

Presenting a live 90-minute webinar with interactive Q&A

Structuring QDOTs for Non-Citizen and Nonresident Spouses: Deferring Tax Through Qualified Domestic Trusts

Overcoming Unfavorable Exemption Rules for Non-U.S. Spouses, Utilizing Portability, and Maximizing Asset Transfers

TUESDAY, MAY 9, 2017

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

Today's faculty features:

Nancy O. Kuhn, Director, **Jackson & Campbell**, Washington, D.C.

John C. Martin, Founding Partner, **The Law Offices Of John C. Martin**, Menlo Park, Calif.

Jonathan A. Mintz, Partner, **Evergreen Legacy Planning**, Newport Beach, Calif. and Evergreen, Colo.

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What We'll Cover

- Transfer Tax Exemptions for Non-U.S. Persons
- Terms of QDOTs
- Withholding and Trustee Provisions
- Benefits and Risks of QDOTs
- Structuring Examples



TRANSFER TAX EXEMPTIONS FOR NON-U.S. PERSONS

Presented By:

Jonathan A. Mintz, JD, TEP

Evergreen Legacy Planning, LLP



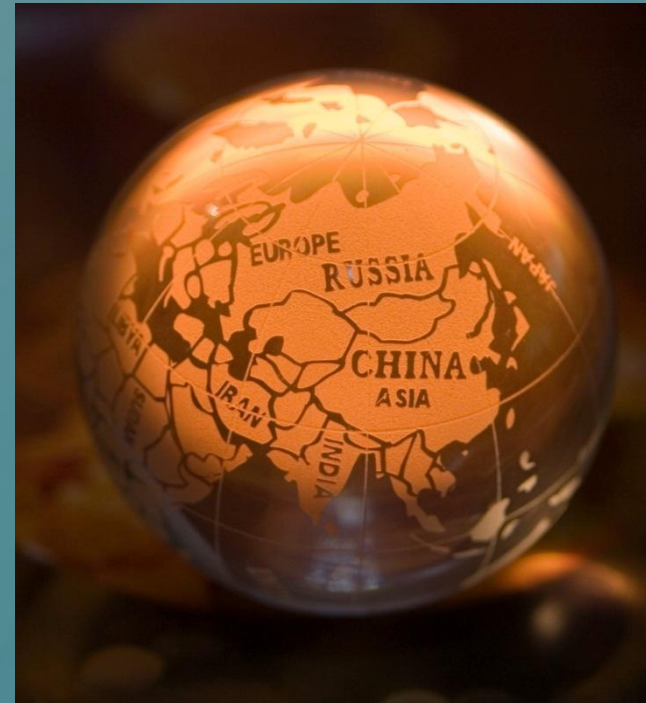
WHY IS THIS SO IMPORTANT *Now*?

- U.S. = the new Switzerland?
 - U.S. as the last secrecy haven?
 - Comparison to other jurisdictions
- Desire of non-resident aliens (NRAs) to invest in or move to the U.S.
 - Relatively stable economy
 - Relatively stable political system
 - Relatively inexpensive real estate
- Resulting in more NRAs investing in and immigrating to the U.S.



KEY CONCEPTS - GIFT & ESTATE TAX GENERALLY

- U.S. citizens and non-citizen “residents” are subject to gift, estate and generation-skipping transfer taxation on their *worldwide assets*.
- Non-citizen, non-“residents” are subject to estate, gift and generation-skipping transfer tax *only on U.S. situs assets*.
 - “Situs” is a technical term meaning the location of the assets for legal purposes.
- Non-citizen “residents” have the \$5 mil exemption, but no unlimited marital deduction
(We’ ll come back to this)



NOTE: Gift and/or estate tax treaty with native country may modify these general rules.

