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Optimal Marital Trust Planning for Non-U.S. Citizen Surviving Spouses

Maximizing income can minimize federal estate tax.

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Qualified domestic trusts (QDOTs), established under Internal Revenue Code Section 2056A, are used by decedents with taxable estates who wish to defer the federal estate tax due on assets passing to a surviving spouse who isn't a U.S. citizen (a non-U.S. spouse). However, optimal design of a QDOT can decrease (and not just defer) the federal estate tax due by maximizing the fiduciary accounting income generated by the QDOT each year.[1] Accordingly, an advisor facing a situation in which: (1) a U.S. citizen or domiciliary leaves assets to a non-U.S. spouse; or (2) an individual who's neither a U.S. citizen nor domiciled in the United States leaves U.S. situs assets to a non-U.S. spouse, must analyze the assets in the estate and help to design a QDOT that will minimize the federal estate tax due.

A QDOT may appear similar in operation to the typical marital deduction trust (that is, a qualified terminable interest property (QTIP) trust[2]) used for surviving spouses who are U.S. citizens in that both provide for annual payments of income to the surviving spouse. However, amounts distributed as income from a QDOT during its term will be exempt from federal estate tax on termination of the QDOT, whereas amounts distributed from a QTIP trust will be added to the taxable estate of a surviving spouse. If a QDOT makes a distribution of income to a non-U.S. spouse who's domiciled outside of the

United States, however, the non-U.S. spouse can avoid having the value distributed being subject to federal estate taxation by making sure that the amount distributed is converted to an asset not subject to U.S. federal estate tax (including foreign currency, U.S. bank deposits or bonds bearing portfolio interest). If a QDOT makes a distribution of income to a non-U.S. spouse who's domiciled in the United States and thus subject to federal estate taxation, the non-U.S. spouse will be entitled to the full federal estate tax exemption (currently $11.4 million) rather than the $60,000 exemption of the spouse who funded the QDOT. Thus, maximizing the amount that can be distributed by a QDOT as income will potentially create significant federal estate tax savings for the decedent's heirs.

QDOTs and Income Distributions

The QDOT provisions ensure that property passing to a non-U.S. spouse will eventually be subject to federal estate tax. As a result, a deferred federal estate tax is enforced on distributions of principal, other than distributions on account of hardship, from a QDOT during the non-U.S. spouse's lifetime and on the balance of the corpus on the earlier of the termination of such trust or the non-U.S. spouse's death.[3] After the QDOT is established and funded, any subsequent distributions of principal to the non-U.S. spouse will result in federal estate tax, unless the distributions are treated as income distributions, which are exempt from federal estate tax, a critical component of the planning described below.[4]

However, "income" for purposes of a QDOT doesn't mean "taxable income" or income in the usual sense used by tax practitioners.[5] Rather, for QDOTs, the term "income," when not preceded by the words "taxable," "distributable net," "undistributed net" or "gross," means the income of the estate or trust as determined under its governing instrument and the applicable local law.[6] That is, "income" usually means the amounts for which a fiduciary would be accountable to the court having jurisdiction of the estate or trust.[7]

Notwithstanding the foregoing, Treasury Regulations Section 1.643(b)-1 allows the trustee to expand the normal definition of income by making certain adjustments to income (that is, exercising a power to adjust) and establishing non-charitable unitrusts. Specifically, the regulation permits:

(1) allocating to income a reasonable amount of total return, composed of amounts including ordinary income, tax-exempt income, capital gains and appreciation pursuant to applicable local law, to fulfill the trustee's duty of impartiality between income and remainder beneficiaries; and

(2) using a state statutory provision that allows unitrust amounts (for example, a fixed percentage of 3 percent to 5 percent of the fair market value of trust assets determined at the beginning of each year) to be treated as income irrespective of the source.[8]

To the extent that the above rules increase the amount that can be distributed tax free as income, estate tax will be reduced on termination of the QDOT.

