Estate Planning for the Non-Citizen Spouse (Resident Alien)

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Mr. Merric presents nationwide usually more than 30 times annually. He is honored to have spoken at:

- Regis Campfield's Notre Dame Tax and Estate Planning Institute (2007);
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Mark Merric has been fortunate to be one of the few authors that have had three, four, and five part series published in Estate Planning Magazine, Journal of Practical Estate Planning, and Leimberg LISI. He is also a co-author of the following three treatises:

- The Asset Protection Planning Guide: A State-of-the-Art Approach to Integrated Estate Planning, Commerce Clearing House (CCH) treatise, first edition;
- Asset Protection Strategies, American Bar Association (two chapters); and
- Asset Protection Strategies Volume II, American Bar Association to be published Apr. 2005 (MM responsible for 1/5 of the text).

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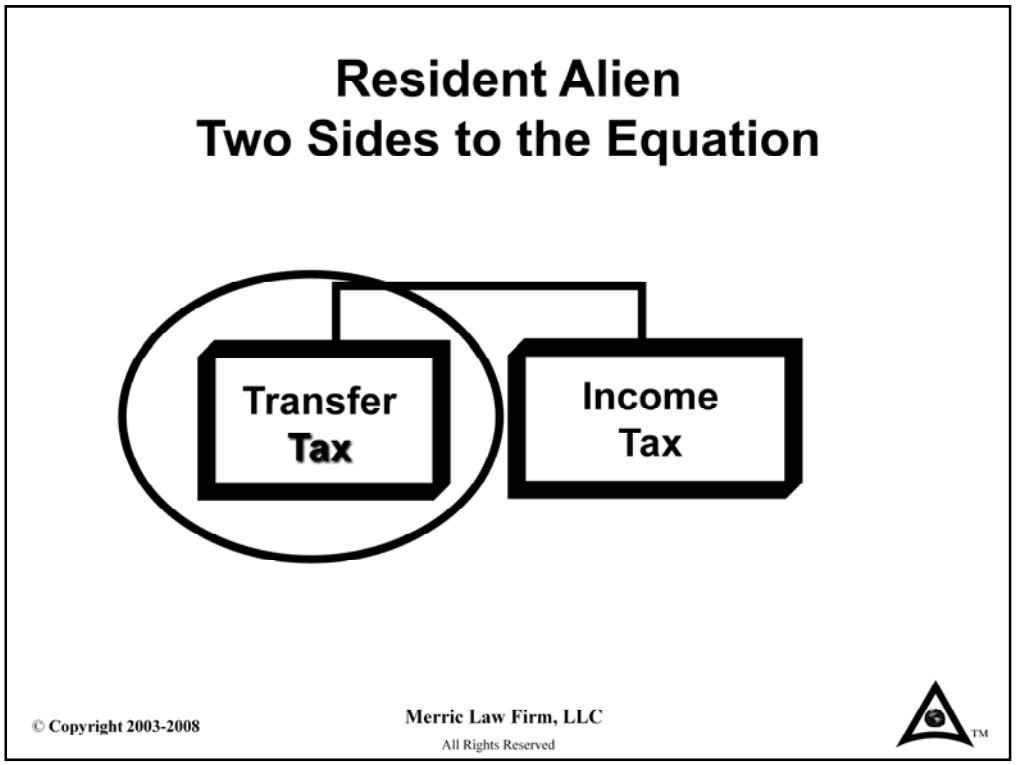


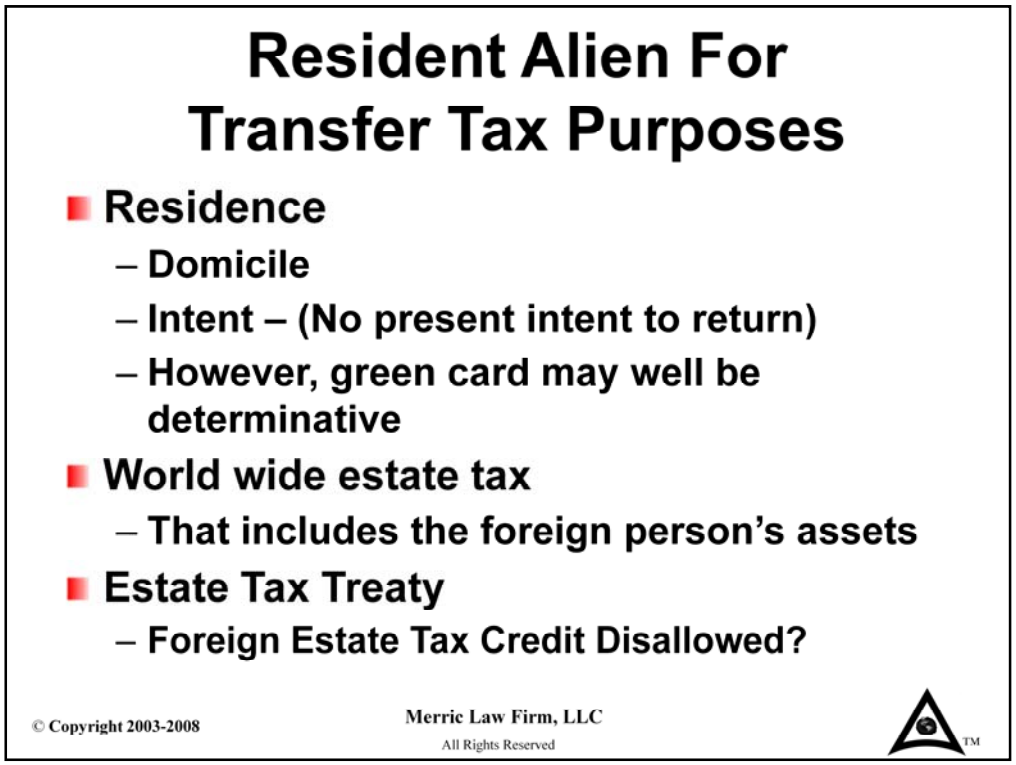
A. Resident Alien – Two Sides to the Equation

1. Two Different Tests

There are two separate tests for determining whether a foreign person is classified as a resident alien. The 183 day test or the green card test is used for income tax purposes. On the other hand an "intent" or factor test is used to determine whether a person is a resident for estate tax.

2. Non-Citizen Spouse

In most cases, a non-citizen spouse will be classified as a resident alien for both income tax and transfer tax purposes. Conversely, since the tests are different, the transfer tax test will be discussed in this outline.



