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White Paper

Qualified Domestic Trust (QDOT)

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Qualified Domestic Trust (QDOT)

What is it?

A qualified domestic trust (QDOT) allows a U.S. citizen spouse to transfer assets to a noncitizen spouse without having to pay federal gift and estate tax at the time of the transfer.

Generally, spouses are treated as one economic unit. They may transfer assets between themselves free from federal gift and estate tax under the unlimited marital deduction. This defers any federal tax liability on marital assets until the death of the surviving spouse, keeping the whole of those assets available to the surviving spouse for his or her own support or for any other purpose. At the surviving spouse's death, his or her estate (regardless of citizenship) is then entitled to an exemption, \$3.5 million in 2009, and excess amounts are subject to estate tax at rates as high as 45 percent (in 2009).

However, the unlimited marital deduction does not apply when a citizen spouse transfers assets to a noncitizen spouse. The reason for this is that the federal government is concerned that noncitizen spouses will leave the United States once assets are transferred to them, thereby removing the assets from the federal estate tax system forever. Without the unlimited marital deduction, surviving spouses who are not citizens can only receive, tax free, amounts that do not exceed the decedent spouse's available exemption. Assets over that amount are subject to estate tax, and may be substantially reduced by such tax, depleting the assets remaining available to the surviving spouse.

The QDOT was created by Congress as a substitute for the unlimited marital deduction. A QDOT temporarily qualifies property passing to a surviving noncitizen spouse for the marital deduction until the surviving spouse's death, and ensures that the property will eventually be taxed.

Tip: Another way to avoid paying federal gift and estate tax on transfers from a citizen spouse to a noncitizen spouse is to have the noncitizen spouse become a naturalized citizen of the United States. As long as the noncitizen spouse becomes a U.S. citizen before the citizen spouse's federal estate tax return is filed, and as long as the noncitizen spouse has been a resident of the United States at all times after the death of the citizen spouse and before becoming a U.S. citizen, transfers to the surviving spouse will qualify for the unlimited marital deduction.

Tip: A citizen spouse can transfer up to a certain amount each year (\$133,000 in 2009; \$128,000 in 2008) to a noncitizen spouse free from federal gift tax under a special exclusion. If the gifting program begins early enough, the citizen spouse can transfer a substantial amount of assets tax free to the noncitizen spouse. To qualify for this special exclusion, the gift to the noncitizen spouse must qualify under the rules for the standard annual gift tax exclusion. The gift must also meet the requirements for the unlimited marital deduction (as if the recipient spouse were a citizen). The noncitizen spouse may then use the assets for his or her own support or for any other purpose. Some estate planning attorneys recommend that the noncitizen spouse use such

gifts to purchase life insurance on the citizen spouse. By following this strategy, the noncitizen spouse can leverage the value of the special exclusion.

How does a QDOT work?

A QDOT can be created by will or a separate trust document prior to the death of the citizen spouse. At the citizen spouse's death, assets are transferred to the QDOT. Because the transfer qualifies for a marital deduction, no federal estate tax will be imposed on the transfer. The surviving noncitizen spouse can receive all the income from the trust for the remainder of his or her lifetime. However, with limited hardship exceptions, the surviving noncitizen spouse cannot receive distributions of principal from the trust without paying federal estate tax on the distributions.

Upon the death of the surviving spouse, the assets pass to the remainder beneficiaries named either in the trust document or by the surviving spouse under a power of appointment. The remaining assets in the QDOT on the surviving noncitizen spouse's death are subject to estate tax as if they were in the estate of the first spouse to die. That is, estate tax is calculated using the tax rates in effect at the time of death of the first decedent.

