

**“Survivor”**

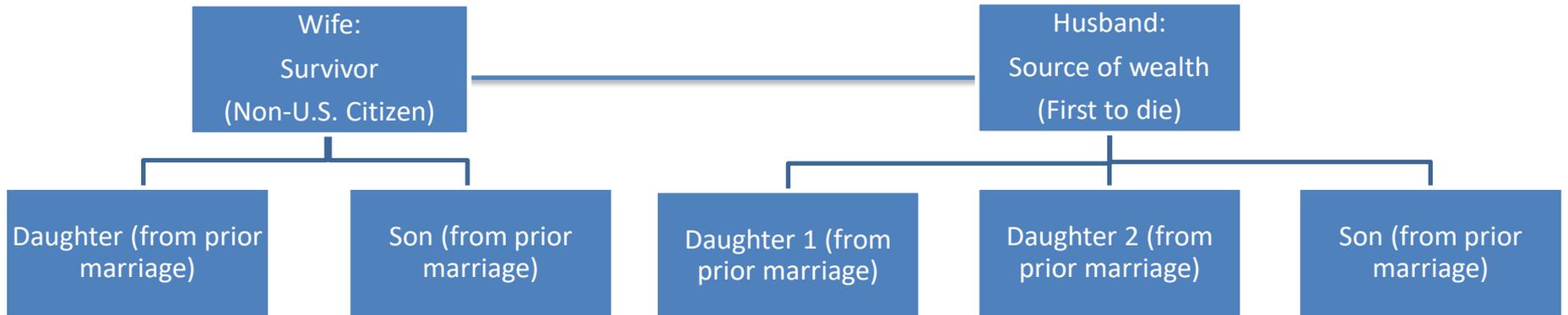
## **Drafting and Administering a QDOT**

Considerations from the drafting attorney and trust officer on how to handle complex assets and family dynamics when working with QDOTs