KEY CONCEPTS – “RESIDENCY”

- Residency for gift and estate tax purposes determined by one’s “domicile”:
 - Residence with an intent to live there indefinitely.
 - This is *different* from the residency test for income tax purposes
- Domicile is a subjective test determined by objective facts and circumstances:
 - Duration of stay in the U.S. and other countries and frequency of travel between countries
 - Size, cost, and nature of homes (vacation home, owned, rented, etc.)
 - Location of business and social contacts



KEY CONCEPTS – “RESIDENCY” FOR TRANSFER TAX PURPOSES

- Membership in religious and other organizations
- Location of expensive/cherished personal possessions
- Registration to vote
- Place of driver’s license and vehicle registration
- Location of bank and investment accounts
- Reasons for residency (temporary employment, etc.)
- Declarations of residency or intent made in visa applications, estate planning documents, letters, and oral statements



KEY CONCEPTS - MARITAL DEDUCTION?

- Unlimited lifetime and testamentary transfers to a *U.S. citizen* spouse
- NRAs do not have an unlimited marital deduction or lifetime exemption - a 40% tax applies to transfers above the following thresholds:
 - For transfers to spouses, \$149,000 annually and \$60,000 at death.
 - For transfers to non-spouses, \$14,000 annually and \$60,000 at death.
 - Unlimited exemption for *direct* transfers to educational and medical providers.
- QDOT is the only way to get a marital deduction w/ transfers to a *non-citizen* surviving spouse
 - Let's further explore why QDOTs are so critical

KEY CONCEPTS – GIFT TAX

- NRAs are subject to gift tax only on gifts of *U.S. situs real property and tangible personal property*.
 - Tangible personal property = jewelry, antiques, artworks, cars, etc.
 - The annual exclusion of \$14,000 for gifts may apply.
- Intangible personal property is *not subject to U.S. gift tax*
 - Shares of stock of U.S. corporations
 - (Not clear for partnership and LLC interests)
 - Debts of U.S. or any state (e.g. T-Bills)
- Gifts of cash (likely including checks) that take place within the United States may be subject to gift tax
 - Therefore, any *gifts of cash by a non-U.S. person to a U.S. person should be made outside the United States.*



KEY CONCEPTS - GIFT TAX

- Note: Annual cumulative gifts from one or more NRAs greater than \$100,000 must be reported on Form 3520, but no gift tax due.

Form 3520 Department of the Treasury Internal Revenue Service	Annual Return To Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts ▶ Information about Form 3520 and its separate instructions is at www.irs.gov/form3520 .	OMB No. 1545-0159 2016
Note: All information must be in English. Show all amounts in U.S. dollars. File a separate Form 3520 for each foreign trust.		
For calendar year 2016, or tax year beginning _____, 2016, ending _____, 20		
A Check appropriate boxes: <input type="checkbox"/> Initial return <input type="checkbox"/> Initial return (extension filed) <input type="checkbox"/> Final return <input type="checkbox"/> Amended return		
B Check box that applies to person filing return: <input type="checkbox"/> Individual <input type="checkbox"/> Partnership <input type="checkbox"/> Corporation <input type="checkbox"/> Trust <input type="checkbox"/> Executor		
C Check if any excepted specified foreign financial assets are reported on this form (see instructions) <input type="checkbox"/>		
Check all applicable boxes.		
<input type="checkbox"/> (a) You are a U.S. transferor who, directly or indirectly, transferred money or other property during the current tax year to a foreign trust, (b) You held an outstanding obligation of a related foreign trust (or a person related to the trust) issued during the current tax year, that you reported as a "qualified obligation" (defined in the instructions) during the current tax year, or (c) You are the executor of the estate of a U.S. decedent and (1) the decedent made a transfer to a foreign trust by reason of death, (2) the decedent was treated as the owner of any portion of a foreign trust immediately prior to death, or (3) the decedent's estate included any portion of the assets of a foreign trust. Complete all applicable identifying information requested below and Part I of the form and see the instructions for Part I.		
<input type="checkbox"/> You are a U.S. owner of all or any portion of a foreign trust at any time during the tax year. Complete all applicable identifying information requested below and Part II of the form and see the instructions for Part II.		
<input type="checkbox"/> (a) You are a U.S. person who, during the current tax year, received a distribution from a foreign trust, or (b) You are a U.S. person who is also a grantor or beneficiary of a foreign trust (1) that has made a loan of cash or marketable securities, directly or indirectly, to you or a U.S. person related to you during the current tax year, or (2) from which you or a U.S. person related to you received the uncompensated use of trust property. Complete all applicable identifying information requested below and Part III of the form and see the instructions for Part III.		
<input type="checkbox"/> You are a U.S. person who, during the current tax year, received a distribution from a foreign trust, or (b) You are a U.S. person who is also a grantor or beneficiary of a foreign trust (1) that has made a loan of cash or marketable securities, directly or indirectly, to you or a U.S. person related to you during the current tax year, or (2) from which you or a U.S. person related to you received the uncompensated use of trust property. Complete all applicable identifying information requested below and Part III of the form and see the instructions for Part III.		