B. Resident Alien For Transfer Tax Purposes

1. Residence

a. Domicile

A decedent is a resident for U.S. income tax purposes if at time of death he or she had his or her domicile in the U.S. Domicile is the place a person lives with no definite present intention of leaving. IRC § 2001(a); Treas. Reg. § 20.01-1(b)(1).

b. Intent

Therefore, residence is a subject test that is based on "intent." *Estate of BlochSulzberger*, 6 CCH TCM 1201 (1947).

c. Factors

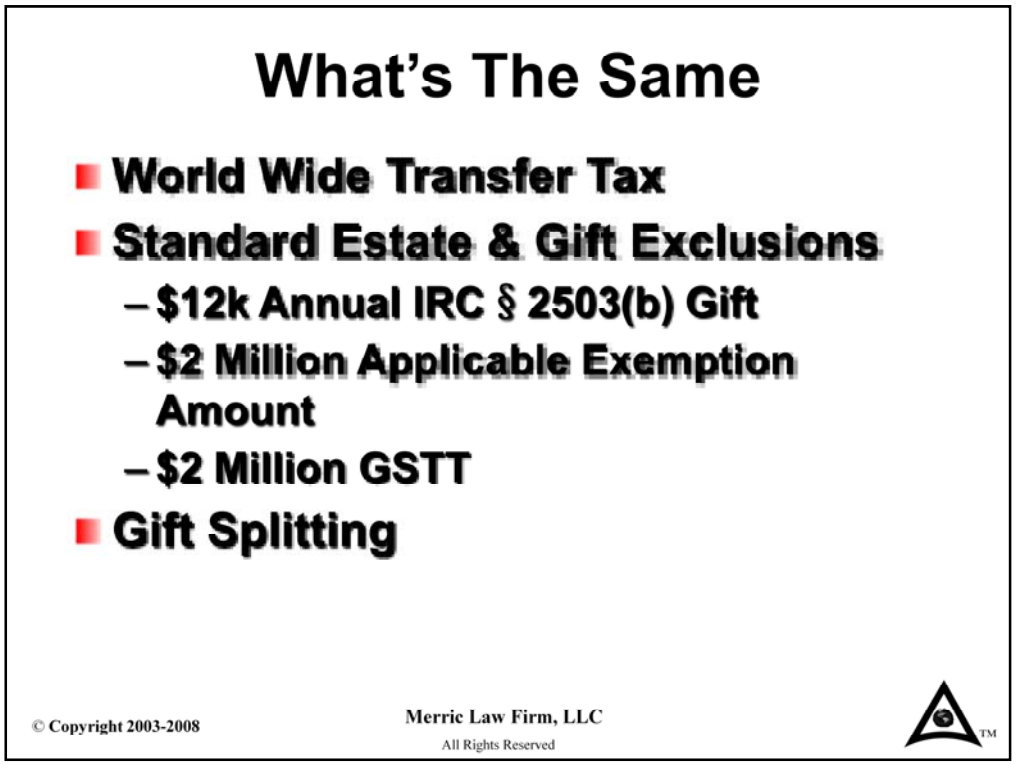
Owning a home, the period of time the decedent lives in the U.S. each year, how long (in years) the decedent has been away from his previous home residence, and why the decedent did not return to his previous home are all factors that are considered for residency status. Rev. Rul. 80-209; *Estate of Paquette v. Commr.*, T.C.M. 1983-571 (1983); *Estate of Nienhuys v. Commr.*, 17 T.C. 1149 (1952); *Estate of Khan*, TC Memo 1998-22 . Many times the issuance of a green card will result in residency for estate tax purposes. Rev Rul 80-363; *Estate of Jack*, 54 Fed. Cl. 590 (2002).

2. World Wide Taxation

Unlike a foreign person (i.e. non-resident alien), a non-citizen (resident) alien spouse in many ways is taxed similar to a citizen or resident-alien for estate tax purposes. Transfer tax for a non-citizen (resident alien) spouse is computed on his or her world wide assets.

3. Tax Treaties

Under the 96 U.S. Model Treaty, a person is a resident in the place he or she has a permanent home. If he or she has two permanent homes his or her economic interests are analyzed. Further, the foreign tax credit is denied if the other country does not allow a similar estate tax credit for U.S. estate tax.



C. What's the Same

Unlike a foreign person (i.e. non-resident alien), a non-citizen (resident) alien spouse is taxed similar to a citizen or resident-alien for estate tax purposes.

1. World Wide Taxation

Both citizens and resident aliens are subject to estate tax on their world-wide assets. Even if a resident alien leaves the country prior to death, he or she would be subject to the ten year expatriation provisions if the resident alien was a "long term resident" at the time of expatriation. A "long term" resident is a foreign person who has been a resident for 8 out of the last 15 years. IRC § 877(e)(2).

2. Standard Estate and Gift Tax Exclusions

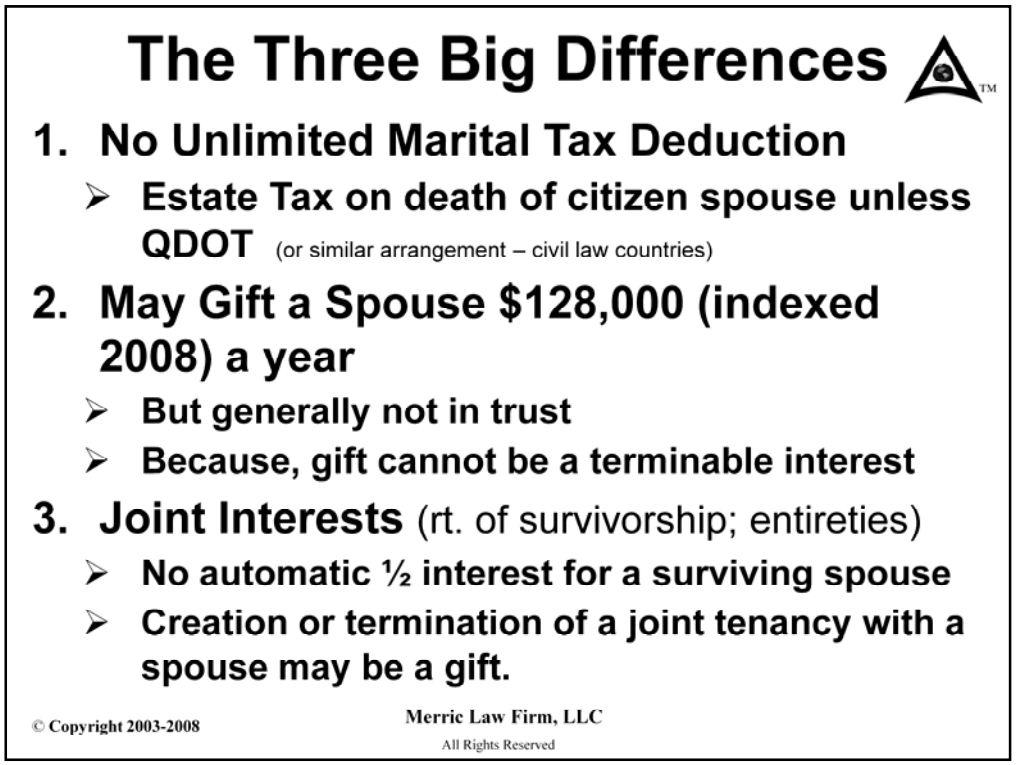
At first glance, it appears that a non-resident spouse receives the benefits of a U.S. Citizen and a resident alien, because the non-resident alien spouse receives the following benefits:

- $12,000 annual IRC § 2503(b) exclusion;
- $2 million applicable exclusion amount; and
- $2 million GSTT exclusion.