RUPIA

The Revised Uniform Principal and Income Act of 2008 (RUPIA) includes provisions that will allow a QDOT to be designed in a way that will maximize the amounts that can be distributed as income under IRC Section 643. The RUPIA has been adopted by 47 jurisdictions, including Delaware.[9]

Delaware total return unitrust. Several states, including Delaware, incorporate in their principal and income statutes the power of a trustee to convert the trust to a unitrust. A unitrust QDOT provides

one model for maximizing the amount distributed as income each year if expected annual aggregate income (ordinary income plus capital gains) is less than 5 percent per year. A unitrust allows a trustee to calculate trust accounting income as a percentage of the trust's assets at least annually and allows the trustee to use a valuation date or dates or averages of valuation dates as it deems appropriate.[10] Trust accounting income is thought to be some percentage (between 3 percent and 5 percent) of the principal of the trust, irrespective of the actual amount of income earned by the trust.[11] In establishing the unitrust percentage, the trustee must consider the intentions of the settlor as expressed in the governing instrument, the needs of the beneficiaries, general economic conditions, projected current earnings and appreciation for the trust and projected inflation and its impact on the trust.[12]

To the extent that the adjusted income payout exceeds the QDOT's total return for a year, the excess is recharacterized as income and should have no federal estate tax consequences.[13] For example, if the QDOT's total return for a year is 2 percent and the trustee opts into the unitrust regime (selecting a 5 percent payout), the 3 percent payout in excess of the trust's total return for a year is considered income for trust accounting purposes and can be distributed free of the QDOT federal estate tax.[14]

Power to adjust. Under the RUPIA, the power to adjust authorizes a trustee to adjust between principal and income (by allocating income to principal or principal to income) if the trustee manages trust investments under the prudent investor rule and if, after administering the trust in accordance with the governing instrument and the respective law, the trustee is unable to administer the trust impartially between the current and remainder beneficiaries (except to the extent that the governing instrument clearly manifests an intention that the trustee favor one or more beneficiaries).[15] To the extent that the terms of the trust do require or permit the trustee to favor the income beneficiary, for example, the trustee must conclude that he's unable to achieve the degree of partiality required or permitted and may thus exercise the power to adjust.[16] In deciding whether and to what extent to exercise the power to adjust, a trustee shall consider all factors relevant to the trust and its beneficiaries, including the following factors to the extent they're relevant:

(1) The nature, purpose and expected duration of the trust;

(2) The intent of the settlor;

(3) The identity and circumstances of the beneficiaries;

(4) The needs for liquidity, regularity of income and preservation and appreciation of capital;

(5) The assets held in the trust; the extent to which they consist of financial assets, interests in closely held enterprises, tangible and intangible personal property or real property; the extent to which an asset is used by a beneficiary; and whether an asset was purchased by the trustee or received from the settlor;

(6) The net amount allocated to income under the other sections of this chapter, and the increase or decrease in the value of the principal assets, which the trustee may estimate as to assets for which market values aren't readily available;

(7) Whether and to what extent the terms of the trust give the trustee the power to invade principal or accumulate income or prohibit the trustee from invading principal or accumulating income, and the extent to which the trustee has exercised a power from time to time to invade principal or accumulate income;

(8) The actual and anticipated effect of economic conditions on principal and income and effects of inflation and deflation; and

(9) The anticipated tax consequences of an adjustment.[17]

Based on these rules, when designing a QDOT to maximize income distributions, it would be appropriate to include language in the QDOT stating that the intent is to benefit the surviving spouse over the remaindermen and requiring the trustee to exercise the power to adjust to the maximum extent possible to benefit the income beneficiary (the non-U.S. spouse).

A trustee has protections under the RUPIA relating to the trustee's power to adjust. For example, a court may not change a trustee's decision to exercise or not to exercise the power to adjust unless it finds that the trustee abused its discretion, and a determination by the trustee isn't an abuse of discretion merely because the court would have exercised the power in a different manner.[18] Nonetheless, the power to adjust may be challenging to continue long term, and the trustee may instead prefer a rule that would allow the trustee to invest for total return without the constant need to take an action.[19] Either way, these provisions can help increase the amount of distributions classified as income coming out of the QDOT.

Special rules for distributions from a business entity. Many QDOTs will be funded not with stocks or bonds that generate income or capital gains but with interests in business entities (such as real estate partnerships and closely held businesses) that generate distributions. In these cases, the income and gains generated by the business entity are irrelevant for determining a QDOT's income. Rather, with respect to corporations, partnerships, limited liability companies, regulated investment companies and real estate investment trusts (REITs), Sections 401(b) and (c) of the RUPIA provide that a trustee shall allocate to income any money received from an entity, except that the following receipts from an entity must be treated as principal:

(1) Property other than money;

(2) Money received in one distribution or a series of related distributions in exchange for part or all of a trust's interest in the entity;

(3) Money received in total or partial liquidation of the entity; and

(4) Money received from an entity that's a regulated investment company or a REIT if the money distributed is a capital gains dividend for federal income tax purposes.