The QDOT may be set up as an estate trust in which no income is paid to the surviving noncitizen spouse. Therefore, closely held stock (non-dividend-paying) and other non-income-producing assets may be transferred to the QDOT and still qualify for the deferral of estate taxes. The QDOT may also be set up as a qualified terminable interest property (QTIP) trust, where the surviving spouse receives all the income from the trust for life, but the first spouse to die designates in the trust instrument where the assets in the trust will pass when the surviving spouse dies. The QDOT may also be set up as a life estate with a general power of appointment where the surviving spouse receives income for life and can designate where the assets pass upon his or her death. In either case, the surviving spouse must be given the right to the income from the trust for life (distributed at least annually) and the right to force the trustee to make any nonproductive assets income-producing.

Who can create a QDOT?

The citizen spouse, the personal representative of the deceased citizen spouse, or the surviving noncitizen spouse can create a QDOT. The QDOT must be created by the time the estate tax return for the deceased citizen spouse's estate is filed. Therefore, if the citizen spouse dies and has failed to set up a QDOT, either the citizen spouse's personal representative or the surviving noncitizen spouse can create a QDOT to hold assets transferred to the noncitizen spouse by the citizen spouse. In this manner, assets that have been left directly to the noncitizen spouse can be transferred to the QDOT and thereby made to qualify for the unlimited marital deduction. Furthermore, an existing trust can be reformed to meet all of the requirements of a QDOT, and a transfer to the reformed trust will qualify for the unlimited marital deduction.

What are the requirements for a QDOT?

The QDOT must be set up under either U.S. federal or state law

A QDOT must be administered under the laws of a state in the United States or under the laws of the District of Columbia. All records of the trust must be kept within a state or the District of Columbia.

One trustee must be either an individual who is a U.S. citizen or a domestic corporation

At least one of the trustees of the QDOT must be an individual who is a citizen of the United States or a domestic corporation. The type of domestic corporation that is typically named as a trustee is a bank or a trust company.

The QDOT must follow special rules

Special rules apply to both large and small QDOTs. If the QDOT has assets in excess of \$2 million, it is classified as a large QDOT. The trust instrument must then require either that at least one of the trustees be a bank or that the U.S. trustee (who can be an individual trustee) furnish a bond or letter of credit equal to 65 percent of the fair market value of the assets in the trust. A small QDOT (a trust with less than \$2 million in assets) must either have a bank as the trustee or require that no more than 35 percent of the trust assets be real property located outside the United States.

The U.S. trustee must be given the power to withhold estate tax, if any, from distributions made to the noncitizen spouse

The trust document must stipulate that the trustee has the power to withhold the federal estate tax, if any, from any distribution of principal that is made to the noncitizen spouse. The U.S. trustee must be able to withhold the tax without the approval of the other trustee.

The personal representative of the deceased citizen spouse's estate must make an irrevocable election on the estate tax return

To qualify for QDOT treatment, the personal representative of the deceased citizen spouse's estate must make an irrevocable election by checking the correct box on the federal estate tax return.

Tradeoffs

Assets in a QDOT must be subject to federal estate tax at the death of the noncitizen spouse

Technically, the value of the QDOT assets is not included in the estate of the surviving noncitizen spouse. However, the QDOT must be subject to tax when the surviving spouse dies--the tax is calculated as if the

assets were included and taxed in the deceased citizen spouse's estate (if any federal estate tax was imposed). Any appreciation in the value of the assets after the transfer to the trust is also taxed upon the noncitizen spouse's death, again as if it were included in the deceased citizen spouse's estate and not with reference to the assets of the noncitizen spouse. Although the surviving spouse can receive income from the trust, it is virtually impossible for that spouse to remove assets (i.e., principal) from the trust without paying federal estate tax. Because of the special way QDOTs are treated, the noncitizen spouse will not be able to reduce federal estate tax on assets left to him or her in a QDOT in this manner.

If a QDOT fails to meet any of the QDOT requirements, then federal estate tax may be imposed

If a QDOT fails to meet any of the QDOT requirements at any time after the death of the citizen spouse, estate tax may be imposed on the assets in the QDOT as of the date the trust failed the requirements (if estate tax was imposed in the year the decedent dies). Federal estate tax will be imposed as if the surviving spouse (the noncitizen) had died on the day the trust failed the requirements. However, the QDOT assets are taxed as if they were included in the deceased citizen spouse's estate for estate tax purposes.

