Tax Briefs

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Estate and Gift Tax Planning with a Non-Citizen Spouse

As if estate and gift tax planning for U.S. citizens wasn't already complicated enough, here comes the Internal Revenue Code once again to make an already difficult situation even worse. In the June 16, 2003 edition of *Tax Briefs*, we addressed estate-planning considerations for *nonresident alien individuals*. In this article we focus on estate and gift tax planning for *U.S. citizens* that have non-citizen spouses.

In general, an individual may make unlimited lifetime or post-death transfers of property to a spouse free of estate and gift taxes- *unless the recipient spouse is a non-citizen.* For example, H and W are a married couple. H is a U.S. citizen. H provides in his will that all property he owns at his death is left to W. If W is a U.S. citizen H's estate is not liable for *any* estate taxes. However, if W is a non-citizen, to the extent the value of H's estate exceeds the estate tax exemption amount, H's estate is liable for estate taxes imposed on the value of property passing to W.

Let's look at another example. H and W are a married couple and jointly hold title to their primary residence. In an effort to protect his assets from creditors, H decides to title the home solely in W's name. If both H and W are U.S. citizens no adverse tax consequences result. However, if one spouse is a non-citizen a taxable gift may very well occur simply by altering title to the home.

Prior to 1988, the above described transfers ordinarily escaped taxation because U.S. citizens and resident aliens were allowed to transfer unlimited amounts of property to their spouses free of any U.S. estate and gift tax. This was, and still is, known as the unlimited marital deduction (because the amount transferred to the spouse was deducted from the gross taxable gift or estate). In 1988, Congress

determined that the unlimited marital deduction could be abused where one spouse is a non-citizen. Assets could be transferred to the non-citizen spouse who would return to her home country, relinquish U.S. residency and escape U.S. taxation on all property other than those assets situated in the U.S. In order to remedy this perceived abuse, Congress enacted a series of laws that place substantial burdens and restrictions on transfers to non-citizen spouses. Understanding these laws and planning accordingly will insure that you maximize the amount of wealth you transfer to your non-citizen spouse and family, while minimizing or eliminating Uncle Sam's share.

In General

Congress has altered the rules applicable to non-citizen spouses in the following ways (all discussed in more detail below):

- The unlimited *estate tax* marital deduction for transfers to non-citizen surviving spouses is disallowed, unless such property is placed in a qualified domestic trust (QDOT);
- The unlimited *gift tax* marital deduction for transfers to non-citizen spouses is disallowed, but the annual exclusion from the federal gift tax is increased;
- The full value of jointly held property is includible in the estate of the U.S. citizen spouse; and
- In certain situations taxing the creation or termination of a joint tenancy where one spouse is a non-citizen.

Estate Tax Marital Deduction

The federal estate tax is imposed on the value of all property owned by an individual at the time of death. Items ordinarily included in the taxable estate include bank accounts, investments, personal property, residences, and even life insurance proceeds payable to the surviving spouse. Ordinarily, when calculating the amount of the taxable estate, a deduction is allowed for the value of all property passing to a surviving spouse (the marital deduction) thereby insuring that such property is not taxed. However, if the surviving spouse is a non-citizen, no marital deduction is allowed unless the property passes to the spouse through a QDOT and the personal representative of the deceased spouse's estate makes a timely QDOT tax election.

Here's how it works: H dies, leaving a non-citizen spouse, W, and two children with the following assets:

Bank Account	$ 10,000
Investments and retirement	250,000
Residence (net of mortgage)	350,000
Life Insurance Proceeds	700,000
Total Assets	$1,310,000

H's will provides that all property passes to W. Ordinarily, H's estate would owe no estate taxes since all property passes to his spouse. However, since W is a non-citizen no marital deduction is allowed. H may still use his unified credit equivalent to exempt $1 million from estate taxation, but the remaining $310,000 results in a tax liability of $91,200 in 2003. However, if H's will had provided that all property passes to a QDOT for the benefit of his wife and children, estate taxes would have been avoided.

