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Qualified Domestic Trusts

Hello!

This month's newsletter highlights Qualified Domestic Trusts (QDOTs), a type of irrevocable trust specifically utilized in situations where one spouse is a non-U.S. citizen. Currently, under U.S. law, spouses can transfer (gift) an unlimited amount of assets to each other while living. When one spouse passes away, his or her assets can pass automatically to the surviving spouse without a gift tax or estate tax liability and this is known as an unlimited marital deduction. However, this is not the case in which one spouse is a non-U.S. citizen as they are subject to these limitations:

- For gifts made to the non-U.S. citizen spouse, the annual limit is $139,000 for 2012.
- There is no unlimited marital deduction (in effect since 1988).
- At the death of the spouse who is a U.S. citizen, the estate may be subject to an estate tax liability.
- For assets jointly owned, they are not automatically considered one-half owned by the surviving spouse and are instead based on consideration.

By setting up a QDOT, it provides for the non-citizen spouse to benefit from the marital deduction and allows for him or her to be entitled to all income from the assets held in the trust. It also results in the postponement of federal estate taxes applicable on the property of the deceased when the surviving non-citizen spouse passes away.

How QDOTs work

When the first spouse (U.S. citizen) passes away, the assets are transferred to a QDOT. The Trust owns the assets and the surviving spouse receives income from the QDOT and at the trustee's discretion under certain circumstances, is also entitled to receive the principal of the Trust.

Requirements

- An irrevocable election must be made on the decedent's federal tax return by the executor.
- At least one of the trustees must be a U.S. citizen or a U.S. financial institution.
- For an estate with over $2 million in assets, the trustee must be a U.S. bank so that the IRS has a guarantee that any taxes will eventually be paid. An exception is in the event the U.S. trustee secures a bond in an amount equal to 65% of the fair market value (FMV) of the QDOT's assets, or the U.S. trustee provides an irrevocable letter of credit (ILOC) issued by a bank in an amount equal to 65% of the FMV of the Trust's assets.

Distributions

- This Trust allows for the surviving spouse to receive the income over his or her lifetime, and under certain circumstances, to receive principal.

- Any principal amounts the surviving spouse receives from the QDOT (unless the distribution is coded as a "hardship" withdrawal as defined by the IRS) is subject to estate taxes immediately.
- Income earned and/or distributed to the surviving spouse is subject to income taxes but not estate taxes.

Death of Second Spouse

After the death of the surviving spouse, the assets held in the Trust are subject to estate tax as if they were included in the estate of the first spouse who died.

Summary

As an estate planning strategy, a QDOT is the only type of trust that qualifies for the marital deduction for a decedent whose surviving spouse is a non-U.S. citizen. Given this, it can provide for significant asset protection to the non-US citizen surviving spouse, since without it, the estate could potentially be subject to estate taxes.

Without a QDOT, estate taxes would have to be paid when the first spouse passes away. By setting up this type of trust, any estate tax liability is postponed until the surviving spouse dies, resulting in more assets available for use by him or her. In the event that the surviving spouse does eventually become a U.S. citizen, assets in a QDOT will not be subject to estate taxes.

It is highly recommend that an estate planning attorney be consulted to learn more about if a QDOT would be appropriate in your situation.