KEY CONCEPTS – ESTATE TAX

The following are subject to U.S. estate tax:

- U.S. real property, including houses and condominiums.
- U.S. located tangible personal property, unless the items are in transit or on loan for an exhibition.
- Shares of stock of U.S. corporations, and interests in partnerships and LLCs
- Cash deposits with U.S. brokers, money market accounts with U.S. mutual funds and cash in U.S. safe deposit boxes

KEY CONCEPTS – ESTATE TAX

The following are NOT subject to U.S. estate tax:

- Life insurance on the life of the NRA issued by a U.S. carrier.
- Leases.
- Debt obligations that would otherwise qualify as portfolio interest loans.
- Assets held in the foreign branch of a U.S. bank.
- Other assets not held in the U.S.



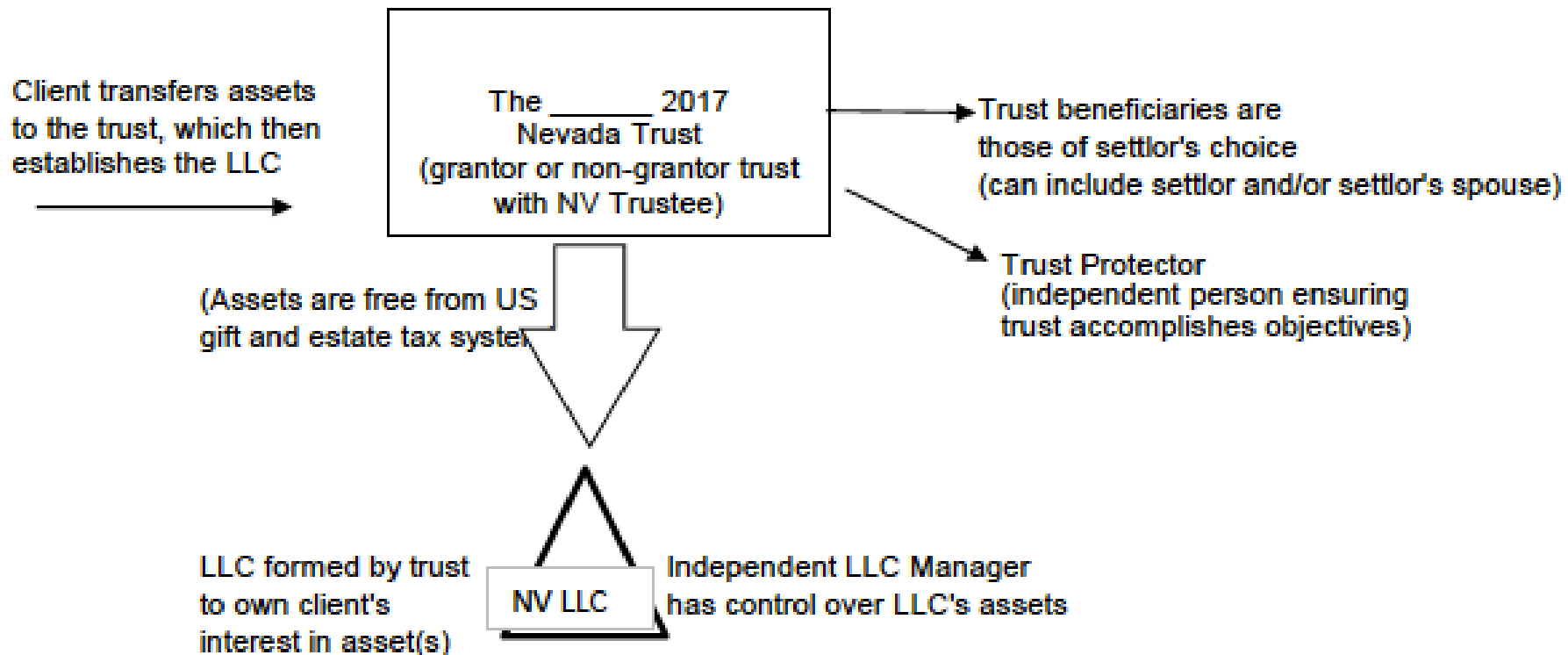
KEY CONCEPTS – ESTATE TAX

Important distinction between gift and estate tax:

- U.S. situs intangibles owned by a NRA are *not* subject to U.S. gift tax.
- U.S. situs intangibles owned by a NRA *are* subject to U.S. estate tax.
- Therefore critical that the NRA transfer these assets during lifetime, or they will be subject to a 40% tax.



Sample Domestic Trust Structure



Foreign vs. Domestic Trust

- All trusts are foreign trusts unless satisfy both the Control and Court tests of IRC Sec. 7701(30)(E):
- Control Test requires that “one or more United States persons have the authority to control all substantial decisions of the trust.”
 - A citizen (wherever located) or U.S. resident is a U.S. person for purposes of the Control Test, and thus this prong is satisfied if trust names a U.S. resident trustee.
- Court Test requires that a U.S. court be “able to exercise primary supervision over the administration of the trust.”
- Under Regs., 26 CFR 301.7701-7, have up to **12 months** to fix a trust that “inadvertently” becomes a foreign trust

Foreign vs. Domestic Trust?

- Thus, client could set up a trust in a U.S. jurisdiction and have it be a “foreign” trust for U.S. tax purposes