The surviving spouse cannot take principal out of the QDOT without having to pay estate tax, if any are due

If the trustee distributes principal from the QDOT to the noncitizen spouse, the distribution may be subject to federal estate tax, if federal estate tax was imposed in the year the citizen spouse died. Federal estate tax is calculated as if the distribution of principal had been included in the estate of the first spouse to die. Estate tax will not be imposed if the distribution is made to the noncitizen spouse before his or her death under a hardship exception. Unfortunately, the IRS is very strict regarding what it considers to be a hardship distribution. The trustee of the QDOT should consult an experienced estate planning attorney before making any hardship distributions.

If a QDOT pays estate tax on a distribution of principal, then that payment is considered a taxable distribution

There is a double whammy if the QDOT makes a distribution of trust principal and pays estate tax out of trust assets. The payment of estate tax itself from the trust assets is considered a taxable distribution. A further tax will be due on the payment of the tax on the first distribution of trust assets. If the second payment of the tax was also made from trust assets, this would again be considered a taxable distribution subject to further tax, and so on. For this reason, QDOTs are generally set up with the understanding that the trust principal will almost never be paid out to the surviving noncitizen spouse, or if principal distributions are made to the surviving spouse, the taxes on such distributions will be paid out of the noncitizen spouse's personal assets.

The surviving spouse is liable for federal income tax on trust income

If the QDOT pays income to the surviving noncitizen spouse, that spouse is responsible for paying federal income tax, if any, on the income received by him or her.

The applicable exclusion amount is not available to the noncitizen spouse for QDOT taxable events

A person who is not a citizen of the United States may use the applicable exclusion amount (\$3.5 million in 2009) to shelter his or her own assets from federal estate tax. However, a noncitizen spouse cannot use the applicable exclusion amount to shelter any distributions of principal from a QDOT, because QDOT assets are never considered part of the noncitizen spouse's tax base but rather continue to be considered part of the deceased spouse's estate for estate tax purposes. Similarly, a noncitizen spouse cannot use the applicable exclusion amount to shelter assets in a QDOT from estate tax upon his or her death.

QDOTs are complicated to set up and administer

There are many complex rules and regulations that must be followed to make a QDOT work. An experienced and competent estate planning attorney should be hired to draft the trust document. Furthermore, there may be grave and costly consequences if the trust fails any of the QDOT requirements. For example, if at any time the trust fails to meet the QDOT requirements, federal estate tax may be imposed on the trust assets as if the surviving spouse had died on the date the trust failed the requirement (if estate tax was imposed in that year). This means there could be a substantial unplanned estate tax liability at a time when the surviving spouse is not able to pay the tax.

Questions & Answers

What happens if the noncitizen spouse becomes a naturalized citizen after the QDOT is established?

The QDOT will not be subject to the special estate tax rules once the noncitizen spouse becomes a naturalized citizen if one of the three following tests is met:

- The surviving spouse was a resident of the United States at all times after the decedent's death and before becoming a citizen, or no distributions were made from the QDOT before he or she became a citizen
- No taxable distributions were made from the QDOT before the surviving spouse became a U.S. citizen
- The surviving spouse elects to treat any taxable distributions made to him or her before he or she became a U.S. citizen as taxable gifts by him or her, and he or she elects to treat any reduction in the special estate taxes due to the predeceasing spouse's applicable exclusion amount as a reduction in his or her own applicable exclusion amount

Disclosures

This material does not constitute the rendering of investment, legal, tax or insurance advice or services. It is intended for informational use only and is not a substitute for investment, legal, tax, and insurance advice.

State, national and international laws vary, as do individual circumstances; so always consult a qualified investment advisor, attorney, CPA, or insurance agent on all investment, legal, tax, or insurance matters.

The effectiveness of any of the strategies described will depend on your individual situation and on a number of other factors. After reviewing your personal situation, we may recommend that you not use any strategy in this document but instead consider various other strategies available through our practice.

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