A QDOT actually serves to defer payment of any estate tax liability on the deceased spouse's estate so it is not a perfect answer to the lost unlimited marital deduction. QDOT taxes are due only upon the occurrence of certain events such as the death of the surviving non-citizen spouse, distributions of trust principal to the spouse, or the termination of a trust as a QDOT. The QDOT tax is determined using the

same estate tax rates otherwise imposed against the estate of the decedent spouse. The amounts subject to tax are equal to the amount of distributed money or value of distributed property. Distributions of QDOT income, as opposed to distributions of trust principal, are not subject to QDOT tax.

The spousal and familial support provisions of QDOTs are usually very similar to ordinary marital trusts. All income must be paid to the surviving spouse no less frequently than quarterly (limited exceptions to this rule exist). Generally, the trustee of the QDOT is allowed to make additional discretionary distributions to the surviving spouse, provided such distributions meet certain ascertainable standards (e.g., surviving spouse and children's health, education maintenance and support). Often, the trustee is granted the right to terminate the trust if doing so will not result in an additional estate tax liability. This right may be useful where the surviving spouse later becomes a U.S. citizen. Upon the surviving spouse's death, trust principal may be distributed outright to surviving family members, friends, charities, etc., or may remain in trust for the benefit of such persons.

QDOTs are subject to numerous statutory requirements, which are most easily met with a properly drafted last will and testament, revocable trust or similar estate planning document. Occasionally, if an outright property transfer to the non-citizen surviving spouse has been made, the marital deduction is available if the surviving spouse subsequently transfers the property to a similar QDOT prior to the date on which the estate tax return must be filed.[1] Because of the complexities involved, a QDOT should only be drafted by a qualified estate planning attorney.

At least one trustee of a QDOT must be a U.S. citizen or domestic corporation. If an individual, the trustee must have a regular place of business or abode in the U.S. The QDOT document must also provide that the U.S. trustee has the right to withhold any QDOT tax on any distributions of trust principal. Trust records must be kept in any state or the District of Columbia. As a practical matter, records are usually maintained at the location of the trustee.

QDOTs are divided into two classes: those with assets in excess of $2 million (Large QDOTs), and those with assets of $2 million or less (Small QDOTs). Large QDOTs must have a trustee that is a U.S. bank, furnish a bond in favor of the IRS equal to 65-percent of the value of the trust assets, or furnish an irrevocable letter of credit equal to 65-percent of the value of trust assets. Small QDOTs need to comply with these provisions only if the amount of real property located outside the U.S. accounts for more than 35-percent of all trusts assets.

Gift Tax Marital Deduction

There is no federal gift tax marital deduction for lifetime transfers to a non-citizen spouse. Instead, an individual may transfer up to $100,000 annually to a non-citizen spouse without gift taxes being imposed, provided the gift would otherwise qualify for the marital deduction (for example, a gift of a future interest in property would not qualify).

As an example, assume on January 1, 2004 H transfers title to his family residence worth $250,000 to his wife, W, a non-citizen of the U.S. Also assume on January 1, 2005 W becomes a U.S. citizen. The transfer to W in 2004 is a taxable gift. No marital deduction is available, but H can exclude $100,000 of the value of the residence from the taxable amount, but the remaining $150,000 is a taxable gift. The fact that W becomes a U.S. citizen in 2005 makes no difference because she was a non-citizen at the time of transfer.

[1] A rarely used exception to these rules allows certain transfers of nonassignable annuities or other arrangements to qualify for the marital deduction, provided other requirements are met.

Effect of Joint Tenancies

Generally, the Internal Revenue Code provides that upon the death of a spouse, one-half of the value of property held jointly with the surviving spouse is included in the deceased spouse's taxable estate. For example, H and W hold joint title to their primary residence. H dies when the home is valued at $200,000. Only $100,000 is included in H's taxable estate.

However, where the surviving spouse is a non-citizen, this rule is completely eliminated. In the above example, if W is a non-citizen spouse, H's estate may be subject to estate taxes on the full $200,000 value of the residence. Upon W's death, she could claim a credit for estate taxes previously paid, but only if her estate is subject to U.S. estate taxes.