- Why do this? Take advantage of U.S. laws while minimizing tax to non-U.S. beneficiaries
- If the trust is a grantor trust, NRA will be subject to all trust income
 - Is a grantor trust if settlor can revoke OR if settlor and spouse are only beneficiaries during the settlor’s lifetime



Impact of Tax Treaty?

- Some tax treaties permit a pro-rata marital deduction based upon the ratio of U.S. over worldwide assets
 - E.g., U.S.-Canada income tax treaty authorizes the following limited marital deduction for Canadian-only citizens:

Unified credit for U.S. persons $\times \frac{\text{value of NRA's U.S. situs property}}{\text{value of NRA's worldwide property}}$

- Example . . .
 - Note: Must elect treaty benefits by attaching a statement or Form 8833 to the 706-NA



Impact of Tax Treaty?

- Other tax treaties permit a marital deduction equal to the amount of a U.S. citizen's unified credit
 - E.g., U.S.-German estate tax treaty
- Again, must elect treaty benefits by attaching a statement or Form 8833 to the 706-NA





Drafting Qualified Domestic Trusts

II. TERMS OF QDOTS

III. TRUSTEES, AND WITHHOLDING

© LAW OFFICES OF JOHN C. MARTIN

JOHN C. MARTIN, ESQ.

1145 MERRILL STREET, MENLO PARK, CA 94025

650-329-9500 | JCM@JOHNCMARTINLAW.COM

Snapshot: Purpose of QDOT

- ▶ Preserves marital deduction when otherwise unavailable for transfers non-US Citizen spouse
- ▶ Defers, does not eliminate estate tax
- ▶ Can pay income to the spouse and hardship distributions (can be a unitrust interest of no less than 3 percent and no more than 5 percent of the fair market value if provided for by local law)
- ▶ Subject to tax on distributions other than hardship or income
- ▶ Why? Government wants a guarantee that it will get tax \$\$\$\$ even if non US Citizen spouse takes off and is not subject to US Estate Tax
- ▶ May provide some time for Surviving Spouse to become a US Citizen