However, while a non-citizen (resident alien) spouse receives these benefits, there are a few key benefits that he or she does not receive as well as several problems with jointly held property (joint tenancy with right of survivorship and joint tenancies).

3. Gift Splitting

A non-citizen spouse who is a resident alien may elect to gift split. IRC § 2513(a)(1). However, non-resident aliens may not make a gift splitting election.



D. The Three Big Differences

1. No Unlimited Marital Tax Deduction

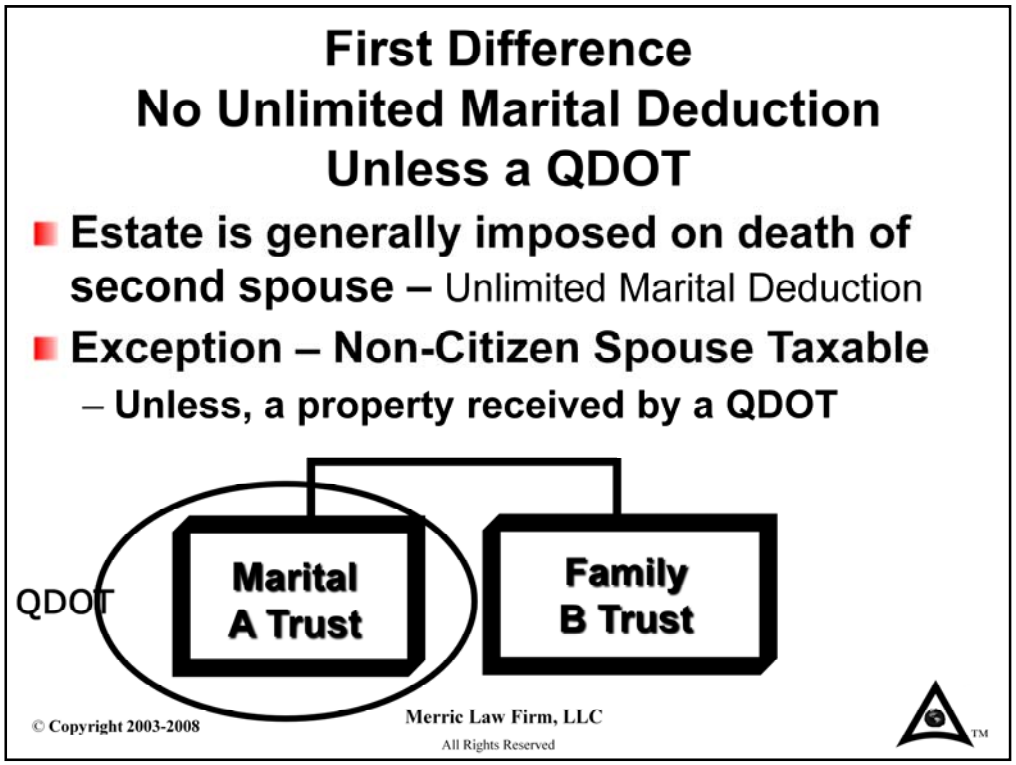
Prior to the Technical and Miscellaneous Revenue Act of 1988 (TAMRA), transfers to a non-citizen spouse also qualified for the unlimited marital tax deduction. However, after TAMRA, a transfer at time of death to a non-citizen spouse only qualifies for the marital deduction if such property is transferred to a qualified domestic trust (QDOT) or similar arrangement in certain civil law countries. IRC § 2056(d). In addition to providing the QDOT limitations, TAMRA also created limitations in two other key areas.

2. Gifts to A Spouse

A gift to a non-citizen spouse does not qualify for the unlimited marital deduction. IRC § 2523(i)(1). Instead, a citizen spouse may transfer to a non-citizen spouse up to $128,000 (indexed 2008) annually as an IRC § 2503(b) gift. However, there are several unique requirements to these IRC § 2503(b) gifts that are discussed in the following pages.

3. Joint Interests

Joint tenancy with right of survivorship or tenancies by the entirety also create several estate planning issues. In particular the assumed one-half interest in the aforementioned joint property to the surviving spouse rule does not apply. IRC § 2056(d)(1)(B). Further, the creation or termination of a joint interest in the aforementioned property may also be a gift to a non-citizen spouse. IRC § 2523(i)(iii).



E. No Marital Deduction Unless a QDOT

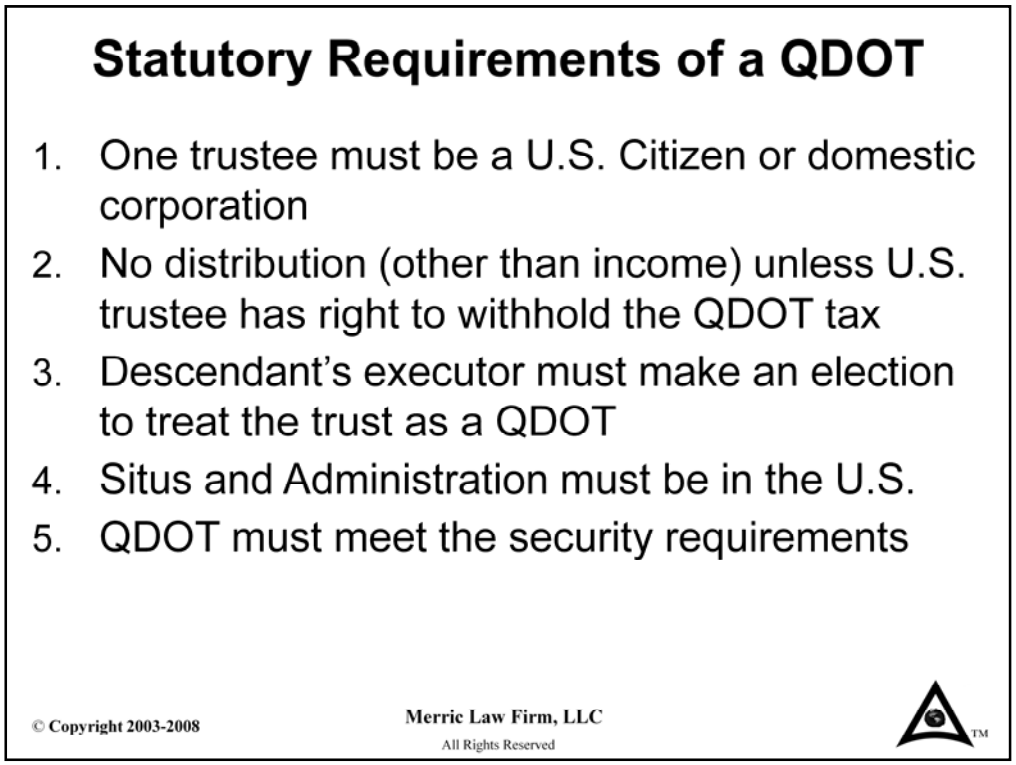
Except for a non-deductible terminable interest, the unlimited marital deduction allows all of the deceased's property to pass to a surviving citizen spouse without the incurrence of any estate tax. Instead, the estate tax will be imposed on the death of the second spouse. However, the rule is not the same for a non-citizen spouse, even if he or she is a resident alien for U.S. tax purposes.