Generally, the creation of a joint tenancy in real property (real estate) between a husband and wife has no tax consequences, regardless of which spouse actually furnishes consideration for the purchase price of the joint property. However, upon the termination of a joint tenancy in real property, other than by reason of death, a spouse may be considered to have made a gift to the other spouse. The amount of the gift to the donee spouse is dependent upon the value of the interest in property received, multiplied by the percentage of consideration the donee spouse provided towards the original purchase of the property. For instance, H, a U.S. citizen, and W, a non-citizen, purchased a residence. H provided all of the consideration paid for the purchase of the home, which was titled jointly in both spouses' names. For liability protection purposes, the home is later transferred into the sole name of W. A taxable gift occurs. Since W is a non-citizen the unlimited marital deduction is not available, and to the extent the amount of the gift exceeds $100,000, federal gift tax is due.

The creation of a joint tenancy in personal property is ordinarily treated as a gift. However, special rules exist for certain types of personal property. For example, the creation of a joint bank account does not result in a taxable gift. The taxation of terminations of joint tenancies in personal property is less clear. It appears that an equal separation of personal property or proceeds from the disposition of such property does not result in a taxable gift, regardless of which spouse furnished consideration for the original purchase of the property.

Summary

Many estate and financial planning professionals often overlook special considerations that should be made where one spouse is a U.S. citizen and the other is not. Care needs to be taken, not only in planning for a spouse's well-being following the death of the first spouse, but also in structuring acquisitions of wealth, disposition of property, or asset protection matters. You should always consult with a professional with experience in international tax and estate planning matters to insure that you avoid unnecessary taxes, and that your spouse and family are adequately provided for in the event of your untimely death.

Ways and Means Sends Charitable Giving Bill to the House Floor

On September 9, the House Ways and Means Committee approved a tax package consisting of $12.6 billion of targeted tax cuts primarily designed to encourage charitable giving. The Charitable Giving Act, among other things would:

- Allow taxpayers that do not itemize to deduct cash contributions in excess of $250 ($500 for joint filers) in 2005 and 2006;
- Gradually raise the cap on corporate charitable contributions from 10-percent to 20-percent in 2012;
- Replace the 2-percent excise tax on private foundation net investment income to 1-percent;

- Modify the tax on unrelated business income of charitable remainder trusts;
- Adjust the basis of S corporation stock for certain contributions;
- Suspend tax-exempt status of organizations that support terrorism, and
- Allow taxpayers age 70 1/2 and over to distribute tax-free IRA donations to charitable organizations.

The full House is expected to take up the bill this week. A similar bill has already passed the Senate. The Senate version offsets tax cuts with tougher penalties on tax shelter transactions, and codifies the economic substance doctrine.

UK's Inland Revenue Provides Guidance on Foreign Aspects of Inheritance Tax

On September 8, Inland Revenue issued a new booklet concerning the UK inheritance tax which applies to both lifetime transfers and transfers taking effect on account of death. The booklet is designed to help (i) those individuals domiciled in the UK who own foreign assets, and (ii) those individuals not domiciled in the UK, but who own UK assets.

Among other topics, the booklet addresses the concept of domicile. Domicile may be used to determine the extent to which the inheritance tax applies to an individual. In general, UK law is similar to US law in that an individual's domicile is the location where he or she maintains a permanent home. Domicile is not the same as citizenship, nationality or residence. Under UK an individual may also have a "deemed domicile." A person is deemed to have a UK domicile if she was domiciled in the UK within three years of a transfer of wealth, or was a resident in the UK in 17 of the 20 income tax years ending with the year of transfer.

Individuals domiciled in the UK are subject to the inheritance tax on their worldwide assets. Other individuals are only subject to inheritance tax on assets situated in the UK. For these purposes, real estate and personal property are situated where physically located; registered stock is situated where the stock is registered; bearer securities are situated where the certificate of title is located; partnership interests are situated in the country under whose laws the partnership was formed; bank accounts are situated at the bank where the account is maintained, and debts are situated where the debtor resides.

The following countries currently maintain inheritance tax treaties with the UK:

Republic of Ireland	South Africa	United States of America
The Netherlands	Sweden	Switzerland

Treaties entered into prior to the enactment of the UK's current inheritance tax regime, but still in force, include France, Italy, India, and Pakistan.