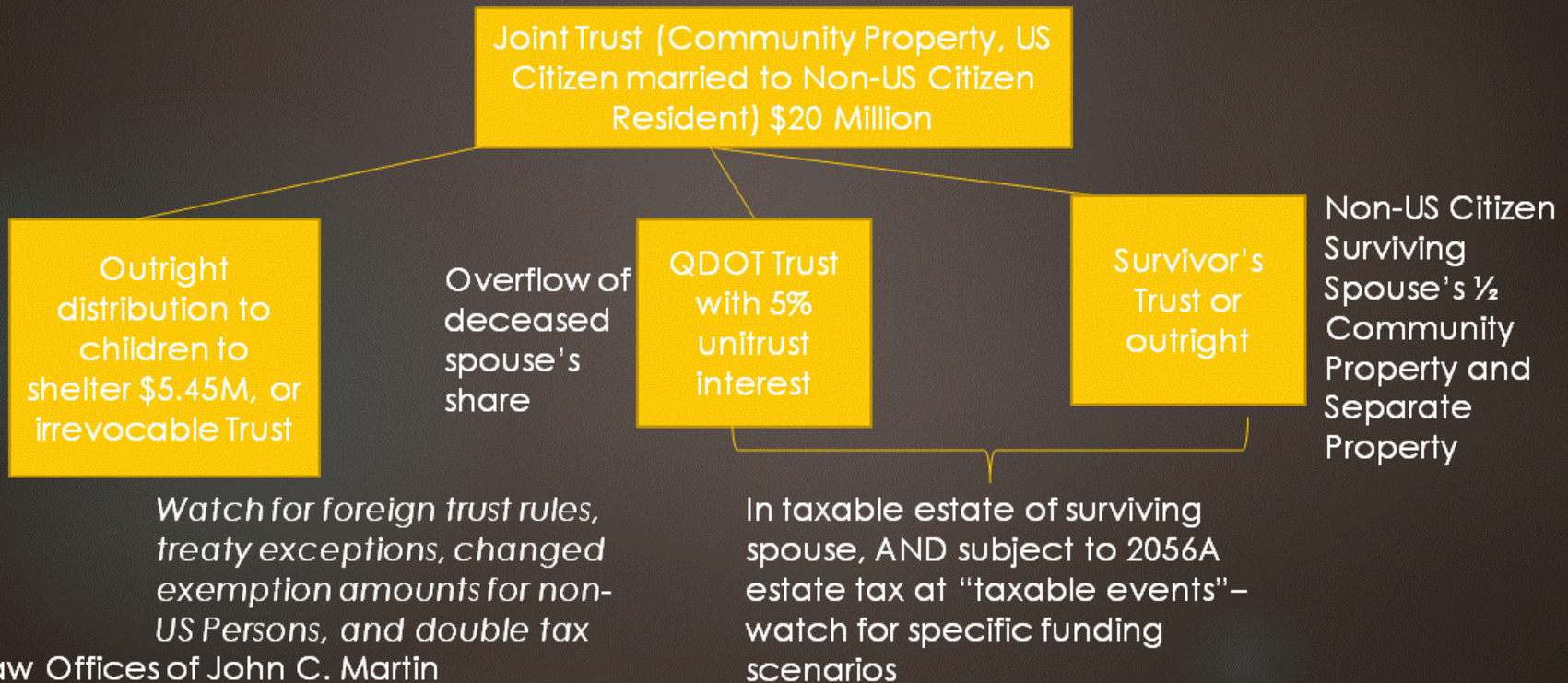
Example

Typical Marital Deduction Trust planning



Example

QDOT to Preserve Marital Deduction



BEFORE PROCEEDING, CONSIDER:

- Whether the surviving spouse is likely to become a US Citizen, or is likely to move back to a foreign country—often clients are not sure and want insurance in the form of a QDOT, but certainty one way or the other may inform planning options such as inter-vivos gifting, life insurance, foreign entities, etc.
- Other estate planning goals that may go into choosing a marital deduction trust (asset protection, beneficiary lock-in, access to principal, etc.)
- Trustee selection-- US citizen Individuals or banks who may be available to serve as a co-Trustee with the surviving spouse

Requirements

- ▶ 1. Provide that the laws of a U.S. state or the District of Columbia govern its administration; Qualify as an ordinary trust under Regs. Sec. 301.7701-4(a);

2. Be a Trust that Qualifies for the marital deduction

Example: Trust is typically both a QTIP / Power of Appointment Trust and a QDOT

3. Follows regulations re: distributions

- ▶ "Income" means fiduciary accounting income, may be a unitrust interest
- ▶ The distributions of principal must be limited to the trustee's right to withhold Section 2056A estate tax
- ▶ Trustee will be personally liable for payment of 2056A estate tax if not paid
- ▶ Hardship distributions of principal *may* be sought by the trustee

4. Additionally, Trust must have a U.S. Citizen Trustee

- ▶ At least one Trustee must be a U.S. Citizen or U.S. corporation

And beware foreign trust rules....

