Estate Planning

Non-Citizen Spouses, QDOTs and Life Insurance

If a non-U.S. citizen is considered to be a resident alien, the result is that U.S. transfer taxes will be applied to all of their worldwide assets. Many non-citizens will do their best to arrange their affairs to avoid "resident" status, but family and business needs often prevent this from happening. If a person is a non-resident alien, U.S. estate taxes can be applied only to assets that are "located" in this country. Even if the decedent is an American, however, special rules concerning transfer taxes must be dealt with, if his or her spouse is a (resident or nonresident) alien. The use of a qualified domestic trust (QDOT) may help to defer transfer taxes but often that's not enough. What else can be done?

One Solution – Life Insurance

Many estate planning advisors often recommend that their clients purchase life insurance to provide a surviving non-citizen spouse with a source of funds that avoids the complications of a qualified domestic trust ("QDOT"). Survivorship life insurance that covers husband and wife, or single-life coverage on the life of the citizen spouse, is typically used.

Background

While the tax rules that apply to resident aliens are very similar to the rules that apply to U.S. citizens, there are important differences, and one of the most important differences is in the availability of the marital deduction for gift and estate tax purposes. Consider that a gift or bequest made *by* a resident or nonresident alien to his or her U.S. citizen spouse, outright, or in various types of permissible trusts, completely escapes any transfer tax concerns at that point because the law provides for an unlimited gift and estate tax marital deduction. What that means is that gifts or bequests *to* a U.S. citizen spouse are completely tax free. However, if a person, even a U.S. citizen, gifts or bequeaths assets to his or her spouse who is *not* a U.S. citizen, the unlimited marital deduction does not apply.

The difference in treatment arises out of a concern that the non-citizen spouse would return to his or her country of origin after the death of the citizen spouse, and take all of the couple's property with him or her. If an unlimited marital deduction were allowed on the same terms as apply to gifts or bequests to U.S. citizens, and the non-citizen spouse returns to his or her country, it would frustrate the ability of the IRS to recover any gift or estate taxes that might be due.

As a result, the QDOT rules were designed to increase the likelihood of the payment of U.S. gift and estate tax. Under these rules, the property passing to the non-U.S. citizen spouse does not qualify for the marital deduction unless one of the following applies: a) the property passing to the surviving spouse goes into a trust, called a Qualified Domestic Trust, or b) the surviving spouse becomes a U.S. citizen before the decedent's estate tax return due date. However, there are a number of events that can trigger *immediate* estate tax on assets held by a QDOT. These include any distribution of principal to the surviving spouse that does not qualify as a "hardship" distribution, as well as the surviving spouse's death.

For married couples who have accumulated significant wealth, ensuring that the decedent's estate qualifies for the marital deduction is one of the most important planning issues they face, and, as you can see, this could present significant challenges because of the complexity of the rules governing non-citizen spouses.

Life insurance is a solution to avoid these rules and complexities.

Insurance on the life of the citizen spouse can normally be owned by the non-citizen spouse or by a life insurance trust. If ownership is established in this manner at the policy's inception (or later, by transferring an existing policy to the non-citizen spouse, and the insured then living at least three years), the insurance proceeds will not be included in the citizen spouse's gross estate, and the surviving spouse can consume, gift or expatriate all of the proceeds without exposing any of this money to U.S. estate tax. Indeed, the insurance proceeds may even completely replace the assets that the decedent citizen spouse may have wished to leave to the non-citizen spouse. The insurance can also provide the liquidity needed to pay any estate taxes or settlement costs that might arise, and provide the surviving spouse with a supplemental source of income.

Life insurance can be an easy and simple solution. At the very least, it can help to alleviate some of the financial concerns and issues arising out of a marriage to a non-citizen.

Please consult with your Guardian Financial Representative if you have any questions concerning this document.

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