Please contact Levin & Weiser if you would like a copy of the booklet, or visit www.inlandrevenue.gov.uk.

European Commission Proposes Changes to the Existing Parent-Subsidiary Directive

On September 8, the European Commission proposed changes to the parent-subsidiary directive that broadens its scope to cover a larger range of companies and make more companies eligible for the tax benefits associated with the directive.

The parent-subsidiary directive is designed to eliminate the double taxation of profits distributed in the form of dividends by a subsidiary located in one member state of the European Union (EU) to its

parent company located in another member state. The member state of the subsidiary is required to abolish any withholding tax, while the member state of the parent company is required to either exempt the dividends from taxation, or impute the tax already paid to the subsidiary's member state, against the parent's tax.

The proposed changes would update the list of companies eligible to take advantage of the directive. The updated list would include a new entity known as the "European Company" which can be created beginning in 2004, to allow companies operating in more than one member state the ability to organize as a single entity under EU law. A second proposal would reduce from 25-percent to 10-percent, the minimum shareholding a parent must have in its subsidiary in order to take advantage of the exemption from withholding taxes. Finally, the requirement that exempts dividends from the parent's member state taxable income would be expanded to include remote subsidiaries (e.g., second tier subsidiaries and beyond).

In Summary . . .

The IRS issued temporary and final regulations concerning "bonus" depreciation. IRC § 168(k)(1) allows a 30-percent additional first year depreciation deduction for property acquired after September 10, 2001, and IRC § 168(k)(4) allows a 50-percent additional first year depreciation deduction for property acquired after May 5, 2003. To qualify for bonus depreciation (i) depreciable property must be of a specified type, (ii) the original use must commence after the above dates, (iii) the property must be acquired within a specified time period, and (iv) the property must be placed in service by a specified date. Please contact Levin & Weiser for the full text of the regulations. Also see the May 23, 2003 edition of *Tax Briefs*. . . . **Gain or loss need not be recognized on stock received as a distribution from a profit sharing plan if the stock is contributed to a charitable remainder unitrust**. In Private Letter Ruling 200335017 the IRS also ruled that the charitable contribution deduction was limited to 30-percent of adjusted gross income. . . . **The Tax Court held a 15-percent minority discount and 24-percent marketability discount, were appropriate with respect to a family limited partnership.** In Lappo v. Comm'r, T.C. Memo 2003-258, the main issue before the Tax Court involved whether the valuation method used by the taxpayer's appraiser or IRS appraiser was most appropriate. The fact that such significant discounts were determined to be appropriate and that the family limited partnership was respected should be viewed as a victory for taxpayers. The assets of the family limited partnership consisted of securities and real property. . . . **The IRS issued proposed regulations concerning partnership withholding taxes on effectively connected income allocable to foreign partners**. The regulations concern how to determine the status of a partner, calculate effectively connected income allocable to each partner, and make installment payments of the withholding tax. Special rules exist for publicly traded partnerships and tiered partnerships. Please contact Levin & Weiser for the full text of the regulations. . . . **Correction:** In the September 1, 2003 edition of *Tax Briefs* we reported that the 9th Circuit Court of Appeals ruled attorney's fees awarded in connection with an injury award were includible in income. In fact, the 9th Circuit reversed the holding of the Tax Court and ruled that the unique features of Oregon law resulted in the exclusion of the award of attorney's fees from income. We regret the error.

Q&A

Q: I am a Canadian citizen. I was working in the U.S. and got laid off. I am planning on going back to Canada. Would I be able to get back the money I paid for social security or at least part of it?

A: Unfortunately, refunds of social security taxes are not available even if you never intend to receive any benefits from the U.S. system of social security. For more detailed information, please see the July 15 edition of *Tax Briefs*.

If you have any questions on any tax matter feel free to write us at info@lw-law.com. We can't answer every question we receive, but if you ask a short question that can be answered concisely, we'll consider it for publication. Remember, questions answered are only intended to provide general information. Consult with your attorney before acting on information you see here.

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