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Estate Taxes

Lee A. Wendel and James S. Tsang of Squire Patton Boggs, in the first of two articles on estate planning for couples residing outside the U.S. in which one spouse is a U.S. citizen but the other isn't, consider planning for the possibility that the U.S. citizen spouse will predecease the noncitizen. The authors focus on planning issues that are outside the norm in more traditional estate planning for U.S. couples.

Estate Planning for the U.S. Citizen With a Noncitizen Spouse, Resident Abroad

BY LEE A. WENDEL AND JAMES S. TSANG

Recently we have had opportunities to do estate planning for couples residing outside the U.S. in which one spouse is a U.S. citizen but the other is not. This article (which will appear in two installments) discusses several special U.S.-focused planning issues we have addressed, that are outside the norm for more traditional estate planning for U.S. couples.

This first installment covers planning for the possibility that the U.S. citizen spouse will predecease the noncitizen spouse. The second installment will discuss planning for the possibility that the noncitizen spouse will predecease the U.S. citizen spouse, and planning for their children following the survivor's death.

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Representative Family

Consider the following planning case:

- Mark is 42 years old and is a citizen of the U.S. Mark was born in New York but moved abroad following college and has made his career (and built his wealth) outside the U.S. Mark has had a successful career as an investment banker. Currently his net worth is approximately $12 million.

- Wendy is 39 years old. Wendy isn't a citizen of the U.S. nor is she resident in the U.S. Like Mark, Wendy has had a successful career as an investment banker. Wendy's net worth currently is approximately $4 million. She also anticipates that she may inherit approximately $10 million from her parents.

- Mark and Wendy have two children. Debby is 9 years old and Sam is 6 years old. Both Debby and Sam are U.S. citizens due to Mark's U.S. citizenship. Debby and Sam also are citizens of their country of residence.

- Mark's mother is a U.S. citizen and resides in California. His father is deceased. Mark also has two siblings. His brother resides in Florida and his sister resides in London. Both are U.S. citizens.

- Wendy's parents are both still living. Neither is a citizen or resident of the U.S. Wendy also has one sister, who is neither a citizen nor a resident of the U.S.

We are intentionally being vague about the jurisdiction in which Mark and Wendy reside and about Wendy's citizenship. One of us practices in Hong Kong and

so our experience and thinking is built partly on planning for couples in Mark's and Wendy's situation who reside and have built their wealth in Hong Kong. However, we will move Mark and Wendy around the world where helpful to illustrate particular planning points and opportunities.

Hong Kong is a former British colony. Its legal system is built on English common law principles as well as statutes, and it recognizes trusts. However, Hong Kong no longer has an estate tax, it doesn't have an estate tax treaty with the U.S., and generally it doesn't subject investment income and capital gains to income tax.[1] Hence Hong Kong is a convenient non-U.S. jurisdiction in which to place Mark and Wendy for the purpose of discussing the impact of U.S. estate tax and gift tax rules and the impact of U.S. income tax rules for foreign trusts.

Planning for Wendy If Mark Dies First

Designing Mark's estate plan is complicated, first of all, by the fact that Wendy isn't a U.S. citizen. Consequently, no marital deduction can be claimed on Mark's U.S. federal estate tax return for property that Mark leaves to Wendy as outright owner.[2]

Rather, outright bequests to Wendy will expend portions of the applicable exclusion amount ($5.34 million if Mark's death occurred during 2014[3]) that otherwise could be used to set wealth aside in a credit-shelter-type trust for the ultimate benefit of Debby and Sam. To the extent that Mark's available applicable exclusion amount is exceeded, such outright bequests to Wendy would incur U.S. estate tax (at a 40 percent marginal rate if Mark's death occurred during 2014.[4])

Use of Qualified Domestic Trust

In order to avoid incurring substantial U.S. estate taxes upon Mark's death that would reduce the wealth remaining to provide for Wendy, Debby and Sam, Mark could implement a trust-based estate plan that includes the following components:

■ A traditional credit-shelter trust, to hold the portion of Mark's property that can be sheltered by his applicable exclusion amount (less any portion, such as tangible personal property or Mark's ownership interest in their residence in Hong Kong, which is given to Wendy as outright owner for reasons of practicality and simplicity notwithstanding the absence of a marital deduction). Wendy, Debby and Sam all can be current beneficiaries of this credit-shelter trust, eligible to receive distributions of net income or principal for health, support, education or other purposes.