1. Marital Trust ("A" Trust)

The marital trust (i.e. "A" Trust) is typically drafted as a QTIP or a Power of Appointment trust for a citizen spouse so that it will qualify for the unlimited marital deduction. IRC § 2056(b)(7) & IRC § 2056(b)(5). However, regarding a non-citizen spouse, such a trust will not qualify for the unlimited marital deduction unless it is also drafted to qualify as a QDOT. IRC § 2056(d).

2. Family Trust ("B" Trust)

The family trust (i.e. B trust, bypass trust, credit shelter trust, exemption trust – all being synonyms for the same type of trust) is by definition a non-deductible terminable interest. Therefore, it purposefully fails to qualify for the unlimited marital deduction forcing the use of any unused unified credit at the decedent's death. Since the B trust is purposefully included in the decedent's estate (i.e. it is purposefully a non-deductible terminable interest), QDOT provisions do not apply to the B trust.



3. Requirements of a QDOT

In order to qualify as a QDOT, the QDOT must meet four basic requirements, and a security requirement that depends on the fair market value of the QDOT assets at the decedent's date of death (or alternative valuation date).

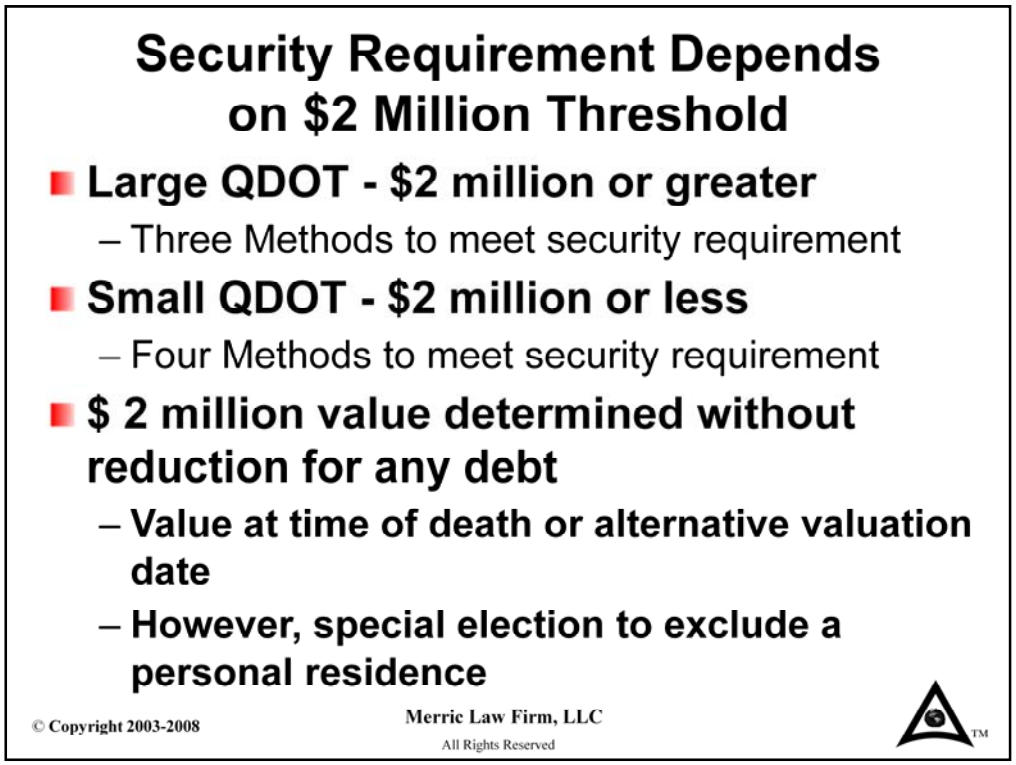
a. Four Basic Requirements

All QDOTs must have a trustee that is a U.S. citizen or a domestic corporation. IRC § 2056 A(a)(1)(a). As discussed later in this outline, depending on the FMV of the QDOT assets as discussed later, the trustee may be a bank trustee in order to meet the security requirement.

In addition to a U.S. trustee, the QDOT must provide that the trustee has the right to withhold the QDOT tax (IRC § 2056A(a)(1)(B)), and the descendant's executor must make the QDOT election (IRC § 2056A(a)(3); Treas Reg. § 20.2056A-3(a)). Finally, the situs and administration must be in the U.S. Treas. Reg. § 20.2056A-2(a).

b. Security Requirement

As stated later in this outline, depending on whether the fair market value of the QDOT assets determined as of the decedent's date of death (or alternate valuation date) are greater than $2 million, the QDOT must meet the security requirement by one of the few methods that are provided.



c. $2 Million Threshold

i. Large or Small QDOT

The security requirement that must be contained in a QDOT depends on whether the QDOT is qualified as a small or large QDOT. If the fair market value of the QDOT assets are greater than $2 million, the trust is classified as a large QDOT and one of three methods must be utilized to meet the security requirement. Treas. Reg. § 20.2056A-2(d)(1)(i)(B) & (C).