Example

Spouse may be sole trustee, if desired.

Spouse must have right to all income on the interest, or a specific portion of the interest for life in a QTIP (exception to terminable interest rule)

Typical QTIP

May provide for Principal for health, education, maintenance or support, or no right to principal, may include 5 or 5 power

Balance of trust at death goes to named beneficiaries, or may include limited testamentary power of appointment

Trust may be a QTIP Trust to protect the marital deduction and achieve estate planning goals, if desired. As a QTIP, spouse need not have a right to principal or a testamentary power of appointment. Need to make a QTIP election.

Example— start with typical marital deduction trust & add that:

QDOT Marital Deduction Trust

At least one Trustee shall be US Citizen or bank

No distributions of principal authorized without the prior approval of the US trustee. The US Trustee may, in its sole and absolute discretion, withhold the tax imposed by IRC 2056A from any principal distributions. Trustee may be authorized to seek a hardship exemption from 2056A tax.

EXAMPLE: "My Independent Trustee may pay or apply to benefit of the surviving spouse such amounts of principal as may be so paid or applied without making a distribution that will be subject to tax (regardless of whether any tax would be due) under Internal Revenue Code §2056A(b)."

See definitions and rules on income in the QDOT regs

WHAT IS 2056A tax?


- A deemed tax on the deceased spouse's estate-- the estate tax that would have been imposed on the deceased spouse's estate if the amount distributed from the QDOT (or upon death of the spouse or failure to qualify as a QDOT), were instead included in such deceased spouse's estate
- Note that the QDOT will also likely be included in the surviving spouse's estate and be subject to estate tax, in addition to 2056A tax, at the surviving spouse's death. However a credit for prior estate taxes paid, including by the deceased spouse as 2056A estate tax, may apply, under IRC 2013, up to 10 years from the deceased spouse's death without phase-out adjustment, with certain limitations.

What are Hardship distributions?

- distributions made "in response to an immediate and substantial financial need relating to the spouse's health, maintenance, education, or support"

5. If the value is less than \$2 Million

- ▶ Trust must provide that no more than 35% of the trust property, as determined on the last day of the trust's tax year, will consist of foreign real property, OR is subject to same requirements as a \$2 Million+ QDOT



6. If the value exceeds \$2 Million, or greater than 35% foreign property

- ▶ One of the two trustees must be a U.S. Bank, bond must be posted for 65% of the FMV of the property transferred to the trust (or trustee furnishes the IRS with a letter of credit of 65% of such amount)

7. Timely File 706 making QDOT Election

- ▶ 7. The trust language may empower the Trustee to direct the executor / personal representative of the estate to make a QDOT election, or to make such election themselves. Must be made in a timely filed US estate tax return, or e
- ▶ This is made by properly listing the QDOT Trust on schedule M

Additional Provisions

- ▶ Provisions saying when QDOT provisions will apply– i.e. if the Surviving Spouse is not a US Citizen prior to the point Form 706 is due; the marital deduction would otherwise be unavailable, and an election is timely made.
- ▶ Trust should have some mechanism for terminating the trust or reverting back to the desired marital deduction trust in the event the spouse becomes a citizen and the trust is no longer subject to tax.
- ▶ Trust may include provisions that the Trustee can take any action to ensure the QDOT will comply with IRC Section 2056A– an independent Trustee may be given the power to amend the provisions of the trust to comply with any such requirements.
- ▶ May include savings provisions to avoid foreign trust treatment and preserve the marital deduction.
- ▶ May include savings provisions to appoint a US Trustee in the event there is none serving
- ▶ May include provisions indemnifying the Independent Trustee for taking actions to qualify the QDOT as a QDOT
- ▶ Provisions allowing a Marital Trust / QTIP to be divided and allocated to the QDOT (See 26 CFR 20.2056(b)-7)
- ▶ Provisions directing the Trustee to obtain a separate tax id number for the QDOT

OR– Reform Existing Trust to be a QDOT

- ▶ Encouraged under the Regs., must be done prior to deadline for 706
- ▶ Sample language for complying with the security requirements is contained in Rev Proc 96–54, 1996–2 Cum Bull 386 for purposes of a court petition, and contains the same requirements as previously discussed.