■ A ''qualified domestic trust'' (QDOT), to hold the balance of Mark's assets that must qualify for the marital deduction in order to avoid current payment of U.S. estate tax.[5]

Estate Planning Options for Couples With One Noncitizen Spouse

■ A qualified domestic trust, or QDOT, benefiting the noncitizen surviving spouse can qualify for the marital deduction in calculating estate taxes on the U.S. citizen's estate.

■ Foreign trust status for trusts created under the U.S. citizen's estate plan won't necessarily result in adverse U.S. income tax consequences, but can have negative effects on the surviving spouse's death for the couple's U.S. citizen children.

■ Outright distributions from the U.S. citizen's estate to the noncitizen surviving spouse can generate substantial U.S. estate tax but also provide future benefits with respect to overall estate tax savings and basis step-up on the surviving spouse's subsequent death.

Mark's estate may claim a marital deduction for property he leaves to a QDOT in calculating the U.S. estate tax payable by reason of Mark's death. However, the QDOT must satisfy all of the following requirements:

■ If created by Mark's estate plan, rather than by Wendy using property she receives through Mark's estate plan as outright owner, the QDOT must be in a form that qualifies for the marital deduction under the rules contained in Section 2056 of the Internal Revenue Code and the Treasury regulations issued under that section. In order to avoid treatment of the QDOT as a ''foreign trust'' for U.S. income tax purposes, for reasons discussed later in this article, the QDOT likely would be structured to qualify for election to be treated as ''qualified terminable interest property'' under Section 2056(b)(7).

■ The QDOT must have at least one trustee who is an individual citizen of the U.S. or a U.S. domestic corporation (the ''U.S. Trustee'').

■ The QDOT must require that no distribution of principal may be made (subject to certain exceptions for financial hardship distributions or income tax payments) unless the U.S. Trustee has the right to withhold from such distribution the estate tax payments required by Section 2056A(b). The trustee or trustees of the QDOT will have responsibility for reporting such distributions, and each trustee of the QDOT (not just the U.S. Trustee) will have personal liability for payment of the estate tax imposed.

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[1] An exception is that Hong Kong does tax income (other than dividends and bank interest) and gains from the sale of assets if the taxpayer carries on a trade or business in Hong Kong with respect to such assets and the income and gains are derived from the trade or business.

[2] See I.R.C. Section 2056(d). All section references are to the Internal Revenue Code of 1986, as amended, or to Department of Treasury regulations issued to implement its provisions.

[3] See I.R.C. Section 2010; Rev. Proc. 2013-35, I.R.B. 2013-47, at Section 3.32.

[4] See I.R.C. Section 2001(c).

[5] The U.S. income tax treatment of distributions to Wendy from these trusts is beyond the scope of this article. However, we note that it may be possible to structure the trusts' investments so that income distributed to Wendy isn't subjected to U.S. income tax.

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■ The QDOT must be maintained under the laws of a state of the U.S. or the District of Columbia, and the administration of the QDOT must be governed by the laws of a state of the U.S. or the District of Columbia.

■ The QDOT must meet various requirements prescribed in Treasury regulations to ensure the collection of the estate tax imposed on principal distributions or upon the surviving spouse's death.

■ Mark's executor must make a timely election to treat the trust as a QDOT.[6]

Avoid Treatment as Foreign Trusts

Unless and until Wendy becomes a citizen of the U.S., Wendy must accept the following restrictions on her access to and control over Mark's property that would be subject to this trust-based plan:

■ Wendy can't be sole trustee of the QDOT. At a minimum the QDOT must have a co-trustee who (or which) qualifies as a U.S. Trustee. Consequently, Wendy must accept shared responsibility for administration of the QDOT with a co-trustee such as Mark's mother, his brother or his sister, or a U.S. bank or trust company.