ii. Fair Market Value

(1) Date of Death

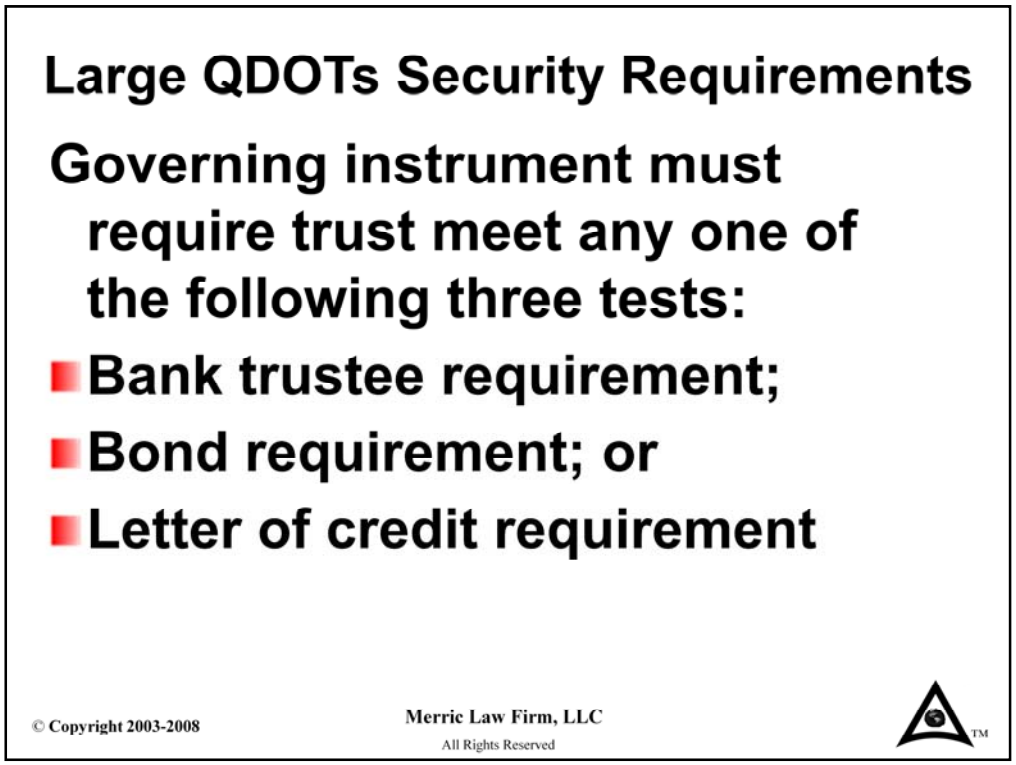
The fair market value (FMV) of the QDOT is determined at the decedent's date of death or the alternative valuation date.

(2) Debt Does Not Reduce Value

The FMV is <u>not</u> reduced by any debt that the property is subject to. Treas. Reg. § 20.2056A-2(d)(1)(i) and (ii). In other words, if a rental property is subject to a mortgage and is transferred to a QDOT, for the purpose of the $2 million test, the gross value of the rental property be included – <u>not</u> reduced for the mortgage.

(3) $600,000 Residence May Be Excluded For Computation

However, in computing the $2 million test, the descedent's estate may election to exclude up to $600,000 of the personal residence and furnishings. Treas. Reg. § 20.2056A-2(d)(iv)(A). Residence means the surviving spouse's principal residence plus one other residence. Treas. Reg. § 20.2056A-2(d)(1)(iv)(D).



iii. Large QDOT Security Requirmentes

A large QDOT will meet the security requirements if anyone of the following three tests are met:

(1) Bank Trustee Requirement

Under this requirement, at least one U.S. trustee must be a U.S. bank as defined under IRC § 581 or a U.S. branch of a foreign bank with a U.S. trustee. Treas. Reg. § 20.2056A-2(d)(1)(i)(A).

(2) Bond Requirement

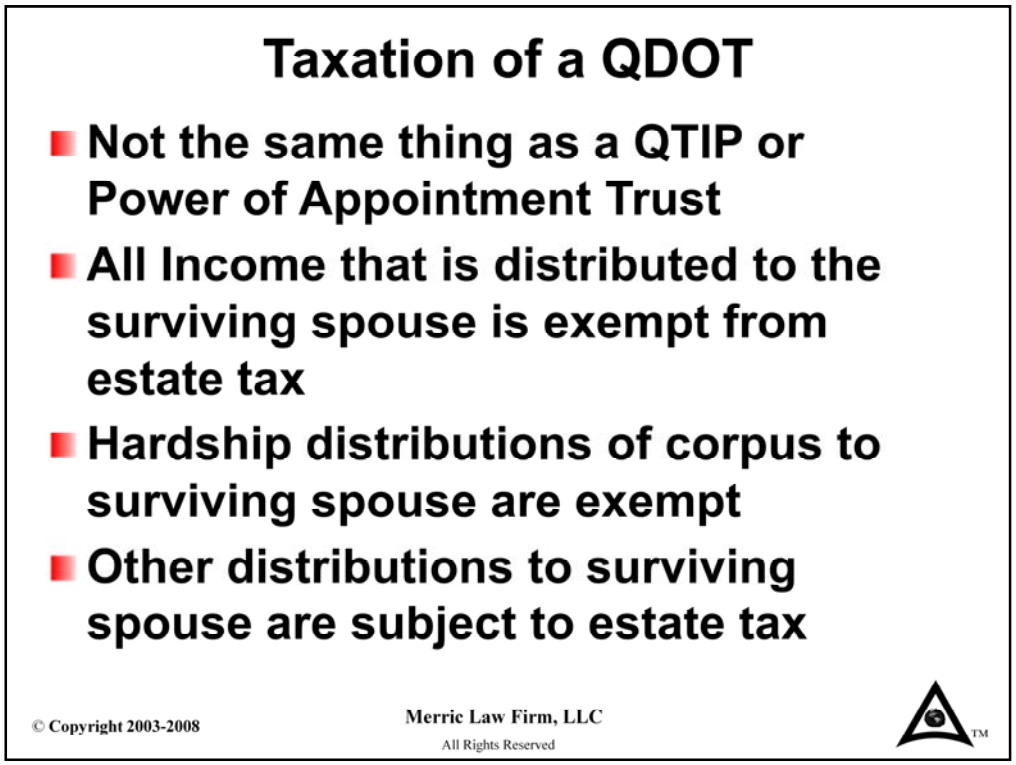
If the U.S. Trustee provides a bond in amount equal to 65% of the FMV of the trust assets (not reduced for any debt) to the Service, the bond requirement is met. Treas. Reg. § 20.2056A-2(d)(1)(i)(B). The FMV of the assets are determined on the decedent's date of death or alternate valuation date, and the fair market value of the trust assets are reduced by the amount subject to the personal residence exclusion discussed previously.

(3) Letter of Credit Requirement

Instead of meeting either the bank trustee requirement or the bond requirement, a large QDOT may meet the security requirement by providing an irrevocable letter of credit in an amount equal to 65% of the FMV of the trust assets (not reduced for any debt). The letter of credit must be issued by a bank defined in IRC § 581, the U.S. branch of a foreign bank, or a foreign bank approved by the Service. Treas. Reg. § 20.2056A-2(d)(1)(i)(C). Similar to the bond requirement, the FMV is determined on the date of the decedent's death or alternate valuation date, and the FMV of the trust assets are reduced by the amount subject to the personal residence exclusion.

