

## **The Basics For Estate and Gift Taxation When One Spouse is not a Citizen**

### **Introduction**

For those of us who have made our careers in the area of estates and trusts, we soon develop an understanding of federal estate and gift taxation centered around the assumption that both spouses are US citizens. We slowly fix in our minds certain Atax instincts@ regarding the gift or estate tax concepts such as 1) the Amarital deduction@, 2) the meaning of Aqualified joint interest@ and 3) the use of the gift tax Aannual exclusion@.

It is these three concepts that I will address; not in the context of both spouses being US citizens but in the context of the transferee spouse not being a US citizen (such non-citizen spouse will hereafter be referred to as the ANCS@). For me, I had to put my Atax instincts@ aside until they were broadened to accommodate the NCS.

This article is not intended to be an exhaustive discussion of tax concepts but is rather intended, because we increasingly encounter non-citizens in our business, to make you more sensitive to issues relating to federal estate and gift taxation when discussing these concepts with spouses, one of whom is a NCS. If necessary, the spouses can then be directed to individuals that are experts in the area. Any reference to the ACode@ refers to the Internal Revenue Code.

### **Estate Tax and the AQdot@**

In 1988 Congress repealed the marital deduction for transfers made from one spouse to a NCS for both gift tax and, with one exception, for estate tax. The estate tax exception is known as a AQualified Domestic Trust@ (AQdot@) which was established as the only method by which a deceased spouse could leave assets to his or her non-citizen spouse and obtain a marital deduction for estate tax purposes.

Basically, the Qdot works as follow: The deceased spouse leaves assets to the Qdot giving the NCS a lifetime income interest with the remainder going to named beneficiaries after the death of the NCS. The law, however, subjects the Qdot to strict statutory provisions in order for the Qdot to qualify for the marital deduction. The Qdot can be studied at Code ' 2056(d) and Code ' 2056A. One of those provisions is the method by which the Qdot assets are eventually taxed on distribution of principal during the life of the NCS or at his or her death.

If principal is distributed from the Qdot during the life of the NCS, or upon the death of the NCS, a Qdot estate tax is imposed. The amount of the Qdot estate tax is determined by recomputing the estate tax of the first spouse to die by now adding to the taxable estate of such spouse the value the assets distributed from the Qdot or the value of the Qdot assets at date of death. The resulting increase in estate tax of the first spouse=s estate, computed at the prior estate=s tax rates existing at that time of death, is the Qdot estate tax.

### **Distinction between estate tax treatment of Qdot assets**

### **and assets of a marital trust for a US citizen**

There is a significant distinction in the method by which the assets of a marital trust are taxed in the estate of the second spouse to die who was a US citizen and the method by which a Qdot is taxed. The marital trust assets for the US citizen spouse are, of course, included in that spouse's gross estate at death. Those marital trust assets, however, only become taxable after consideration is given to the applicable exclusion amount, deductions and credits available to the estate of the second spouse. The Qdot assets, however, are not included in the gross estate of the NCS but, instead, are taxed in the estate of the first spouse to die by simply adding the value of Qdot assets to the value of the first spouse's taxable estate at the then existing tax rate. None of the estate tax benefits of the applicable exclusion amount nor deductions available to a US citizen are available to the NCS in computing the Qdot estate tax because such assets are taxed in the estate of the first spouse to die. Therefore, there is no opportunity to shelter those Qdot assets with the applicable exclusion amount available to the second spouse's estate.

### **Estate tax treatment of tenancy by the entirety or joint property with right of survivorship when resident alien spouse is the survivor**

The repeal of the estate tax marital deduction for all transfers to a NCS, except a transfer to a Qdot, means that any other transfer to a NCS, in excess of the applicable exclusion amount, is estate taxable and not subject to the benefits of the marital deduction..

A good example of this is real property held as a tenancy by the entirety or as joint tenants with right of survivorship between the spouses (hereafter referred to as **Ajoint tenancy@**).

Prior to 1982, for estate tax purposes, ownership of the joint tenancy attributable to each spouse was based on the amount of consideration contributed by each spouse for the purchase of the joint tenancy. For estate tax purposes, however, it was presumed that all of the contribution was furnished by the decedent and, therefore, 100% of the value of the joint property was included in the estate of the first spouse to die. The contribution presumption was rebuttable which meant that to the extent the surviving spouse could prove financial contribution of consideration used to purchase the joint property, the ratio of contributions by each spouse was taken against the fair market value of the joint property and only the value of the joint property attributable to the deceased spouse was included in the decedent's estate tax return. Nevertheless, it was subject to the marital deduction.

Code ' 2040(b) was enacted in 1982 to eliminate the contribution issue for joint tenancies owned by spouses. Since 1982, each spouse's interest in a joint tenancy is valued at one-half the fair market value of the joint interest and only the one-half attributed to the decedent is includable in the decedent's gross estate. That one-half interest is subject to the marital deduction because it passes to the surviving spouse by operation of law. This rule is not available to the NCS who is the survivor of a joint tenancy owned with a deceased spouse.

The pre-1982 contribution rules for jointly owned property still apply to joint property

passing to a surviving NCS. There is no one-half interest rule and there is no marital deduction for the interest passing to the surviving NCS. When combining the pre-1982 contribution rules imposed on the surviving NCS with the loss of the marital deduction for the joint tenancy passing to a NCS, the rules combine to be very harsh.

If there was no contribution on the part of the NCS or the contribution is not proved, the result is that the entire value of the joint tenancy is included in the decedents gross estate and there is no marital deduction available to that estate.

### **The gift tax Annual exclusion@ applicable to gifts made to a NCS**

When the gift tax marital deduction was repealed, the annual exclusion for gifts to a NCS was increased from \$10,000 to \$100,000 and, due to indexing, the annual exclusion for 2009 is \$133,000. This is the only real gift tax advantage for spouses when one is a NCS and it should not be overlooked as a useful planning tool.

### **Conclusion**

During the lives of two spouses, one of whom is a NCS, the large annual exclusion available for transfers to a NCS is a useful tax benefit to be used every year in helping to reduce the negative impact of the joint tenancy rules by converting it to a tenancy in common; and/or reducing the size of a future Qdot by transferring asset to the NCS during the lives of the spouses.