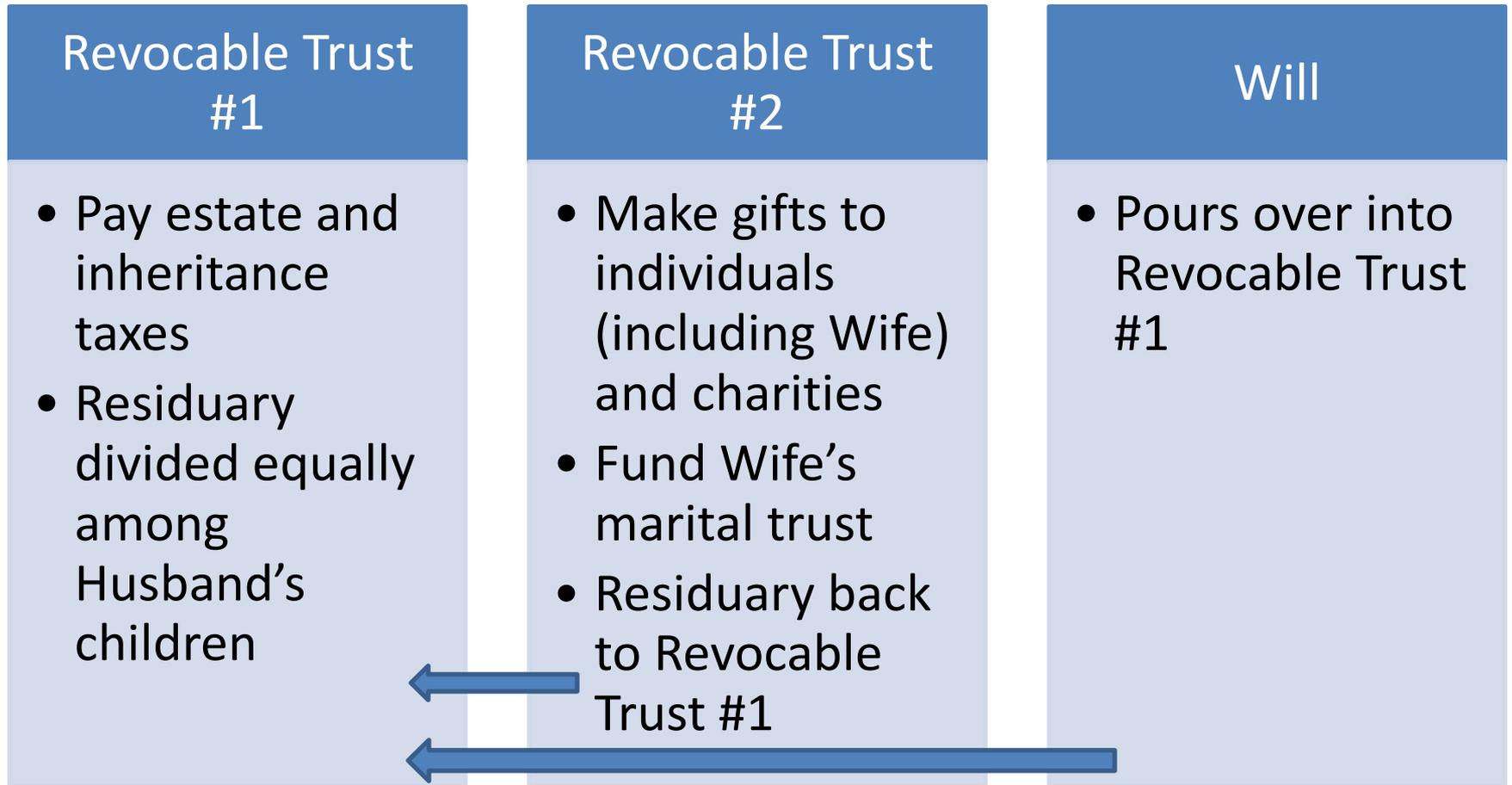
# Introductions

- **Glenn J. Morley** joined Brown Brothers Harriman Trust Company of Delaware, N.A. in 2012. As a trust officer he works closely with his colleagues to administer trusts and estates as part of broader estate plans for the firm's high net worth private banking clients. Prior to joining Brown Brothers Harriman, Glenn began his career and spent five years with J.P. Morgan's private banking business, working in the firm's offices in Newark, Delaware and Rochester, New York. Outside of the office, Glenn is an active member of the professional community including the Delaware Estate Planning Council, Delaware Bankers Association, and volunteers annually for Delaware Bankers' Teach Children to Save Day. Glenn received his Masters in Taxation and Certificate in Estate Planning from Villanova University, his M.B.A. with a concentration in finance from Rochester Institute of Technology, and earned his Bachelors degree from SUNY Geneseo. Glenn is originally from Skaneateles, New York, and currently lives in Middletown, Delaware with his wife and son.
- **Michael (Mike) J. Sorrow** focuses his practice on tax, estate planning, family business and trust and estate administration matters. Mike regularly advises wealthy individuals and families on all aspects of wealth and tax planning matters. In addition, Mike works extensively with families that control significant public and private businesses, counseling them and their family offices on matters relating to effective tax planning, succession and governance planning and the intra-family issues that arise in the management of a family business. Mike also has successfully represented taxpayers on tax controversy matters through audits, administrative appeals and litigation. Mike is a certified public accountant. Prior to going to law school, he worked as a senior tax accountant for a Big Four accounting firm. While in law school, he served as an extern for the Honorable Amy J. St. Eve of the US District Court for the Northern District of Illinois. He also worked for Northwestern's Small Business Opportunity Center, where he assisted small business entrepreneurs on a wide variety of legal and business issues confronting their start-up enterprises.

# Family Tree



# Husband's Estate Plan



# QDOT: Qualified Domestic Trust

- *What is a QDOT:* Marital trust benefitting a non-U.S. citizen surviving spouse that qualifies for the estate tax marital deduction.
- *Why use a QDOT:* Otherwise, assets passing to a non-U.S. citizen surviving spouse generally would not qualify for the estate tax marital deduction and would be taxable in the estate of first to die.

# QDOT Requirements

- Treasury Regulations § 20.2056A-2 sets out the requirements for a QDOT:
  - It must be an ordinary trust.
  - The trust must qualify for the federal estate tax marital deduction.
  - At least one trustee of the QDOT must either be an individual who is a U.S. citizen or a domestic corporation.
  - The trust instrument must expressly provide that the U.S. trustee has a right to withhold tax on any non-income distribution.
  - The trust instrument must provide it is administered under the laws of a U.S. state or the District of Columbia.
  - If QDOT funding is more than \$2 million, the trust instrument must provide for at least one of three additional requirements to ensure QDOT tax is collected.
  - The executor must make a QDOT election on the decedent's federal estate tax return.