Small QDOTs Security Requirements

- Any one of the three security requirements for a Large QDOT
- or the foreign real property requirement
  - No more than 35% of the trust assets are foreign real property
  - To avoid reporting requirements, most small QDOTs prevent the trust from owning any foreign real estate
    - This is the most common method utilized by a small QDOT



v. Taxation of a QDOT

(1)Not the Same Thing as a QTIP or POA Trust

Distributions of income or principal to a surviving spouse from a QTIP or a general power of appointment trust do not result in a current estate tax when received by the surviving spouse. Only the remaining value of a QTIP or POA trust is included in the surviving spouse's estate.

(2) Income Distributed is Exempt From Estate Tax

Similar to a QTIP or POA trust, any income distributed from a QDOT to a surviving spouse is exempt from estate tax. IRC § 2056A(b)(3)(A).

(3) Hardship Distribution of Principal Exempt From Estate Tax

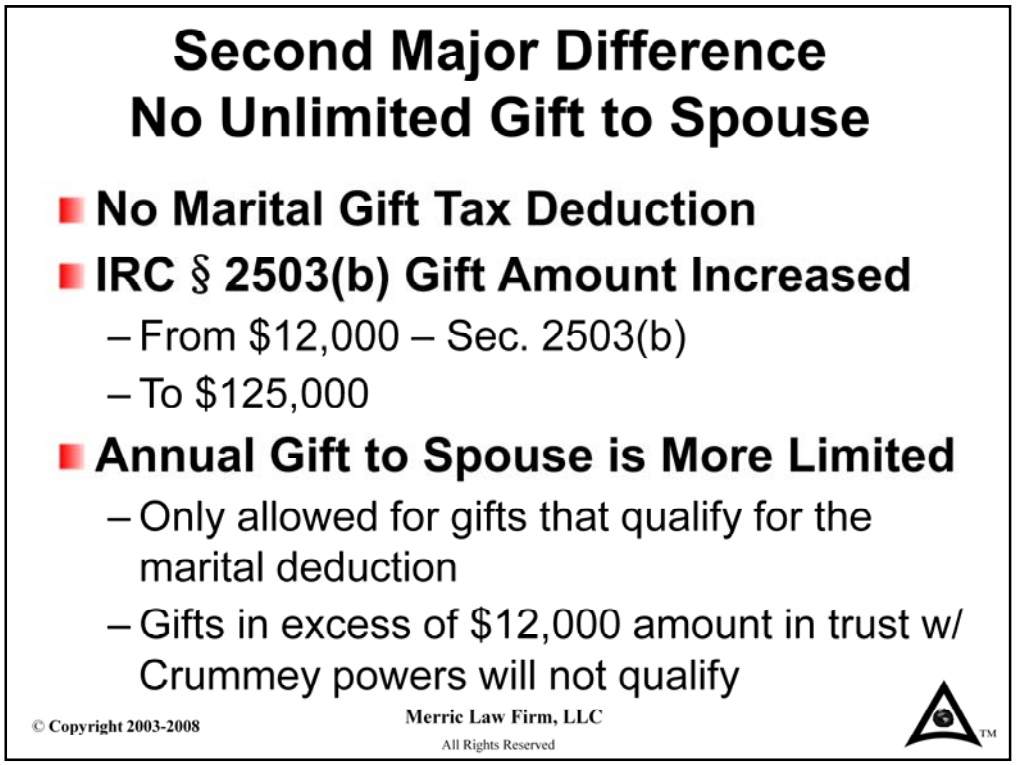
Hardship distributions of corpus to a surviving spouse are also exempt from estate tax. IRC § 2056A(b)(3)(B). The regulations follow the hardship definition in 401(k) plans where a distribution may be made in response to an immediate and substantial financial need relating to health, education, maintenance, and support. Treas. Reg. § 1.401(k)-1(d)(2)(i). Other assets need to be considered to the extent they are liquid assets. Likewise, non-liquid assets are generally excluded.

(4) Other Distributions to Surviving Spouse Subject to Estate Tax

All other distributions to a surviving spouse are subject to estate tax at the time of the distribution. The amount of the tax is computed as if each distribution was incrementally added to the decedent spouse's estate and an incremental estate tax was computed.

(5) Death of the Non-Citizen Spouse

Upon the death of the death of the Non-Citizen Spouse, the assets of the QDOT are included in the Non-Citizen Spouse's estate.



F. Second Major Difference – No Unlimited Marital Deduction

A citizen spouse receives an unlimited marital deduction. However, a non-citizen, (even if such spouse is a resident) does not receive an unlimited marital tax deduction. IRC § 2523(i)(1); Treas. Reg. § 25.2523(i)-1(a).

1. IRC § 2503(b) Annual Gift Increased to $125,000 (Indexed - 2006)

Instead of allowing an unlimited marital gift tax deduction for a non-citizen spouse, a non-citizen spouse may receive a $125,000 annual gift without the donor incurring any gift tax. IRC § 2523(i)(2).

2. Annual $125,000 Gift (Indexed 2006) to Spouse More Limited

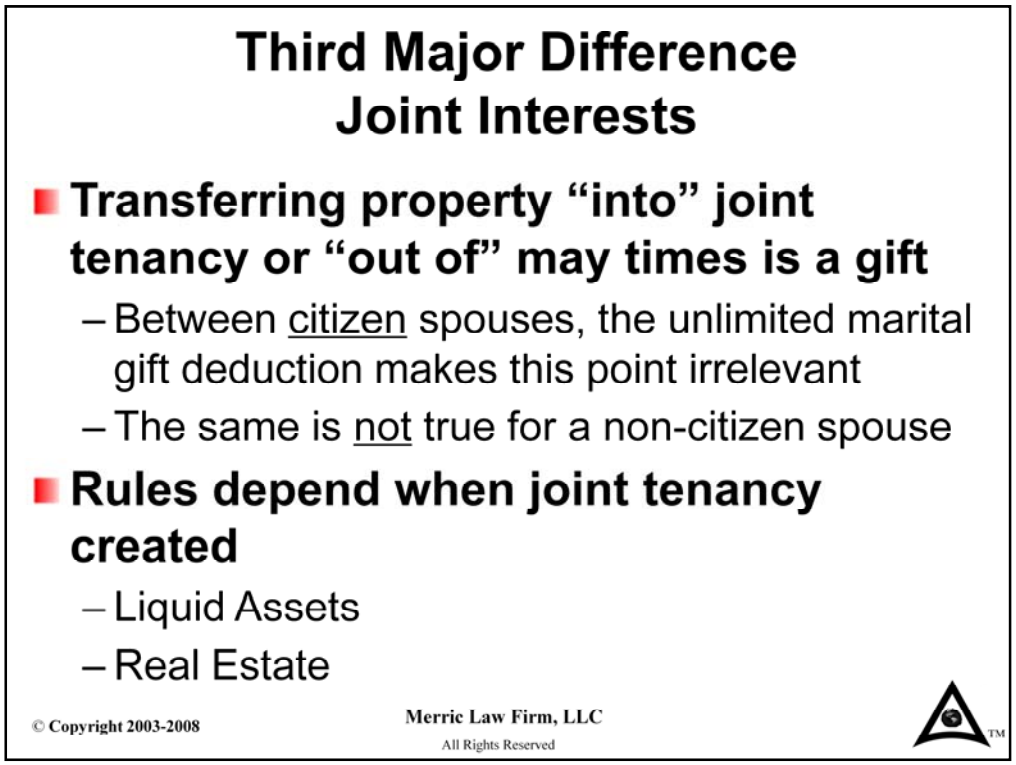
At first glance, the $125,000 annual exclusion (indexed) appears to be nice benefit that could be easily leveraged by using an irrevocable trust with withdrawal powers. Similar to an IDIT, with a beneficiary defective trust allows a non-citizen spouse might be able to transfer the non-citizen's spouse's assets to the trust through an installment sale. Unfortunately, this is not the case.

