the year of citizenship forward and (ii) calculating any estate tax imposed upon the death of the spouse under § 2001. Congress seems to assume that any QDOT distribution made to this spouse, who prior to becoming a U.S. citizen was not at all times a U.S. resident, must have been dissipated by such spouse outside of the U.S. tax system and, as a result, Congress determined that upon allowing such person to become a citizen, the spouse should have to include such distributions in calculating further U.S. transfer taxes. Like the estate of the ever-resident spouse, however, the estate of the spouse who had not been a resident at all times prior to becoming a citizen will ultimately enjoy the TPT credit for previously imposed Section 2056A tax.[41]

The second part of the now-citizen spouse's election involves a possible reduction of his unified credit.[42] If the prior decedent's unused unified credit had been taken against the Section 2056A tax on a previously filed Form 706-QDT, then the spouse must agree that his own unified credit will be reduced by such amount. The effect of this provision is consistent with the non-portability of the unified credit. The spouse in this scenario benefited by the prior decedent's unused credit when it was applied against the Section 2056A tax on QDOT distributions, so as part of becoming a U.S. citizen and escaping further Section 2056A tax, the spouse must now be subject to the normal rules of a U.S. citizen.

III. Conclusion

The rules relating to estate and gift taxes on transfers to a noncitizen spouse represent a mature area of transfer tax law. Despite the complexity of the statutes and regulations, there has been relatively little subsequent administrative or judicial activity concerning them. Although the law in this arena is well-settled, the practitioner needs to remain aware of the scheme applicable to the situation.

ENDNOTES

1. For purposes of federal estate and gift taxes, residency is the equivalent of domicile (involving physical presence plus the requisite intent to remain indefinitely). Treas. Reg. § 20.0-1(b). A person does not need to be a lawful permanent resident under U.S. immigration law (a "Green Card" holder) in order to be a resident for estate and gift tax purposes. Furthermore, a "resident alien" for U.S. income tax purposes may not be considered a resident for estate and gift tax purposes, as the income tax residency test does not require the intention to remain permanently. IRC § 7701(b)(1)A).
2. IRC § 2523(e).
3. IRC § 2523(f).
4. IRC § 2523(g).
5. Treas. Reg. § 25.2523(i)-1. It is noteworthy here that the QTIP election is not available to qualify the gift as a present interest. Treas. Reg. § 25.2523(i)-1(d), Ex. 4.
6. Rev. Proc. 2008-66, 2008-45 IRB (Nov. 10, 2008).
7. Special rules apply to a joint and survivor annuity (IRC § 2523(i); Treas. Reg. § 25.2523(i)-1(b)) and to a joint tenancy with right of survivorship in real or personal property (IRC § 2523(i)(3); Treas. Reg. § 25.2523(i)-2).
8. The taxation of the property of the nonresident noncitizen upon his subsequent death will be limited to that imposed under IRC §§ 2101 *et seq.*, which taxes only property "situated in the United States". IRC § 2103. Thus, gifts of non-U.S. situs property (such as shares of stock in non-U.S. corporations) would escape taxation upon the subsequent death of the nonresident noncitizen.
9. IRC § 2001.
10. IRC § 2056(d).
11. IRC § 2056(d).
12. IRC § 2056A(a).
13. IRC § 2056A(a).
14. Treas. Reg. § 20.2056A-2(d)(1)(i)
15. Treas. Reg. § 20.2056A-2(b)(1).
16. Treas. Reg. § 20.2056A-2(a).

17. Treas. Reg. § 20.2056A-2(d).
18. U.S.-Canada Income Tax Treaty, Article XXIX.B.3. All references to this treaty are as amended by U.S.-Canada Protocol (1995). These provisions are included in the Income Tax Treaty between the two countries, rather than in an estate tax treaty, because the Canadian tax is on "gains at death", which is an income tax on deemed realization of gains. U.S.-Canada Income Tax Treaty, Article II.2(a). The transfer to the surviving spouse must otherwise qualify for a U.S. marital deduction which would have been available for bequests to a citizen spouse, such as outright transfers and QTIP transfers.
19. U.S.-Canada Income Tax Treaty, Article XXIX.B.3(d). The election must be made by the date on which a qualified domestic trust election could have been made.
20. U.S.-Germany Estate and Gift Tax Treaty, Article 10.6 (as added by the U.S.-German Protocol (1998)).
21. U.S.-France Estate and Gift Tax Treaty, Article 11(3) (as added by the U.S.-French Protocol (2004)).
22. IRC § 2001.
23. For example, see U.S.-Germany Estate and Gift Tax Treaty, Article 10.4.
24. IRC § 2056(d)(1).
25. IRC § 2056(d)(4) and Treas. Reg. 20.2056A-1(b). The regulations liberally interpret the statute to apply to the time at which the estate tax return would be due, including extensions. Thus, the period for becoming a citizen is generally fifteen months after date of the decedent's death.
26. Treas. Reg. § 20.2056A-2(b)(2).
27. See Treas. Reg. § 20.2056A-4.
28. ORC § 5801.10.
29. ORC § 5801.10(C).
30. IRC § 2056A(b)(1). Furthermore, if the trust ceases to meet the requirements of a QDOT, the cessation is treated as the equivalent of the death of the spouse. IRC § 2056A(b)(4).
31. IRC § 2056A(b)(9).
32. IRC § 2056A(b)(3)(A).
33. IRC § 2056A(b)(3)(B) and Treas. Reg. § 20.2056A-5(c)(1).
34. IRC § 2056A(b)(2).
35. U.S.-Canada Income Tax Treaty, Article XXIX.B.7. The Canadian "gains at death" tax is in fact an income tax. See fn 18.
36. IRC § 2056A(b)(11).
37. IRC § 2056A(b)(12)(A) & (B). The trustee must notify the IRS of the spouse's attainment of citizenship on Form 706-QPT.
38. IRC § 2056(d)(3).
39. IRC § 2056A(b)(12)(C).
40. IRC § 2056A(b)(12)(C)(i).
41. IRC § 2056(d)(3).
42. IRC § 2056A(b)(12)(C)(ii).