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Qualified Domestic Trust (QDOT)

If your spouse is not a U.S. citizen and your estate is large enough to pay estate taxes when you die, you may need some additional planning.

Your estate will have to pay federal estate taxes when you die if the net value (assets minus debts) is more than the exempt amount at that time. In 2016, the federal estate tax exemption is $5.45 million; every dollar over the exempt amount is taxed at 40%. The exemption adjusts annually for inflation. State estate/inheritance taxes vary, but because they may apply at a lower threshold, your estate could be exempt from federal tax and still have to pay a state tax.

If your spouse is a U.S. citizen, you can leave him or her an unlimited amount of assets with no estate taxes when you die by using the unlimited marital deduction. Uncle Sam lets you do this because he plans to collect the taxes when your surviving spouse dies.

But if your spouse is not a U.S. citizen, he or she could possibly take the assets after you die and leave the country with them...and that would leave Uncle Sam empty handed. He simply does not want noncitizen spouses to inherit sizeable estates and then return to their homelands without paying any estate taxes. Noncitizen spouses do not get the benefit of the unlimited marital deduction.

The result is that, if your spouse is not a U.S. citizen and you do not plan ahead, everything in your estate over the amount of the estate tax exemption when you die will be subject to estate taxes. A qualified domestic trust (QDOT or QDT) can prevent this from happening.

The assets that are transferred to this trust are not taxed when you die, so the entire estate is available to provide for your surviving spouse. The trust (not your spouse) owns the assets, but your spouse can receive income from the trust and, with the trustee's approval, may also receive principal.

The income your spouse receives from the QDOT is taxed as ordinary income in the year it is received. But any principal your spouse receives (unless the distribution is due to "hardship" as defined by the IRS), plus assets remaining in the QDOT when your spouse dies, will be taxed as if they were part of your estate when you died (at your highest estate tax rate).

Without a QDOT, these estate taxes would have to be paid when you die. But with a QDOT, the taxes are delayed until your surviving spouse dies, which means more assets are available to provide for your spouse.

To make sure estate taxes are paid when your spouse dies, at least one trustee of the QDOT must be a U.S. citizen or U.S. corporation. (Sometimes a surviving spouse wants to return to his/her homeland and finds it would be easier to have the trust administered there, but their country does not authorize trusts or allow trusts to have U.S. trustees. In these instances, Congress may allow the requirement for a U.S. trustee to be waived and a similar legal arrangement to be used instead of a trust.)