a. Must Qualify For the Marital Deduction

In addition to being a gift of a present interest, a gift to a surviving spouse must also qualify for the marital deduction. Treas. Reg. § 25.2523(1)-1(c). However, it is only the amount that is over the standard $12,000 annual 2503(b) exclusion (i.e. $125,000 - $12,0000 [indexed]= $113,000) that must qualify for the marital deduction. 136 Cong. Rec. H7147 (daily ed. Aug 3, 1990) (statement of Rep. Rostenkowski introducing H.R. 5454).

3. Gift to Irrevocable Trust Where Non-Citizen Spouse is a Beneficiary

As stated above, the $108,000 amount computed above must also qualify for the marital deduction – this amount may not be a terminable interest. A gift to an irrevocable trust where the non-citizen spouse's interest terminates on his or her death – is a terminable interest. Therefore, the use of a beneficiary defective trust is not possible with this part of an annual gift to a spouse.



G. Third Major Difference – Interests in Joint Property

The third major difference is the joint tenancy rules.

1. The Rule No One Usually Cares About

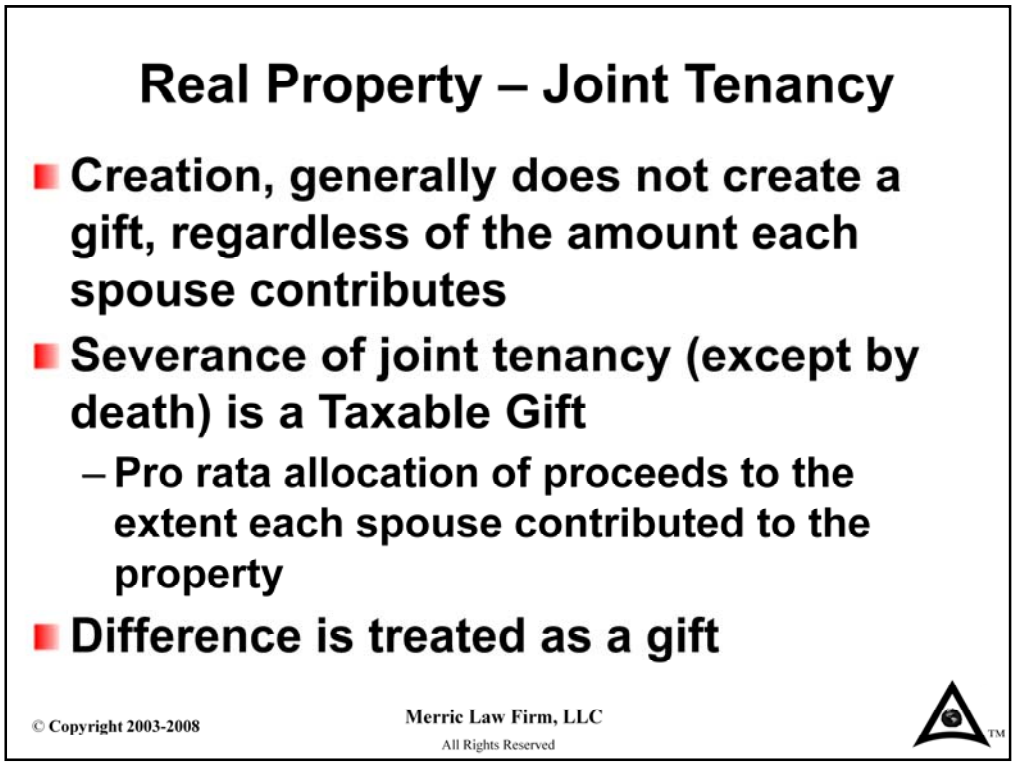
When U.S. citizens transfer property by placing them in joint tenancy or taking them out of joint tenancy, no current tax issue is present. Under IRC § 2523, the donor spouse does not incur a gift tax and the receiving spouse receives a carryover basis. Further, at time of death, a gift of any property held in joint tenancy with right of survivorship or tenancies by the entirety is included in the deceased spouse's estate, regardless of who furnished the consideration. IRC 2040(b). These special rules do not apply to a non-citizen spouse. IRC § 2523(i); IRC § 2040(b); IRC § 2056(d)(1)(B); Treas. Reg. § 20.2056A-8(a)(1) .

2. General Rule

The creation of a joint tenancy between spouses with a non-citizen spouse is governed by Old IRC § 2515 and 2515(A) - before such rules regarding joint tenancies between husband and wife were repealed for citizen spouses. IRC § 2523(i)(3).

3. Tax Result Depends on Type of Property

Whether the creation of a joint tenancy or the ending (by sale or change to ownership into only one spouse's name) results in a gift depends on whether the property is personal property or real property, and when such property acquired becomes as joint tenancy property.