OR Having Surviving spouse establish an inter-vivos QDOT

- ▶ Procedure: property 1st passes to the surviving spouse (in an outright distribution) and he or she irrevocably assigns the property to the new QDOT, before the estate tax return is filed.
- ▶ Advantage: Can be treated as a grantor trust under IRC § 671, which simplifies income tax reporting. Spouse may retain a power of appointment over the remainder interest to avoid making a completed gift when property is transferred to the trust (or some other way to avoid making a completed gift)
- ▶ Allows for no gain or loss to be recognized if the surviving spouse/settlor exchanges assets with the trust after the trust is funded.
- ▶ Does not need to qualify as a typical marital deduction trust, but will still qualify for the marital deduction as long as requirements # 4 & #5 are satisfied (at least one US citizen or corporation TTEE & restriction on principal distributions)
- ▶ But...watch out for foreign trust rules and reporting

Benefits & Risks of QDOTs

Presented by:

Nancy Ortmeyer Kuhn



Benefits of QDOTs

- QDOT may be established post-death
- Unlimited marital deduction for property in QDOT
- Deferral of estate tax for US situs property
- Income distributions not taxed: § 643(b)
- Hardship exception

Benefits

- Allows resident non-citizen spouse more time to pursue citizenship
- Future abolishment of estate tax could reward deferral

Risks of QDOTs

- Trustee Control of Assets
 - Requires US trustee
 - Withholding requirement on all distributions of corpus
 - US Trustee personally liable for QDOT tax
- Assets \$2 million + requires US Bank Trustee or Bond
- US Situs Property Not Always Clear
- Annuities/retirement account payments complex

Risk: Double Tax for NRA

- Dual citizenship/residence for G/E tax
 - US and Country Z may have inconsistent rules
- Resident of Country Z may be subject to double tax on US situs property
 - Country Z may not allow a credit for estate tax paid to country where property is located
 - Country Z may have different situs rules

US Situs Property

- Classification of property as US or non-US
 - Partnership interests unclear: aggregate v. entity issue
 - May classify based on underlying assets
 - Residence of donor/decedent
 - Where P/S organized and managed

US Situs Property

- e.g.: NRA decedent owns interest in P/S that owns US real estate:

IRS takes position that if a P/S is engaged in a US business and generates ECI, then ownership interest in the P/S is Effectively Connected and US property

Grecian Magnesite v. Comm'r: Docket #19215-12 pending in Tax Court challenges that position

US Situs Property?

- NRA dies owning the following:
 - Stock of Apple
 - Debt of Apple
 - Stock of US mutual fund owning stock/debt of Apple
 - House in BVI
 - House in CA
 - Wholly owned foreign LLC that owns house in NY
 - Art Exhibit on loan to US museum
 - Stock of foreign corporation that owns house in FL
 - Single member US LLC that owns house in Norway
 - Life Insurance Proceeds

Structuring Examples

- Surviving Spouse Annuity
 - Non-assignable
- IRS Requires Information Statement and
 - Election of Roll-Over or Payment Agreement
 - Treas.Reg. 20.2056A-4(d)

Structuring Examples

- Combination of IRA and QDOT
 - IRA Trust: Bank trustee
 - Small IRA may have difficulty getting cost-effective trustee
 - Possibly cheaper to withdraw IRA funds and pay income tax and then transfer to QDOT
 - Multiple QDOT's require designated "return filer"

Jointly-Owned Property

- Real Estate: Joint Tenants with Right of Survivorship.
 - Generally 100% included in estate of first decedent
 - Estate bears burden of proof to establish if some consideration was solely provided by surviving spouse
 - Joint bank account: Treas.Reg. 20.2056A-8(c)
 - Joint liability for mortgage payments
 - PLR 9551014, citing Rev. Rul. 79-302