■ Wendy can't be even a co-trustee of either the QDOT portion or the credit-shelter portion without causing that trust to be a ''foreign trust'' for U.S. income tax purposes and information reporting purposes. (A technical, but probably impractical exception would be if Wendy had at least two co-trustees who were U.S. persons and could outvote Wendy on all substantial decisions.)

■ Wendy can't be given a power of appointment over either trust, nor can she be given authority either to remove a trustee or to appoint a successor trustee for either trust, without causing that trust to be a foreign trust for U.S. income tax purposes and information reporting purposes.[7]

As a practical matter Wendy will be required to cede authority over Mark's property to another member of his family who is a U.S. citizen, or else to a U.S. bank or trust company.

Treatment of the trusts as foreign trusts wouldn't necessarily result in adverse U.S. income tax results, nor in adverse U.S. information reporting requirements, during Wendy's lifetime if she continues to be neither a citizen nor a resident of the U.S.[8] Treatment as a foreign trust may even avoid, or reduce, the U.S. income taxes that otherwise would be payable currently on realized capital gains that are accumulated in the trust.

However, if Debby and Sam continue to be U.S. citizens, treatment of the trusts as foreign trusts could have the following adverse U.S. tax consequences upon and after Wendy's death:

■ Distributions to Debby or Sam, or to trusts for their benefit, from accumulated income (in the credit-shelter trust) or capital gains (in both trusts) may be subject to the throwback rules imposed by Sections 665 through 668. Adverse consequences include taxation of these accumulation distribution items at ordinary income rates (including qualified dividends and long-term capital gains that would have been eligible to be taxed at more favorable rates, or not at all, if received by Wendy, Debby or Sam in the year realized), an interest charge, and the complication and expense of accounting for this throwback treatment.

■ Distributions to Debby or Sam, or to trusts for their benefit, from foreign trusts also must be reported timely on IRS Form 3520, Annual Return to Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts.[9]

In order to avoid the credit-shelter trust and the QDOT (and any subsequent trusts provided for Debby or Sam) being classified as foreign trusts for U.S. income tax purposes and information reporting purposes, each trust must satisfy both of the following requirements:

■ a court within the U.S. must be able to exercise primary supervision over the administration of the trust (the ''Court Test''), and

■ one or more U.S. persons must have the authority to control all substantial decisions of the trust (the ''Control Test'').[10]

In order to avoid being classified as foreign trusts for U.S. income tax purposes and information reporting purposes, trusts must satisfy both the ''Court Test'' and the ''Control Test.''

Treasury regulations detail the requirements, and certain safe harbor provisions, to satisfy the Court Test and the Control Test.[11] A detailed discussion of these requirements and safe harbors is beyond the scope of this article. For present purposes the key requirements for planning and drafting purposes, for a family situation like Mark's and Wendy's, include the following:

■ In order to satisfy the Court Test, each trust probably needs to have at least one trustee who or which is resident in the U.S., and that trustee should have au-

[6] See I.R.C. Section 2056A; Treas. Reg. Section 20.2056A-2; Treas. Reg. Section 20.2056A-11. Complete discussion of the requirements for QDOT treatment is beyond the scope of this article.

[7] Some practitioners believe that granting to a non-U.S. person a power of appointment that would only take effect at the power holder's death doesn't make the trust a foreign trust during the power holder's lifetime. The Treasury regulation that implements the statutory distinction between a U.S. domestic trust and a foreign trust is discussed later in this article. It doesn't address this question definitively.

[8] However, the U.S. Trustee of the QDOT may be required to file annual reports if the QDOT holds real estate, see Treas. Reg. Section 20.2056A-2(d)(3), and the U.S. Trustee will be required to file IRS Form 706-QDT to report any principal distributions to Wendy, see Treas. Reg. Section 20.2056A-11.

[9] See I.R.C. Section 6048(c).

[10] See I.R.C. Sections 7701(a)(31), 7701(a)(30)(E).

[11] See Treas. Reg. Section 301.7701-7.

thority (or at least jointly exercisable authority) over all substantial decisions relating to the administration of the trust.[12] The applicable Treasury regulation authorizes certain actions to be taken to subject the trust to the jurisdiction of a U.S. court without regard (necessarily) to the residence of the trustee,[13] but we haven't had occasion to examine and rely on these provisions for a trustee resident outside the U.S.