# Income Distributions

- Trust accounting income fluctuates throughout the year, which can present a budgeting challenge.
- If there is a need for greater predictability of cash flows for budgeting purposes, and permitted under applicable state law, and not prohibited under the trust agreement, consider exercising the Power to Adjust.

# Income Distributions (continued)

- Exercising Power to Adjust cannot reduce the spouse's income interest.
  - Best practice is to review Power to Adjust percentages periodically to keep up with changing economic conditions (e.g. changing interest rates and the effect on trust accounting income.)
- In our fact pattern, marital QDOT remainder was the family's charitable foundation. Many state laws prohibit exercising Power to Adjust where there is "an amount permanently set aside for charitable purposes."
  - "amount permanently set side for charitable purposes" refers to CRAT/CRUT, and simply having a charitable remainder does not necessarily disqualify the trust from exercising Power to Adjust.

# Principal Distributions:

- Practical consideration: Non-marketable assets in QDOTs can present administrative challenges.
  - Marital QDOT held personal use non-marketable assets (held in LLCs).
  - Sale of non-marketable assets may not be a viable option in all situations, including:
    - Trustee may be directed on investment decisions
    - Asset may be illiquid and take years to sell
    - Family may have emotional attachment to asset
    - Creditor protection may be an important consideration for keeping assets inside an LLC

# Principal Distributions (continued)

- Using principal to cover an expense related to beneficiary usage may be deemed to be a principal distribution to Wife, resulting in QDOT tax.
- Using income to cover expenses would reduce the trust's accounting income available for distribution to Wife.
- Budget and plan ahead: What if expenses reduce or exceed trust's accounting income and there are no other sources of support?

# Self-Settled QDOT

- In our fact pattern, Husband's estate plan provided for outright gifts of cash and tangible property to Wife.
  - Absent a Self-Settled QDOT, assets that Wife received outright would have resulted in an estate tax payable by the estate's residue.
- Wife decided to create a Self-Settled QDOT and to transfer the assets that she otherwise would have received outright to the Self-Settled QDOT.
- Wife's Self-Settled QDOT includes flexibility to eliminate QDOT provisions if she becomes a U.S. citizen.

# IRS Compliance: 706-QDT

- *Purpose of 706-QDT:* Report to the IRS the following:
  - Principal distributions from a QDOT.
  - Principal portion of certain annuity payments.
  - The value of property remaining in the QDOT on the date of the surviving spouse's death.
  - Amount of QDOT tax due, if any.
- *Who must file:* Trustee or Designated Filer must file for any year the QDOT has a “Taxable Event” or makes a principal distribution on account of hardship.
  - *One QDOT:* Acting trustee files and pays tax, if any.
  - *Multiple QDOTs:* QDOTs may file separately or the executor may appoint a Designated Filer to file on a consolidated basis.

# IRS Compliance: 706-QDT (continued)

- “Taxable Event” is any of the following:
  - Any distribution from a QDOT before Wife’s death, except:
    - Income distributions
    - Distributions of principal on account of “hardship”
  - Wife’s death.
  - Failure of the trust to qualify as a QDOT.
- A principal distribution will satisfy the “hardship” exception if it is made in response to immediate and substantial financial need relating to Wife’s (or person Wife is obligated to support) health, maintenance, education or support.

# IRS Compliance: 706-QDT (continued)

- When to File:
  - Form 706-QDT is an annual return due by April 15 in the year after a Taxable Event or Hardship Distribution occurred.
  - If filing because of Wife's death, final 706-QDT is due within nine months following date of death.
  - Filing deadline may be extended by six months by filing Form 4768. Note extension of time to file does not extend the time to pay the tax.

# When Wife Becomes U.S. Citizen

- If Wife becomes a U.S. citizen prior to filing the estate tax return, QDOT is unnecessary (QDOT is elected on the estate tax return).

# When Wife Becomes a U.S. Citizen (continued)

- If Wife becomes a citizen after the estate tax return is filed:
  - If she has been a U.S. resident at all times since decedent's death, or no principal distributions have been made, then trustee notifies the IRS on a timely filed 706-QDT.
  - If she has not been a U.S. resident at all times after Husband's death and a QDOT tax was imposed on a principal distribution, then she must make two elections on the final 706-QDT:
    - Treat prior principal distributions as taxable gifts made by her; and
    - Treat any of decedent's unified credit previously used to reduce the 2056A tax as a reduction of Wife's unified credit.
- Thereafter, the QDOT is no longer subject to the 2056A tax.

Questions or Comments?