Transfers to a Noncitizen Spouse

Unique estate and gift tax rules must be considered when planning for transfers from a U.S. citizen or resident to a noncitizen spouse.

In general, no gift or estate tax is payable when amounts are transferred from one U.S. citizen spouse to another, either during the transferor's lifetime or at death. This is the so-called "unlimited marital deduction," which is very important in tax planning for married couples whose estates exceed the "exemption amount" (in 2016—$5,450,000). Both outright transfers to a citizen spouse and transfers to certain qualifying trusts for the benefit of the citizen spouse qualify for the unlimited marital deduction. The assumption underlying the marital deduction is that the property will be subject to estate tax when the surviving spouse dies.

However, the rule for transfers to noncitizen spouses are different. Transfers to noncitizen spouses currently must be limited to $148,000 (for 2016) annually during lifetime. At death, transfers must be placed in a qualifying trust to avoid adverse tax consequences.

QDOT Requirement For Transfer At Death

The estate tax laws are designed to capture estate tax revenue that would otherwise be lost when a noncitizen surviving spouse could avoid the estate tax at his or her death by moving out of the United States. The estate tax laws currently provide that a marital deduction will be permitted only for assets placed in a so-called "qualified domestic trust" (commonly known as a QDOT) when the surviving spouse is a noncitizen. All other assets would be taxable in the predeceasing spouse's estate.

The statutory provisions are complicated, and some important exceptions and qualifications exist. In general, however, the following rules apply to QDOTs:

1. The personal representative of the deceased spouse must affirmatively elect QDOT.

2. The QDOT must be in the form of a marital deduction trust and at least one trustee of the QDOT must be either an individual U.S. citizen having a U.S. tax home or a U.S. corporation. The QDOT must be governed by the law of a state of the United States.

3. The QDOT must provide specifically that no distributions (other than trust income) can be made from the trust unless the U.S. trustee has the right to withhold the QDOT tax that would be imposed on the distribution.

4. In general, any distribution of principal from a QDOT made before the death of the surviving spouse and any property remaining in a QDOT at the death of the surviving spouse is subject to a QDOT tax equal to the top estate tax rate applicable to the estate of the deceased spouse who created the trust. Distributions of income and certain

hardship distributions of principal are not subject to the QDOT tax. The definition of hardship includes distributions to the surviving spouse in response to an immediate and substantial financial need relating to the spouse's health, maintenance, education or support, or that of any person the spouse is legally obligated to support.

Sometimes property does not pass directly from a deceased spouse to a QDOT, but rather passes to a noncitizen surviving spouse in a form that would meet the requirements for a marital deduction for a citizen spouse. A marital deduction may nevertheless be available if the surviving spouse transfers or irrevocably assigns the property to a qualifying QDOT before the filing of the estate tax return and before the deadline for making a QDOT election.

Certain assets that cannot or should not be transferred to a trust (such as some annuities, retirement plan assets, and IRAs) may still qualify for the marital deduction if certain requirements are met. A surviving spouse has the option of either assigning an individual retirement account or other retirement plan to a QDOT or using special procedures under the regulations to avoid a particularly heavy tax burden. If a deceased spouse's individual retirement account or other retirement plan is not assignable, certain requirements of the regulations must be met to qualify for the marital deduction. If the surviving spouse is eligible for a hardship exemption for all or part of the corpus portion of a non-assignable annuity payment received from a QDOT, then all or a corresponding part of the payment similarly will be exempt from the rollover or the tax payment requirements.

Additional Planning Differences

In addition to requiring a QDOT to preserve the estate tax marital deduction, there are at least two other respects in which transfers to a noncitizen spouse are treated differently than transfers to a citizen spouse for estate and gift tax purposes.

First, only one-half of the value of spousal joint tenancy property (if the tenancy was created after 1977) is included in the estate of the first spouse to die when the surviving spouse is a citizen. If the surviving spouse is a noncitizen, or if the tenancy was created before 1977, that rule does not apply. Instead, the entire value of the joint tenancy spousal property is included in the estate of the first spouse to die, except to the extent that the surviving spouse can show that he or she provided the consideration for his or her interest in the property. Second, unlike with lifetime gifts to a citizen spouse, there is no unlimited marital deduction for gift tax purposes for lifetime gifts to a noncitizen spouse. However, there is a $148,000 (in 2016), and in the future periodically by a cost of living adjustment) annual exclusion for gifts to a noncitizen spouse that is available without having to use a QDOT. Therefore, persons who are a U.S. resident or citizen should be careful not to transfer more than $148,000 (for 2016) to a noncitizen spouse without consulting with an attorney or accountant about the tax consequences of doing so.

Conclusion

If a couple's combined estates exceed their combined exemption amounts, it may be advisable to leave all real and personal property to a QDOT rather than outright to a noncitizen spouse. Similar considerations apply to nonprobate assets, such as life insurance, jointly owned property with right of survivorship, and

joint bank accounts. A QDOT may not be necessary for a couple whose combined estates total less than their exemption amounts (although some tax planning may still be necessary). However, if a couple's estate is likely to increase, incorporating a QDOT into the estate plan should be considered as well as using the annual exclusion for lifetime gifts to a noncitizen spouse.