Thus, cash distributions from an entity to a trustee are presumed to be income, unless the distributions are classified under the above four exceptions.[20] The trustee generally is directed to look at the distributions from the entity but isn't required or directed to determine where the entity receives the cash that's distributed.[21]

Under Section 401(d) of the RUPIA, money is received in partial liquidation either to the extent that the entity indicates that it's a distribution in partial liquidation or if the total amount of money and other property received in one or more distributions is greater than 20 percent of the entity's gross assets. This 20 percent test must be specified on the entity's year-end financial statements immediately preceding initial receipt of property.[22] But, if the entity doesn't designate a distribution as being in

partial liquidation and the distribution isn't greater than 20 percent of the entity's gross assets, then all of the distribution should be treated as income.

Based on this rule, in deciding how a QDOT should be administered, consider whether all assets held by the QDOT should instead be indirectly held by a business entity. To the extent that annual cash flow from the entity might be greater than the fiduciary accounting income on the underlying assets, more cash flow can be distributed from the QDOT estate tax free, thereby reducing the total federal estate tax.

Optimal QDOT Design

To design the optimal QDOT to maximize income distributions, consider that a trust can be designed as an income-only trust, a 5 percent unitrust or a trust that gives the trustee the power to adjust so as to recharacterize capital gains as income. Assume we have: (1) one QDOT asset that's expected to generate annual income distributions at 8 percent; and (2) another QDOT asset of equal value that's expected to appreciate at 8 percent per year but isn't expected to make any distributions or realize any capital gains. One QDOT holding both assets will produce an inferior result to two separate QDOTs holding each asset class.

Eight percent annual income. If one QDOT is structured as an income-only QDOT, the 8 percent annual income payments will be exempt from the QDOT's federal estate tax. At the end of the non-U.S. spouse's life, federal estate tax will be due on the balance in the QDOT. In this situation, an income-only trust is better than a 5 percent unitrust because a unitrust only allows 5 percent of the 8 percent to be paid out free of federal estate tax.

Eight percent growth, no income. If the other QDOT is structured as a 5 percent unitrust QDOT, 5 percent of the 8 percent of annual appreciation will be distributed as income, leaving 3 percent annual appreciation. In this situation, a 5 percent unitrust is better than an income-only QDOT because an income-only QDOT won't distribute any income, leaving more assets subject to federal estate tax. In addition, if capital gains can be recognized before termination of the QDOT, and such gains can be adjusted so as to be characterized as income, perhaps the additional 3 percent gain can be paid out (as in the 8 percent income scenario above) even though the QDOT, on its own, has no fiduciary accounting income.

Proper QDOT design requires analyzing the likely manner that income and gain will be earned over the life of the QDOT. Both the tax practitioner and the trust officers must work together to design the optimal QDOT(s) that will maximize income to minimize federal estate tax.

Endnotes

1. For taxpayers passing away in 2019, a taxable estate means an estate with assets in excess of $11.4 million for decedents who are U.S. citizens or domiciled in the United States. For those decedents who were non-U.S. citizens and who weren't domiciled in the United States, estates with assets in excess of $60,000 will be subject to U.S. federal estate tax.

2. *See* Internal Revenue Code Section 2056(b)(7).

3. *See* IRC Section 2056A(b)(1).

4. *See* IRC Section 2056A(b)(3)(A).

5. *See* Treasury Regulations Section 20.2056A-5(c)(2).

6. *See* IRC Section 643(b).

7. *Ibid*.

8. *See* Treas. Regs. Section 1.643(b)-1.

9. Section 1 of the Delaware Uniform Principal and Income Act (UPIA) adopts the Revised UPIA with some minor modifications.

10. *See* 12 Del. C. Section 61-106(e).

11. *See* 12 Del. C. Section 61-106.

12. *Ibid*.

13. Sharon L. Klein, "Power to Adjust and Total-Return Unitrust Regimes—What Every Trustee and Advisor Should Know About State Developments, Minimizing Tax and Investment Dilemmas, Reducing Litigation Exposure and More," 10 Lazard Wealth Management (2011), *www.americanbar.org/content/dam/aba/events/taxation/taxiq-11mid-112.pdf* .

14. *Ibid*.

15. Richard W. Nenno, "A Delaware Trust Law Primer," Wilmington Trust Company (Oct. 14, 2015), *www.npepc.org/resources /Documents /DE%20Trust%20Law%20Primer.pdf* .

16. *See* UPIA Section 104 cmt. (Uniform Law Commission 2008).

17. *See* UPIA Section 104.

18. *See* UPIA Section 105(a).

19. *Supra* note 16.

20. Christopher P. Cline, Portfolio 861-2nd T.M., "Trustee Investments."

21. *Ibid*.

22. *See* UPIA Section 401(d).

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