a. Real Property – Joint Tenancy

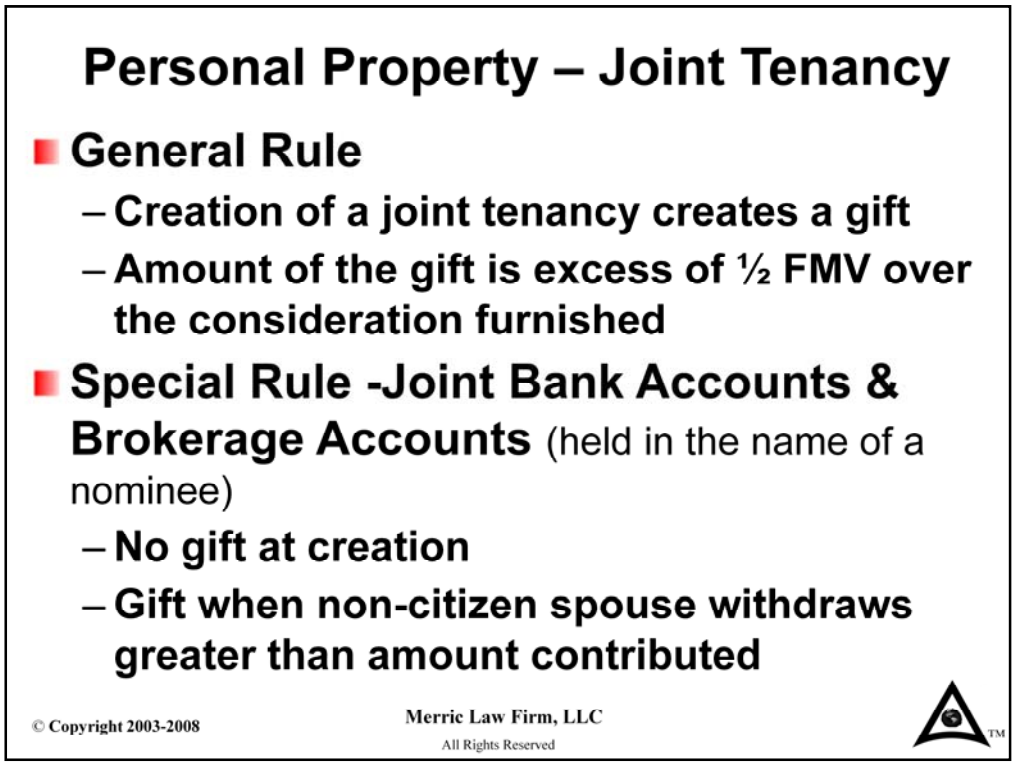
The rules regarding the creation of a joint tenancy in real property depend on whether the joint tenancy was created before January 1, 1982 or after July 13, 1988, and whether gift tax was incurred at the time of the creation. For purposes of this outline, it is assumed that the joint tenancy was created before January 1, 1982 or after July 13, 1988, and gift tax was not incurred at the creation of the joint tenancy.

i Creation of the Joint Tenancy

When a joint tenancy is created with a non-citizen spouse, no gain is recognized at the time of the creation, regardless of the amount each spouse contributed to the acquisition of the jointly held property. Old IRC § 2515(a). Please note that for joint tenancies created after July 13, 1988, an election may not be made under OLD IRC § 2515(c) to treat the transfer as a taxable gift. IRC § 2523(i)(3); Treas Reg. § 25.2523(i)-2(a).

ii Severance of the Joint Tenancy

The severance of a joint tenancy creates a taxable gift to the non-citizen spouse if he or she receives more than the pro rata portion of the consideration provided by such non-citizen spouse. Old IRC § 2515(b).



b. Personal Property – Joint Tenancy

i. General Rule

For creation of joint interests after December 31, 1953, if the amount contributed by the non-citizen spouse is less than one half of the FMV of the personal property placed in joint tenancy, there is a taxable gift at the creation of the joint tenancy. Old IRC § 2515A.

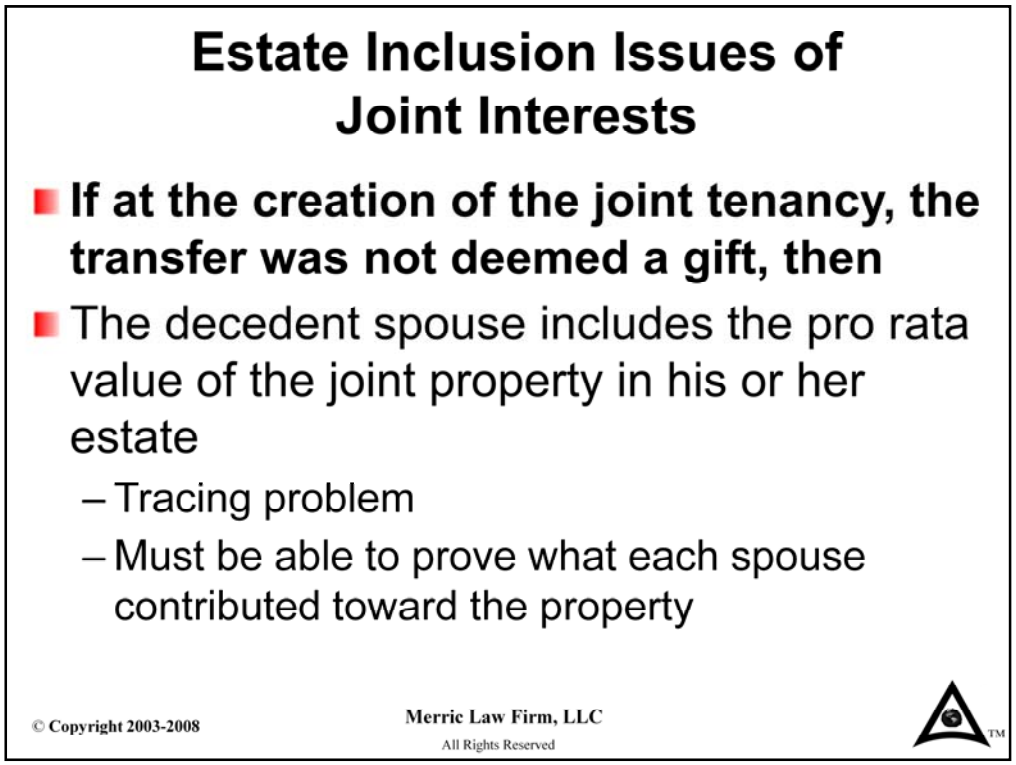
ii. Special Rule

(1) Brokerage Account in Name of Nominee

Conversely, there is a special rule for joint bank accounts and brokerage accounts (where securities are held in the name of a nominee). Under this rule, there is no gift at the creation of the joint tenancy. Treas. Reg. § 25.2511-1(h)(4). Nevertheless, if the non-citizen spouse withdraws greater than the amount he or she contributed there is a gift at that time. There is also a gift if the account is terminated and the non-citizen spouse receives an amount greater than what he or she contributed. Rev. Rul. 69-148.

(2) Certified Form

If securities are not held in a brokerage account in nominee form or if the securities are held in certified form, the special rule does not apply. There is a gift at the creation of the joint tenancy. Treas. Reg. § 25.2511-1(h)(5).



c. Estate Inclusion Issues of Joint Interests

Generally, when property is transferred into joint tenancy, the non-citizen spouse does not recognize a gift tax. This is because no gift tax is applicable, or the client does not know the aforementioned discussed rules. This being the case, there are estate tax issues on the death of either spouse.

i. Must Prove Who Provided the Consideration

The percentage of the joint property that is included in the decedent's estate (either the citizen or non-citizen spouse) is based on the amount of consideration that each spouse provided. IRC § 2040(b); IRC § 2523(i); IRC § 2040(b).

ii. Tracing Problem

Naturally this rule creates a tracing problem when the estate planner is attempting to determine who paid for what.