■ In order to satisfy the Control Test, the following ''substantial decisions'' must be controlled by one or more U.S. persons: whether and when to distribute income or corpus; the amount of any distributions; the selection of a beneficiary; whether a receipt is allocable to income or principal; whether to terminate the trust; whether to compromise, arbitrate or abandon claims of the trust; whether to sue on behalf of the trust or to defend suits against the trust; whether to remove, add or replace a trustee; whether to appoint a successor trustee to succeed a trustee who has died, resigned or otherwise ceased to act as a trustee, even if the power to make such decision isn't accompanied by an unrestricted power to remove a trustee, unless the power to make such decision is limited such that it can't be exercised in a manner that would change the trust's residency from foreign to domestic, or vice versa; and investment decisions, unless a U.S. person hired the investment adviser and can terminate the investment adviser's power to make investment decisions at will.[14]

Consequently, during any time that Wendy is neither a citizen nor a resident of the U.S., the trust can't authorize her to exercise any of these powers unilaterally.[15] Nor can Wendy be authorized to veto (as a co-trustee or otherwise) any of these substantial decisions made by a U.S. trustee or co-trustee. Nor can any other person who isn't a U.S. person under Section 7701(a)(30) be authorized to do so.

Limitations on Income-Tax Basis Adjustment At Wendy's Death

Another potential drawback to this trusts-based plan for Mark is that property held in the credit-shelter trust won't receive a further adjustment to its income tax basis upon Wendy's later death, under Section 1014. Neither may property held in the QDOT except to the extent the QDOT consists at the time of Wendy's death of property that is sitused in the U.S. for purposes of determining the U.S. federal estate tax payable by reason of Wendy's death.[16]

Consider Outright Distributions Instead

For the reasons outlined above, Mark and Wendy may determine instead to make all or a portion of Mark's property payable to Wendy as outright owner, in the event that Mark dies first. The resulting U.S. federal estate tax could be substantial—as much as $2.664 million on the planning assumptions outlined above, if Mark's death occurred in 2014. But as a result of structuring Mark's estate plan this way (and paying this resulting U.S. estate tax):

■ Wendy would enjoy unfettered access to and control over Mark's property, without further U.S. estate tax cost to access it during her remaining lifetime.

■ During Wendy's remaining lifetime, if Wendy continues to be a nonresident alien for U.S. income tax purposes, realized capital gains from property she received from Mark may avoid U.S. income tax.

■ Upon Wendy's death, the property she received from Mark (or from reinvestment of proceeds of that property) may receive a new income tax basis for U.S. income tax purposes, under Section 1014, resulting in less capital gains tax for Debby and Sam when the property later is sold.

■ This basis adjustment can be made for U.S. income tax purposes without necessarily subjecting the value increase between Mark's death and Wendy's death to U.S. estate taxes. With appropriate planning the basis adjustment may be available under subsections (1), (2) or (3) of Section 1014(b) even though the property isn't sitused in the U.S. for U.S. estate tax purposes at the time of Wendy's later death. If Wendy receives the investment portfolio directly, she can structure the portfolio holdings to be sitused outside the U.S. under U.S. estate tax rules at the time of her later death.

■ Wendy will be positioned to leave Mark's remaining property, as well as her own property and her inherited property, to Debby and Sam upon Wendy's death using long-term trust arrangements for Debby and Sam that can remain outside the U.S. estate tax, gift tax and generation-skipping transfer tax system for multiple generations. The planning opportunities available for wealth passing at Wendy's death are discussed further in the second installment of this article.

Variations in tax laws and inheritance laws can cause planning considerations and possibilities to differ based on the couple's country of residence.

Consider now the following distinctly different planning considerations and possibilities if Mark and Wendy were resident in a country such as Germany, rather than in Hong Kong:

■ Germany has community-property-like rules for property owned by married persons. If Mark's wealth was accumulated during his marriage to Wendy, from his employment, Wendy may be considered already to own 50 percent of it. Correspondingly, Mark may be considered to own 50 percent of Wendy's property. Accordingly, Mark's gross estate for U.S. estate tax purposes may be $8 million (i.e. 50 percent of $12 million plus 50 percent of $4 million) rather than $12 million.