Estate of Fung v. Comm'r

117 T.C. 247 (2001), *aff'd w/o pub. op.* (9th Cir. 2003)

- Both spouses NRAs
 - Surviving spouse: 3/8 interest in residual estate
 - US real estate and Hong Kong assets
 - » US real estate was mortgaged
 - » Personal liability for mortgage an issue
 - CA Court agreement after death to allocate US real estate to surviving spouse in satisfaction of 3/8 interest
 - US real estate validly in QDOT
 - IRS and courts: Only 3/8 of marital exemption allowed for adjusted value of two properties; full marital exemption allowed for property owned in Joint tenancy with right of survivorship

Planning Chart

If decedent is:	And Surviving Spouse is:		
	US citizen	US Resident (noncitizen)	Nonresident noncitizen
US Citizen	<ul style="list-style-type: none"> •\$5.49 million exclusion •Unlimited marital deduction 	<ul style="list-style-type: none"> •\$5.49 million exclusion •No marital deduction •QDOT deferral •Potential treaty benefit 	<ul style="list-style-type: none"> •\$5.49 million exclusion •No marital deduction •QDOT deferral •Potential treaty benefit
US Resident (noncitizen)	<ul style="list-style-type: none"> •\$5.49 million exclusion •Unlimited marital deduction 	<ul style="list-style-type: none"> •\$5.49 million exclusion •No marital deduction •QDOT deferral •Potential treaty benefit 	<ul style="list-style-type: none"> •\$5.49 million exclusion •No marital deduction •QDOT deferral •Potential treaty benefit
Nonresident noncitizen	<ul style="list-style-type: none"> •\$60,000 exclusion •Unlimited marital deduction 	<ul style="list-style-type: none"> •\$60,000 exclusion •No marital deduction •QDOT deferral •Potential treaty benefit 	<ul style="list-style-type: none"> •\$60,000 exclusion •No marital deduction •QDOT deferral •Potential treaty benefit

Planning Alternatives

- Citizen decedent spouse; noncitizen resident surviving spouse (“SS”)
- \$10 million US property placed in QDOT for benefit of noncitizen resident spouse
 - \$10 million spousal exemption
 - Estate taxes deferred until death of SS
 - Estate tax liability will be imposed at that time *as if* calculated at date of death of first spouse, with all relevant prior taxable events and credits (including unified credit) part of the calculation

OR

- Citizen decedent spouse; noncitizen resident surviving spouse (“SS”)
- \$10 million US property
- \$5 million placed in QDOT for benefit of noncitizen resident spouse
- \$5 million distributed and taxed currently
 - \$5 million spousal exemption
 - Unified credit used to minimize current estate taxes

Example: Both Spouses NRA

U.S. Property

- One spouse dies—without QDOT all U.S. property is subject to approx. 40% estate tax, minus \$60,000 exclusion
- If property is placed in QDOT before estate tax return is due to be filed: 100% marital deduction allowed
 - QDOT tax is deferred until distributions of corpus occur
 - Treaty benefits may also apply to minimize QDOT taxes
 - Annual gift tax exclusion not available unless gifts made prior to death

Planning Pointers

- Encourage substantial gifts prior to death of first spouse, to take advantage of increased gift exemptions for non-citizens
- Transfer of all US property to a QDOT may not be the best choice—run calculations for various scenarios
- Explore methods to minimize US property holdings

Planning Pointers

- Ensure SS client has clear understanding of income distribution and corpus distribution definitions and QDOT implications
- Review treaty availability: check for dual citizenships and domicile definitions
- Explore life insurance option as a method for QDOT taxes upon death of SS

THANK YOU

If you have any questions or comments

Nancy Ortmeyer Kuhn
Phone: 202.457.1621
nkuhn@jackscamp.com

Jackson & Campbell, P.C.
1120 Twentieth Street, N.W.
South Tower
Washington, D.C. 20036

www.jackscamp.com

**Jackson
& Campbell**
Attorneys and Counselors at Law