[12] See Treas. Reg. Section 301.7701-7(c)(3).
[13] See Treas. Reg. Section 301.7701-7(c)(4)(i)(A)-(C).
[14] Treas. Reg. Section 301.7701-7(d)(1)(ii).
[15] The concern with granting a power of appointment to a non-U.S. person is that the non-U.S. person could exercise the power of appointment to select a beneficiary or to determine the timing or amount of distributions from the trust.
[16] Section 1014(b)(10) of the Internal Revenue Code only authorizes an adjustment to the basis of property for which a QTIP election was made if the property was includible in the gross estate of the surviving spouse under Section 2044. Section 2056A(b)(13) only authorizes a basis adjustment for QDOT property, apart from the general rules of Section 1014, in the case of a distribution made from a QDOT prior to the death of the surviving spouse.

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■ Germany has an estate tax treaty with the U.S. that, among other things, provides a special marital deduction rule for purposes of determining the U.S. federal estate tax. Even though Wendy isn't a citizen of the U.S., Mark's estate could elect under the treaty to deduct from the value of Mark's gross estate property that passes to Wendy in marital-deduction-qualifying form (determined as if Wendy was a U.S. citizen), up to the amount of the applicable exclusion amount allowable for U.S. estate tax purposes. The amount of this special treaty-based marital deduction is determined without regard to any adjusted taxable gifts Mark may have made during his lifetime. It may be claimed in addition to the applicable exclusion amount available on Mark's U.S. federal estate tax return under the normal U.S. estate tax rules.[17] Hence, if Mark's death occurred in 2014, his estate could shelter as much as $10.68 million from U.S. federal estate tax notwithstanding the special limitation on the marital deduction imposed by Section 2056(d).

■ Germany has an inheritance tax (and a gift tax) that may apply to Mark's property if he resides in Germany, and may apply to Wendy's property if she remains a resident of Germany following Mark's death. Germany's inheritance tax provides lower exemption amounts for transfers to a spouse or child than are allowed for U.S. estate tax purposes (currently 500,000 euros ($677,000) for transfers to a spouse and 400,000 euros ($541,000) for transfers to a child). Nevertheless, these German exemption amounts are significantly larger for outright transfers to a spouse or child, and the German inheritance tax rates for such outright transfers are significantly lower, than the German exemption amounts and inheritance tax rates that would apply to transfers in trust.

■ If Mark is considered to be domiciled in Germany, Wendy and the children may have forced-share rights to claim portions of Mark's property upon his death as outright owners, irrespective of trust provisions he otherwise might make for them.

For these reasons, if Wendy expects to remain in Germany following Mark's death, and doesn't plan to become a U.S. citizen, then the optimal plan may be for Mark to leave all or most of his property to Wendy as outright owner. (Mark's plan might allocate to Debby and Sam portions that are sufficient to take advantage of the amounts Mark can provide to each of them free of German inheritance tax or, if greater, to satisfy their forced-share entitlements under German law.) All or nearly all of Mark's property may be sheltered from U.S. estate tax by the combination of his applicable exclusion amount and the special marital deduction allowed under the U.S.–German estate tax treaty. Thereafter Wendy will have full access to and control over the property, as well as the greater U.S. tax-planning flexibility outlined above.

The more general planning point, illustrated by this quick globe-hopping from Hong Kong to Germany, is that optimal planning will depend partly on the country in which the couple resides, and the country in which the noncitizen spouse (and the children) can be expected to reside following the death of the U.S. citizen spouse.

In the second installment of this article, we will examine planning for Mark if Wendy dies first, and then planning for Debby and Sam following the survivor's death.

[17] See Article 10, paragraph 6 of the Convention Between the U.S. of America and the Federal Republic of Germany for the Avoidance of Double Taxation with Respect to Taxes on Estates, Inheritances, and Gifts, signed at Bonn on Dec. 3, 1980, as amended by Protocol signed at Washington, D.C., on Dec. 14, 1998.